

立法會
Legislative Council

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Panel on Financial Affairs

Minutes of meeting
held on Thursday, 4 May 2006 at 8:30 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
Ir Dr Hon Raymond HO Chung-tai, S.B.St.J., JP
Hon LEE Cheuk-yan
Hon James TO Kun-sun
Hon CHAN Kam-lam, SBS, 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 Albert Jinghan CHENG
Hon TAM Heung-man
- Members absent** : Dr Hon David LI Kwok-po, GBS, JP
Hon CHIM Pui-chung

Public officers attending : **Agenda Items IV to VI**

Mr Joseph YAM, GBS, JP
Chief Executive of the Hong Kong Monetary Authority

Agenda Item IV

Hong Kong Monetary Authority

Mr William RYBACK, JP
Deputy Chief Executive (Banking)

Mr Y K CHOI, JP
Deputy Chief Executive (Monetary)

Ms Julia LEUNG, JP
Acting Deputy Chief Executive (Development)

Agenda Item V

Hong Kong Monetary Authority

Mr Francis CHU
Executive Director (Reserves Management)

Mr Christopher MUNN
Executive Director (Corporate Services)

Agenda Item VI

Miss Alice CHEUNG
Principal Assistant Secretary for Financial Services and the
Treasury (Financial Services)²

Mr Christopher MUNN
Executive Director (Corporate Services)
Hong Kong Monetary Authority

Agenda Item VII

Mrs Millie NG
Principal Assistant Secretary for Financial Services and the
Treasury (Financial Services)

Hong Kong Monetary Authority

Mr William RYBACK, JP
Deputy Chief Executive (Banking)

Mr Simon TOPPING, JP
Executive Director (Banking Policy)

**Attendance by
invitation**

: Agenda Items V and VI

Dr Hon Marvin CHEUNG, SBS, JP
Chairman
The Exchange Fund Advisory Committee Governance
Sub-Committee

Mr Christopher CHENG, GBS, JP
Member
The Exchange Fund Advisory Committee Governance
Sub-Committee

Agenda Item VI

Mr Martin WHEATLEY
Chairman
Securities and Futures Commission

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

Staff in attendance : Ms Pauline NG
Assistant Secretary General 1

Mr KAU Kin-wah
Assistant Legal Adviser 6

Ms Rosalind MA
Senior Council Secretary (1)8

Mr Justin TAM
Council Secretary (1)3

Ms May LEUNG
Legislative Assistant (1)8

Action

I. Confirmation of minutes of meeting

(LC Paper No. CB(1)1337/05-06 — Minutes of meeting on 6 March 2006)

The minutes of the meeting held on 6 March 2006 were confirmed.

II. Information paper issued since the last meeting

2. Members noted that an information paper on “Fifth progress report on the operation of the Loan Guarantee Scheme for Severe Acute Respiratory Syndrome Impacted Industries” (LC Paper No. CB(1)1400/05-06(01)) had been issued since the last regular meeting held on 3 April 2006.

III. Date of next meeting and items for discussion

(LC Paper No. CB(1)1338/05-06(01) — List of outstanding items for discussion

LC Paper No. CB(1)1338/05-06(02) — List of follow-up actions)

3. The Chairman informed members that the Administration had proposed the following item for discussion at the next regular meeting of the Panel to be held on Monday, 5 June 2006:

“Briefing by the Financial Secretary on Hong Kong’s latest overall economic situation”

4. The Chairman pointed out that in accordance with the established practice, the Financial Secretary (FS) would brief the Panel and all other Members of the Legislative Council (LegCo) on macro economic issues at the Panel meetings to be held in June and December each year. Members agreed that the above item be placed on the agenda for the meeting to be held on 5 June 2006 from 10:45 am to 12:45 pm.

IV. Briefing on the work of the Hong Kong Monetary Authority and its 2005 Annual Report

(LC Paper No. CB(1)1338/05-06(03) — Letter dated 21 April 2006 from the Chief Executive of the Hong Kong Monetary Authority (HKMA) to the Chairman of the Panel

LC Paper No. CB(1)1338/05-06(04) — Hong Kong Monetary Authority — Annual Report 2005

LC Paper No. CB(1)1338/05-06(05) — Paper provided by HKMA

LC Paper No. CB(1)1372/05-06(01) — Letter dated 24 April 2006 from Hon SIN Chung-kai

LC Paper No. CB(1)1372/05-06(02) — Reply dated 2 May 2006 from HKMA)

Briefing by the Hong Kong Monetary Authority

5. At the invitation of the Chairman, the Chief Executive of the Hong Kong Monetary Authority (CE/HKMA) gave a power-point presentation on HKMA Annual Report 2005 (Annual Report 2005) and the updates on its key areas of work. On the Annual Report 2005, CE/HKMA highlighted the following points:

- (a) On monetary stability, the three refinements to the Linked Exchange Rate (LER) system introduced in May 2005 had effectively reduced the likelihood of easy monetary conditions leading to inflation and asset bubbles and pre-empted the potential impact of renminbi (RMB) exchange rate reform on Hong Kong's monetary system in July 2005. The exchange rate of Hong Kong dollar remained stable within the Convertibility Zone of 7.75 to 7.85.
- (b) The highly competitive environment continued to benefit depositors and borrowers. Despite compressed interest margins, the banking sector managed to achieve decent profit growth. Good progress had been made in preparation for the implementation of Basel II, prevention of money laundering and terrorist financing, as well as the preparatory work for the Deposit Protection Scheme (DPS). Lenders and consumers had also

benefited from the sharing of positive consumer credit data through the Commercial Credit Reference Agency.

- (c) A comprehensive review of financial infrastructure had been completed in 2005. Hong Kong now had an advanced multi-currency, real time gross settlement system which facilitated delivery versus payment and payment versus payment in the region. HKMA would continue to promote cross-border use of Hong Kong's financial infrastructure.
 - (d) The status of Hong Kong as an international financial centre had been reinforced with the expansion in RMB business and listing of the Asian Bond Fund (ABF) Pan Asia Bond Index Fund and ABF Hong Kong Bond Index Fund in Hong Kong.
 - (e) As regards reserves management, the Exchange Fund (EF) achieved an investment return of \$38.2 billion or 3.1% in 2005. The rate of investment return exceeded that of the benchmark portfolio by 24 basis points. The Treasury's share amounted to \$10 billion, compared with the budget estimate of \$14 billion which was made only on the basis of historical average rate of return. Further response to recent comments on the rate of investment return in 2005 would be given in the following briefing on the work of HKMA.
6. CE/HKMA also updated the Panel on HKMA's key areas of work, as follows:
- (a) On currency stability, the Hong Kong dollar exchange rate remained stable within the Convertibility Zone. Since June 2005, the Convertibility Undertakings had not been triggered, and HKMA had not conducted any monetary operations within the Convertibility Zone. The Aggregate Balance remained stable at around HK\$1.3 billion. The discount in the 12-month forward exchange rate widened markedly in recent months and was currently at around 400 pips, indicating willingness on the part of market participants to buy Hong Kong dollars against US dollars in one year's time at around 7.72.
 - (b) On the external factors affecting currency stability, the level of oil prices remained a key factor. Further increase in oil prices might have a more significant impact on global growth. Other external factors included US current account deficit, US interest rate and RMB exchange rate. The US federal funds target rate (FFTR) raised to 4.75% in March 2006. When the rate hike in the US would come to an end remained uncertain. While interest rates might be about to reach a plateau, it did not necessarily look like a peak was forming yet. As the outlook of US interest rate was unclear, there might be considerable fluctuations in the US dollar exchange rate in the coming months, thereby affecting the exchange rate of the Hong Kong dollar. The RMB exchange rate would

continue to be a major factor affecting sentiment on the Hong Kong dollar. Further significant appreciation of RMB might put upward pressure on the Hong Kong dollar, leading to lower Hong Kong dollar interest rates relative to the US rates. Renewed capital inflows into Hong Kong could raise inflation risks. Questions had been raised on the merits of maintaining the LER system. However, given the present exchange rate regime of RMB, it was technically not feasible for the Hong Kong dollar to be linked to RMB.

- (c) The exchange rate of Hong Kong dollar was also supported by Hong Kong's robust economic growth. On a seasonally adjusted quarter-on-quarter basis, Gross Domestic Product (GDP) grew by 0.6% in the fourth quarter of 2005, following an increase of 2.3% in the third quarter. While the Composite Consumer Price Index edged up steadily in recent months, the risk of a sharp increase in inflation remained low. The current account surplus continued to register a notable surplus of around 12.5% of GDP in the fourth quarter of 2005. By February 2006, residential property prices had increased on average by 53% from the trough in the summer of 2003.
- (d) On banking sector performance, the banking sector remained well-capitalized. Cost-to-income ratio decreased from 41.9% in 2005 to 39.8% in the first quarter of 2006. Net interest margin of retail banks edged up slightly to 1.69% in the first quarter of 2006 from the full year average of 1.68% in 2005, but remained low by historical standards. The low net interest margin reflected increased funding cost and the narrowed loan spread in a highly competitive environment. Total domestic lending declined by 0.8% in the first quarter of 2006 after an increase of 3.9% in the fourth quarter of 2005. Despite the improvement in loan performance indicators, there were early signals of deterioration in loan quality. After recording net provision write-backs in 2004 and in most of 2005, banks had recently begun to make new provisions in the fourth quarter of 2005. Residential mortgages based on the Composite Interest Rate (CIR) had started to appear in the market, demonstrating gradual acceptance of retail banks of CIR as an effective reference of costs of funds. After rising for two consecutive quarters, the number of residential mortgage loans in negative equity decreased from 11 000 cases to around 9 200 cases from December 2005 to March 2006, with an aggregate value of HK\$16 billion.
- (e) On the progress of the implementation of Basel II in Hong Kong, briefing on the development of the Capital Rules and Disclosure Rules would be given later at the meeting. As regards prevention of money laundering, a summary report on the self-assessment exercise had been issued to the banking sector in March 2006. On the other hand, preparation for the launch of DPS was in good progress.

- (f) On market infrastructure, HKMA was making good progress on the projects and initiatives arising from the Review of Financial Infrastructure Development conducted in 2005. These included: the RMB Settlement System, a multi-function, multi-currency settlement system and migration to SWIFTNet. HKMA would continue to foster links with other systems in the region. HKMA exercised on-going over-sight on the four local designated clearing and settlement systems. All systems were in compliance with safety and efficiency requirements under the Clearing and Settlement Systems Ordinance.
- (g) A 5-pronged strategy would be adopted for maintaining the position of Hong Kong as an international financial centre: to enhance access of Hong Kong's financial institutions to the Mainland; to enhance the mobility of fund raisers, investors and investment funds from the Mainland to Hong Kong; to enhance the mobility of financial instruments to the Mainland from Hong Kong; to enhance the capability of Hong Kong's financial system to handle transactions denominated in RMB; and to strengthen financial-infrastructure links between the Mainland and Hong Kong.

7. CE/HKMA also took the opportunity to clarify some misconceptions about the investment performance of EF. He pointed out that under Article 113 of the Basic Law and the Exchange Fund Ordinance (Cap. 66), the statutory objectives of EF were primarily for safeguarding the exchange value of the currency of Hong Kong and maintaining the stability and integrity of the monetary and financial systems of Hong Kong. EF was therefore different from ordinary investment funds. The investment objectives included preservation of capital, providing liquidity to maintain monetary and financial stability, full backing for the Hong Kong-dollar Monetary Base and preservation of the long-term purchasing power of the assets. The investment return of EF should be measured against the investment benchmark determined by the Exchange Fund Advisory Committee (EFAC). Under the current benchmark, 77% of the fund was allocated to bonds and 23% to equities. In terms of currency mix, 88% was allocated to US dollar and the remaining 12% to other currencies. Referring to the table on evaluation of investment performance of EF in the past seven years from 1999 to 2005 (page 54 of the power-point presentation material), CE/HKMA pointed out that the average return was 5.7%, which had exceeded the benchmark return by 1.2% (or HK\$11.9 billion in monetary terms). In fact, the actual investment return exceeded the benchmark return in the last seven years except for 2004. In the recent public discussion on this subject, CE/HKMA said that there were a few misconceptions about the investment performance of EF, as follows:

- (a) Comparison with the US Treasury bond yield
The comparison of the actual return of EF of 3.1% with the US Treasury bond yield of 4.5% in 2005 was not appropriate as the latter had not reflected the changes in market prices of US Treasury bonds over the

years. Investment return of a portfolio comprising one to ten-year US Treasury bonds in 2005 calculated in market prices was only 1.6% and that of ten-year was 2.9%.

(b) Comparison with Hong Kong dollar fixed deposit rates

While the Hong Kong dollar fixed deposit rate for large deposits was currently about 4%, the average rates in 2005 were only 1.47% and 1.6% for one-month and three-month fixed deposits respectively. Hong Kong dollar deposit rates were close to 0% before introduction of the three refinements in May 2005. Moreover, investment of EF in fixed deposits might pose unacceptable credit risks to EF.

(c) Comparison with the return on other investment funds in 2005

As mentioned earlier, EF was unlike ordinary investment funds. EF had never suffered a loss while this was often the case with other funds. The investment strategy of EF needed to be more conservative given its statutory objectives.

(d) Comparison with the estimated return in the budget

The estimate in the budget was just a projection based on previous performance and should not be used for evaluating EF's investment return. HKMA adopted an open mind on other options for enhancing the accuracy of the estimated return, e.g. charging an annual fixed fee on the EF or using an average of the actual returns over a number of years.

(e) Pay for HKMA staff should be linked with investment performance of EF

This arrangement would have overlooked the fact that the number of employees engaged in investment management of EF only accounted for less than 10% of HKMA staff.

8. CE/HKMA pointed out that the merits of more aggressive benchmark portfolio for EF had to be examined having regard to the cost involved (such as higher risks and lower liquidity). The prerequisite was that there were adequate reserves to meet the statutory objectives of EF. The community had to reach a consensus on this key issue before any changes should be made. CE/HKMA further reported on the performance of EF in the first quarter of 2006. Year-to-date investment income at the end of March 2006 registered a gain of HK\$18.2 billion. The Treasury's share of the EF investment income was HK\$5.3 billion. While this was a decent return, CE/HKMA warned against over-optimism because of the volatility of the markets.

(Post-meeting note: The updated English and Chinese versions of the power-point presentation material were issued to members and non-Panel Members vide LC Paper Nos. CB(1)1432/05-06 and CB(1)1464/05-06 on 8 and 10 May 2006 respectively.)

Discussion

Investment performance of EF

9. Noting that the actual return of EF exceeded the benchmark return by 5.3% and 0.2% in 1999 and 2005 respectively, Miss TAM Heung-man enquired about the reasons for the significant difference and measures to be taken to improve the management of EF for achieving better investment return. In reply, CE/HKMA advised that the favourable investment performance in 1999 was largely attributed to the investment return from the acquisition of Hong Kong equities during the intervention in the stock market in 1998. Nevertheless, the decision was made under dire circumstances which involved considerable risks and attracted diverse comments from the community. CE/HKMA further pointed out that the investment performance of EF with no record of losses since 1997 was not easy to achieve if a comparison was made with the investment return of other capital preservation funds.

10. Given that the investment benchmark for EF had been determined by EFAC and that external fund managers had been appointed at a high cost to assist in the management of EF, Ms Emily LAU queried whether the investment staff of HKMA, in particular CE/HKMA as the head, would have much value-added in the management of the fund. In this connection, Ms LAU requested CE/HKMA to address the concern of the community over the substantial increase in his annual remuneration package in 2005 despite the low investment return of EF of 3.1%.

11. In reply, CE/HKMA referred members to the table showing the evaluation of investment performance of EF (page 54 of the power-point presentation material) (LC Paper No. CB(1)1338/05-06(05)). He explained that the actual return achieved in the past years in excess of the benchmark return was the result of efforts made by HKMA investment staff in the day-to-day investment decisions for EF having regard to detailed analyses of different economies and assessments of market development. CE/HKMA pointed out that if HKMA staff simply adhered strictly to the benchmark portfolios in making investment decisions, the actual return would not have outperformed that of the benchmark in the past years. CE/HKMA appreciated that the community at large might have misconceptions about the investment return of EF and he was prepared to clarify these misconceptions to the public, such as through meetings of the Panel on Financial Affairs (FA Panel). He pointed out that he had explained the concept of investment benchmark for the assessment of EF investment performance in the past nineteen meetings with the Panel. He further pointed out that the \$2.1 billion return in excess of the benchmark in 2005 was a considerable sum which represented three times the annual operating expenditure of HKMA.

12. Noting CE/HKMA's explanation that the investment performance of EF should be made with reference to the benchmark return, Mr CHAN Kam-lam and Mr Jeffrey LAM were concerned whether the current benchmark was on the conservative side. They suggested HKMA to review the benchmark portfolio with a view to allowing more flexibility in undertaking more aggressive investment

activities without undermining the primary objective of safeguarding the exchange value of the currency of Hong Kong. Miss TAM Heung-man also expressed support for a more aggressive investment strategy for EF. In this connection, she enquired whether HKMA had any plan to seek consensus of the community on the subject, such as through discussions with professionals and LegCo Members. Pointing out that the foreign reserves of Hong Kong had reached a very high level, Mr LAM sought CE/HKMA's view on the "adequate" level of foreign reserves for meeting the statutory objectives of EF so that the amount in excess could be allocated for higher return investments.

13. CE/HKMA reiterated that before considering any adjustment to the benchmark portfolio, the community had to reach a consensus on how many foreign reserves were adequate for meeting the statutory objectives of EF. He pointed out that while theoretically the level of 100% foreign reserves against the monetary base should be adequate under the Currency Board System, this was not the case during the market intervention in 1998 in which EF had to be used to acquire equities for the maintenance of monetary stability. HKMA had undertaken studies and analyses for internal references in this regard, but there could be market sensitivity for disclosure of the relevant findings. While remaining open-minded on what was the "adequate" amount of foreign reserves, CE/HKMA pointed out that this was a complicated subject which required detailed discussions before a consensus could be reached. The final decision would vest in FS as the Controller of EF under the law. He advised that a more aggressive investment strategy would inevitably involve higher risks and the community should be alerted to the risks involved.

14. On HKMA's claim that EF was unlike ordinary investment funds, Mr James TO queried whether EF was so unique that no other investment funds were comparable to it. In this connection, Mr TO noted that the Norwegian Government Pension Fund (NGP Fund) was quoted in the paper provided by HKMA as a comparable fund for EF (Chart 13 of LC Paper No. CB(1)1432/05-06(03)). He doubted whether the average of 1.2% in excess of the benchmark return achieved by EF was comparable to the average return of other investment funds, such as NGP Fund.

15. In response, CE/HKMA said that many central banks or monetary authorities did not publish performance data or asset allocation and HKMA's practice was more transparent in this respect compared with its overseas counterparts. He pointed out that given the requirement for high liquidity resulting from the uniqueness of Hong Kong's monetary system (i.e. the Currency Board System), it might not be appropriate to make direct comparisons between EF and other investment funds. The NGP Fund was used as a reference for comparing the management costs, instead of investment return, with EF. The Deputy Chief Executive (Monetary) of HKMA added that the asset allocation benchmark of the NGP Fund comprised 60% fixed income and 40% equities. Given the difference in asset allocation between the NGP Fund and EF, it would not be appropriate to make a direct comparison between their investment returns. He also pointed out that the compounded annual investment

returns of the NGP Fund and EF in the years 1997 to 2005 were 6.34% and 6.45% respectively. As the NGP Fund had a higher weighting towards equities than EF, the former had recorded negative return of -2.47% in 2001 and -4.74% in 2002 while the returns of EF in 1997 to 2005 were all positive figures. Mr James TO requested HKMA to provide, as far as practicable, further information on the size, portfolio, return and relevant parameters of the NGP Fund and any other investment funds which were broadly comparable to EF.

(Post-meeting note: The information provided by HKMA was issued to members and all non-Panel Members vide LC Paper No. CB(1)1621/05-06(01) on 29 May 2006.)

Treasury's share of EF investment income

16. Mr CHAN Kam-lam said that consideration should be given to changing the arrangement of sharing of investment income with the Treasury, e.g. by using an average of the actual returns over the last five years.

17. Miss TAM Heung-man also expressed concern about the sharing arrangement. She supported the option of charging an annual fixed fee on EF as the Treasury's share of return.

18. Mr SIN Chung-kai asked whether HKMA had explored with the Administration the alternatives for sharing the investment income with the Treasury in order to ensure more stable investment income for the General Revenue. He also asked whether a mechanism could be devised so that the Treasury could derive a greater investment income from EF when the fiscal income was low and vice versa.

19. CE/HKMA responded that while he had no objection to exploring alternatives for sharing EF's investment income with the Treasury, he had no strong view about the existing arrangement which had been working effectively. While the existing arrangement might generate different levels of income for the Treasury because of volatilities in different years, the previous arrangement before 1998-99 which was based on a fixed rate of interest could ensure a more stable income for the Treasury. Nevertheless, there were pros and cons in the existing and previous arrangements and it would be unrealistic to aim to get the best of both worlds, i.e. more stability and higher return at the same time. CE/HKMA opined that charging an annual fixed fee on EF might be a feasible option as it could relieve the pressure for achieving the estimated return, hence reducing the reputation risk of HKMA where the estimated return could not be achieved. He stressed that in working out the annual fee to be charged on EF, the principles of objectivity and reasonableness should be observed. In response to Mr SIN Chung-kai's further enquiry on how to initiate any change to the existing arrangement, CE/HKMA said that the decision on any change would ultimately vest with FS as the Controller of EF. He had discussed the merits of different options with FS. If the public had any view on this matter, they could also raise it with FS.

Cost for management of EF

20. On the management of EF, Mr CHAN Kam-lam suggested that HKMA should explore the possibility of reactivating the Exchange Fund Investment Limited (EFI Ltd) to manage the Hong Kong equity portfolio of EF. This might help reduce the cost for engaging external fund managers.

21. In response, CE/HKMA said that one of the reasons for appointing external managers to manage the assets of EF was to avoid conflict of interest and market sensitivity arising from HKMA's roles as regulator and as manager of EF's assets. While consideration could be given to using EFI Ltd to manage the assets of EF, CE/HKMA pointed out that the costs involved in appointing external managers would be covered in the paper prepared for the next discussion item of this meeting and the subject could be discussed in further detail if members so wished.

22. Mr Ronny TONG was of the view that the additional information on the cost of management of EF provided by HKMA could clarify misconceptions and facilitate the public in understanding the operation of HKMA. He pointed out that it was the responsibility of LegCo Members to monitor the expenditure of HKMA while observing the guiding principle that the operation of HKMA in the performance of its primary functions would not be undermined. To facilitate the monitoring of HKMA's expenditure by LegCo, Mr TONG requested HKMA to enhance its transparency in this regard, in particular the disclosure of information on its annual budget.

23. CE/HKMA pointed out that all along, HKMA was devoted to enhancing its transparency without undermining its independence and effective performance. In fact, the current degree of operational transparency of HKMA was high compared with similar institutions in other jurisdictions. He advised that the Governance Subcommittee (GSC) of EFAC would keep this matter under constant review.

24. Mr SIN Chung-kai clarified that the misconception about linking the pay for HKMA staff with investment performance of EF mentioned by CE/HKMA in his briefing was not related to the issues of concern raised in his letter dated 24 April 2006 (LC Paper No. CB(1)1372/05-06(01)). Mr SIN pointed out that his major concern was the need for HKMA to enhance the transparency of its operation and expenditure to facilitate public monitoring of its work rather than seeking to introduce any fundamental changes to the current system. Referring to the operating expenses of HKMA in page 126 of its Annual Report 2005, Mr SIN was concerned about the substantial increase in investment management and custodian fees from \$543 million in 2004 to \$731 million in 2005.

25. In reply, CE/HKMA explained that the difference in the investment management and custodian fees was mainly attributed to the inclusion of \$130 million trading expenses in the figure of 2005 under the new accounting standard. He

also advised that further details on the management cost for investment of EF would be provided in the briefing by HKMA under Agenda Item V of this meeting.

Business opportunities in the Mainland

26. Mr Jeffery LAM pointed out that there were ample business opportunities for the banking sector available under the new Qualified Domestic Institutional Investors (QDII) policy. Mr LAM referred to the comment made by the Chief Executive (CE) of the Hong Kong Special Administrative Region (HKSAR) Government that local bankers should actively explore the feasibility of business development in the Mainland through direct communication with the relevant Mainland authorities. In this connection, Mr LAM enquired whether and how HKMA could assist the local banking industry in liaising with relevant Mainland authorities such as the People's Bank of China (PBoC) to make best use of the business opportunities.

27. In reply, CE/HKMA said that HKMA and HKSAR Government had been devoting efforts to facilitate financial markets development in the Mainland and the introduction of QDII was one of the achievements made. HKMA would continue its work in communicating with the relevant authorities including PBoC, the China Banking Regulatory Commission and the State Administration of Foreign Exchange on the implementation details of QDII with a view to facilitating the local financial institutions to go into the Mainland. He advised that the banking sector could make good use of Hong Kong's advance financial system in developing their business under QDII, and HKMA would be willing to offer assistance where appropriate to facilitate the communication between the banking sector and the Mainland authorities.

28. Ms Emily LAU also expressed concern about the comment made by the CE that local bankers had not made good use of the opportunity to communicate with the relevant Mainland authorities, in particular PBoC. Ms LAU was concerned whether it was feasible for local bankers to approach the officers of PBoC direct. CE/HKMA confirmed that it was feasible for local bankers to do so. Nevertheless, HKMA as the regulator of the banking industry would spare no efforts in facilitating financial institutions to go into the Mainland to provide services, and would keep the banking sector abreast of the latest development in the Mainland. For example, HKMA had co-organized with the Treasury Market Association a seminar on 3 May 2006 to promote market practitioners' understanding of the rules relating to QDII.

29. Mr Jeffrey LAM further enquired whether the Mainland's economic policy for control of its over-heated economy would have adverse impact on the economic development of Hong Kong. In reply, CE/HKMA said that the Mainland's measures would only have short-term impact on Hong Kong's economy. Moreover, the measures were not as wide-sweeping as those adopted in 2004.

Interception of Communications and Surveillance Bill

30. Mr James TO said that under the Interception of Communications and Surveillance Bill being scrutinized by a bills committee formed by LegCo, it was proposed that one of the permissible grounds for interception was public security consideration which included factors undermining financial stability. He sought CE/HKMA's view on whether there was a justifiable case of interception based on financial stability consideration.

31. CE/HKMA commented that he could not give a straightforward answer to this question. He however pointed out that financial stability was very important to Hong Kong and the task of maintaining financial stability in a small but open market like Hong Kong was not easy. As such, the HKSAR Government should try its best to maintain financial stability, which was also the onus placed on it under Article 109 of the Basic Law, i.e. maintenance of the status of Hong Kong as an international financial centre. While HKMA would welcome the provision of information to facilitate its work in maintaining financial stability, it would be up to individual LegCo Members to make their judgment as to whether the means of accessing to such information was appropriate.

V. Members' proposal for the Administration to brief the Panel on the annual budget of the Hong Kong Monetary Authority

(LC Paper No. CB(1)1338/05-06(06) — Paper provided by HKMA

LC Paper No. CB(1)1338/05-06(07) — Background brief prepared by the Legislative Council Secretariat

LC Paper No. CB(1)1372/05-06(03) — Reply dated 25 April 2006 from the Administrative Assistant to Financial Secretary

LC Paper No. CB(1)1372/05-06(04) — Reply dated 25 April 2006 from the Chairman of the Governance Sub-Committee)

Briefing by the Chairman of the GSC

32. At the invitation of the Chairman, Dr Marvin CHEUNG, Chairman of the GSC, briefed members on the work of the GSC. He advised that the GSC consisted entirely of non-official members of EFAC who did not come from the banking sector. Its role was to monitor the performance of HKMA and make recommendations to FS, through EFAC, on remuneration and human resources policies, and on budgetary, administrative and governance issues. Dr CHEUNG highlighted the following points:

- (a) The GSC kept the disclosure arrangements for HKMA's administrative budget under regular review, taking into account the best practices of

listed companies and other financial regulators in Hong Kong, and central banks overseas. Improvement measures recommended by the GSC in recent years included the disclosure of information on HKMA's administrative budget for the current financial year in its annual report starting from the 2004 Annual Report.

- (b) It was an internationally accepted principle that central banks should have both operational and resource independence. Resource independence mattered because a budgetary approval process could become a tool for political influence over the operations of the central bank, which could affect its primary functions – including, in Hong Kong's case, ensuring the exchange rate stability of the Hong Kong dollar and the regulation of the banking system. It was essential that independence was balanced by accountability, both through legal provisions and through transparency in the institution's operations.
- (c) The effectiveness of HKMA in carrying out its primary policy objectives was not in doubt. On the use of resources, HKMA (with around 600 staff) was a compact organization by international standards. According to a research by the Bank for International Settlements, a central banking institution like HKMA would be expected to have more than 700 staff.

(Post-meeting note: Dr Marvin CHEUNG's speaking notes were issued to members and all non-Panel Members vide LC Paper No. CB(1)1432/05-06(01) on 8 May 2006.)

Briefing by HKMA

33. At the invitation of the Chairman, the Executive Director (Corporate Services), HKMA (ED(CS)/HKMA) gave a power-point presentation on the management costs for the investment of EF. He said that the presentation was prepared in response to the issues raised in Hon SIN Chung-kai's letter dated 24 April 2006 (LC Paper No. CB(1)1372/05-06(01)). From the figures quoted in a table set out in Annex 1 to the letter, it seemed that the operating costs of EF (which included "investment management and custodian fees") had increased by 336% from \$186 million in 1997 to \$811 million in 2005, and the "investment management and custodian fees" had increased by 34.6% between 2004 and 2005. In this connection, ED(CS)/HKMA made the following clarifications:

- (a) The operating costs of EF for 2005 included \$130 million in trading expenses, which was only included in the category of "investment management and custodian fees" in 2005 as a result of the introduction of the new accounting standards in the year. Hence, the \$130 million should be deducted from \$811 million for comparison with the operating

costs for previous years, which were prepared on the basis of the old accounting standards, for 2005.

- (b) To present the exact cost of employing external fund managers and custodians, further subtractions should be made for trading expenses (which were unrelated to investment management fees) of withholding tax and other expenses within the heading of “investment management and custodian fees”. After making such subtractions, the figures derived for comparison in the cost of external fund manager and custodians showed an increase of 249% between 1997 and 2005, and an increase of 8.9% between 2004 and 2005.
- (c) The reasons for the increases in the “investment management and custodian fees” between 1997 and 2005 included: growth of EF from about \$636 billion in 1997 to over \$1,066 billion in 2005 (with the growth in the accumulated surplus and the addition of the Land Fund in 1998); increased complexity in the composition of EF; and greater attention to risk management.
- (d) The cost of investing EF through external fund managers represented about 0.14% of the funds under management (about one third of EF) in 2005. This figure compared well with the management costs of about 0.27% for the externally managed assets of the NGP Fund in 2005, and with the rate of 0.45% to 0.95% typically charged by private-sector managers for institutional investment funds with a mix of fixed-income and equity assets comparable to EF.
- (e) Total direct management costs for the whole of EF, whether by external fund managers or direct investment in 2005, represented about 0.05% of the total assets of EF. To put this into perspective, the return on EF outperformed that of the benchmark portfolio by an average of about 1.2% between 1999 (when the current system of bench-marking began) and 2005. This outperformance represented an average of about \$11.9 billion annually or almost 30 times the annual cost of management of the Fund on average.
- (f) External fund managers were subject to a rigorous, competitive appointment process in accordance with procurement guidelines. Recommendations for appointment were put to FS through EFAC and its Investment Sub-Committee (ISC). The reasons for appointing external fund managers to invest about one third of EF’s assets were:
 - to allow EF to be invested flexibly in a variety of specialized assets in a number of international financial centres;
 - to tap the best investment expertise available in the market;

- to capture a diverse mix of investment styles and transfer knowledge and information about the market to in-house professionals; and
- to avoid conflict of interest and market sensitivity arising from HKMA's roles as regulator and manager of EF's assets.

Discussion

Cost for management of EF

34. Referring to paragraph 33(c) above, Mr SIN Chung-kai did not agree that the growth of EF and the increased complexity in the composition of EF were major reasons for the increase in the "investment management and custodian fees". Given that the addition of the Land Fund and the EF's investment in Hong Kong equities had both started in 1998, Mr SIN did not think that these incidents should account for the increase in investment management cost since 2000.

35. In response, CE/HKMA explained that management of equities acquired during the 1998 intervention in the stock market mainly involved arrangement for the Tracker Fund of Hong Kong for disposal of the equities to investors in the market. Thereafter, the investment of EF in Hong Kong equities had involved more elements of equities and greater use of derivatives and other sophisticated investment instruments aimed at improving yield and diversifying assets. Higher cost was therefore incurred for investment management by external managers for diversifying assets held in equities.

36. Referring to page 126 of the Annual Report 2005, Ms Emily LAU pointed out that the investment management and custodian fees (amounting to \$731 million) in 2005 was much higher than the total staff costs of HKMA for the year (amounting to \$449 million). Noting that external fund managers managed only about one third of EF, Ms LAU enquired about the reasons for the high expenditure on investment management and custodian fees.

37. Dr Marvin CHEUNG advised that as explained by ED(CS)/HKMA in the earlier briefing, the exact cost for employing external fund managers and custodians in 2005 should be \$489 million after subtracting the amounts relating to other expenses. As the amount of \$489 million was still higher than the staff cost of HKMA in 2005, Dr CHEUNG commented that one possible reason for the difference was that HKMA staff were underpaid in general. In this connection, he pointed out that given the competitive packages offered by the financial sector, HKMA had experienced loss of talents to the financial sector in recent years. GSC members had noted this problem with concern but unable to make significant pay increase readily given the political pressure on controlling the expenditure of HKMA.

38. Ms Emily LAU queried how the GSC could convince the public that HKMA staff were underpaid, given the existing high level of remuneration for CE/HKMA

(with an annual package of \$10 million in 2005), which had far exceeded the remuneration of the Chairman of the US Federal Reserve Board. Mr James TO was also not convinced that the pay levels of all HKMA staff should be determined with reference to those in the financial sector. He was of the view that while HKMA might have to compete with the financial sector for talents in the investment and management of EF, this should not be the case for other HKMA staff at the management level. Mr TO pointed out that HKMA staff at senior management level, in particular CE/HKMA, enjoyed the status and prestige of the posts and such qualitative factors should be taken into account in determining their remuneration packages.

39. Noting that HKMA had been facing the problem of staff turnover in recent years, Miss TAM Heung-man enquired about the measures taken to alleviate the problem. In response, ED(CS)/HKMA said that the problem of staff turnover did exist in HKMA, with a wastage rate of 8% in 2005. The problem was more acute at the middle management level with a wastage rate of 10% in 2005. The reasons for high staff turnover were multifold, such as attractive pay packages and better job prospects available in the financial sector as well as increased work pressure in HKMA due to reduction in manpower. To address the problem, HKMA had taken a number of measures, including: recommendation for a pay increase in 2006; increase in manpower provision; and redistribution of work to reduce the work pressure of staff. ED(CS)/HKMA however pointed out that despite the increase in establishment, HKMA was facing the challenge in recruiting and retaining suitable talents and its total strength remained about 5% below its establishment (i.e. establishment of 614 with strength of around 580). CE/HKMA also pointed out that HKMA had experienced high staff turnover rate at the senior management level, with 100% turnover at the DCE level in the past few years.

40. Noting that the appointments of external fund managers were approved by FS on the advice of EFAC, Mr Jeffrey LAM was concerned about the monitoring of the performance of external fund managers appointed. He enquired whether the GSC played any role in this regard and sought information on the number of external managers terminated for unsatisfactory performance in recent years.

41. In response, Dr Marvin CHEUNG said that while the GSC monitored the performance of HKMA on budgetary, administrative and governance issues, it was not involved in operational matters such as the assessment of external fund managers' performance. The Executive Director (Reserves Management), HKMA advised that the performance of external fund managers was monitored continuously against the standards commonly adopted in the market and stipulated in their appointment contracts with HKMA. He pointed out that the investment performance would be assessed against the relevant standards instead of simply on the basis of the percentage of return. Since 2000, the appointment of more than 20 external managers had been cancelled for a number of reasons, including performance below expectations and HKMA's decisions against investing in certain types of assets managed by the managers concerned.

Investment return of EF

42. Expressing concern over the low investment return of EF, Mr Ronny TONG enquired whether a mechanism was in place to review the investment benchmark of EF and whether the GSC had a role to play in this regard.

43. In reply, Dr Marvin CHEUNG advised that the GSC's role was to monitor the performance of HKMA and make recommendations to FS through EFAC on the performance of HKMA, including whether or not the investment return of EF had outperformed that of the benchmark. It was for the ISC, another Sub-Committee under EFAC, to monitor HKMA's investment management work and make recommendations on the investment policy and strategy of EF. The recommendations of the ISC would be submitted to EFAC for comments and then presented to FS for approval. Dr CHEUNG pointed out that while the ISC and EFAC as a whole played their roles in providing advice to FS on the investment strategy of EF, the decision rested with FS.

44. Ms Emily LAU also expressed concern about the review of the investment strategy and benchmark portfolio of EF. She sought the view of Mr Christopher CHENG as a member of the ISC on the subject. In reply, Mr Christopher CHENG, member of the GSC and ISC under EFAC, advised that the ISC considered and commented on the investment policy and strategy of EF on the basis of expert analyses on risk and return. EFAC determined EF's investment benchmark and strategy for presentation to FS for his approval.

45. Mr Albert CHENG enquired whether HKMA could modify the investment benchmark of EF to invest in the Government's divestment projects such as the divestment of the Housing Authority's retail and car-parking facilities through the listing of The Link Real Estate Investment Trust and other upcoming privatization plans relating to the Airport Authority and the Kowloon-Canton Railway Corporation. Mr CHENG was of the view that by investing EF assets in these divestment projects, a higher investment return could be achieved and the public would be benefited from the high return.

46. CE/HKMA reiterated that given the primary objective of EF to safeguard the exchange value of Hong Kong's currency, a consensus on the amount of foreign reserves which was "adequate" to achieve the objective of EF had to be reached before making any changes to the investment benchmark. While the amount of foreign reserves exceeding the "adequate" level might be allocated for higher return investments, it was worth noting that such investments might involve lower liquidity and higher risks which would be contrary to the primary objective of EF. Responding to Mr Albert CHENG's further enquiry, CE/HKMA advised that HKMA had undertaken studies and analyses for internal references in this regard but there could be market sensitivity for disclosure of the relevant findings. He nevertheless welcomed views from LegCo Members and any interested parties on the subject.

47. Mr Albert CHENG, Ms Emily LAU and Mr Ronny TONG remained concerned about how a consensus could be reached on the “adequate” amount of foreign reserves and how a review of the current investment benchmark of EF could be triggered. Mr TONG pointed out that the high level of reserves currently maintained in EF and the low investment return had become a matter of public concern and it was the responsibility of the Administration to examine the subject.

48. CE/HKMA advised that the question of what was an “adequate” amount of foreign reserves was a complicated one involving issues relating to financial and academic concerns. Any interested party could put forward their views and suggestions to FS. HKMA remained open-minded to the subject and would be willing to discuss the subject further with interested parties.

Transparency of HKMA’s budget

49. Ms Emily LAU expressed concern about the mechanism for the approval of HKMA’s budget. She opined that as an integral part of the Government, HKMA should not be exempted from the resource allocation mechanism applicable to other government departments. Ms LAU sought Dr Marvin CHEUNG’s view in this regard.

50. Dr Marvin CHEUNG explained that as he had clearly stated in his opening remarks, resource independence was crucial in eliminating any political influence over the operations of a central bank during a budgetary approval process. Given that HKMA performed the function of a central banking institution in Hong Kong, its resource and operational independence would be of prime importance to the maintenance of Hong Kong’s status as an international financial centre. Hence, he would not support the idea of subjecting HKMA’s budget to the approval of the legislature.

51. While appreciating the importance of resource independence for HKMA, Mr SIN Chung-kai and Mr James TO were of the view that HKMA should improve the current budget disclosure arrangements to enhance its transparency and accountability. Mr SIN suggested that HKMA should follow the example of the Securities and Futures Commission (SFC) to present its annual budget to the FA Panel before the commencement of each financial year, and disclose further details of its annual budget.

52. Dr Marvin CHEUNG advised that the GSC made recommendations to FS through EFAC on the disclosure arrangements for HKMA’s budget, taking into account the best international practice of the financial sector and major central banks in other jurisdictions. He stressed that the current disclosure arrangement recommended by the GSC was in line with the best international practices and the GSC did not consider it necessary to change the arrangement at the present stage. However, the GSC kept the current disclosure arrangement under regular review. In

fact, improvement measures had been recommended by the GSC and approved by FS following the past reviews. Dr CHEUNG assured member that the GSC would continue to keep HKMA's budget disclosure under review with the aim of ensuring that it was consistent with the practices of comparable institutions and the expectations of the community. He welcomed Members' views on this matter and undertook to take their views into account in GSC's upcoming review.

53. Referring to the experience of other public bodies of which operational independence was also important, such as the Independent Commission Against Corruption, Mr Ronny TONG and Mr James TO were of the view that enhancing the transparency of HKMA's budget would not have adverse impact on the independence of HKMA. Mr TONG, Mr TO and Mr SIN Chung-kai shared the view that adequate checks and balances should be in place to monitor the expenditure of public bodies like HKMA without undermining their independence. Mr TONG and Mr TO considered that higher transparency through disclosure of budgetary information should be made for HKMA having regard to the special circumstances of Hong Kong where rotation of Government through democratic elections was not in place.

54. Ms Emily LAU referred to the research report prepared by the Research and Library Division of the LegCo Secretariat on "The Governance of HKMA and Comparable Authorities in Hong Kong" in 2003 and commented that the current governance structure and accountability arrangement for HKMA were unsatisfactory. She invited the GSC to make reference to the findings of the research report on the governance structure and arrangements in comparable authorities overseas and provide the Panel with its written response.

(Post-meeting note: The letter dated 10 May 2006 from the Clerk to Panel to the Chairman of the GSC and the reply dated 30 June 2006 from the Chairman of the GSC were issued to members and all non-Panel Members vide LC Paper No. CB(1)1548/05-06 (01) on 19 May 2006 and LC Paper No. CB(1)1938/05-06 (01) on 5 July 2006 respectively.)

VI. Policies on remuneration for and post-termination employment of senior executives of the Hong Kong Monetary Authority and Securities and Futures Commission

(LC Paper No. CB(1)1092/05-06(01) — Letter dated 9 February 2006 from the Clerk to Panel to the Chairman of the Governance Sub-Committee

LC Paper No. CB(1)1092/05-06(02) — Reply dated 15 March 2006 from the Chairman of the Governance Sub-Committee

- LC Paper No. CB(1)1183/05-06(01) — Letter dated 7 March 2006 from the Clerk to Panel to the Chief Executive of HKMA
- LC Paper No. CB(1)1183/05-06(02) — Reply dated 27 March 2006 from the Chief Executive of HKMA
- LC Paper No. CB(1)1186/05-06(01) — Letter dated 9 February 2006 from the Clerk to Panel to the Chairman of SFC
- LC Paper No. CB(1)1186/05-06(02) — Letter dated 7 March 2006 from the Clerk to Panel to the Chairman of SFC
- LC Paper No. CB(1)1186/05-06(03) — Reply dated 27 March 2006 from the Commission Secretary of SFC
- LC Paper No. CB(1)1338/05-06(08) — Background brief on the remuneration policies for senior executives of the Hong Kong Monetary Authority and Securities and Futures Commission
- LC Paper No. CB(1)1338/05-06(09) — Background brief on the policies on post-termination employment of senior executives of the Hong Kong Monetary Authority and the Securities and Futures Commission)

Discussion

Remuneration for senior executives of HKMA

55. Pointing out that the remuneration level of the Chairman of the US Federal Reserve Board was not comparable to those of private corporations, Mr SIN Chung-kai was concerned why HKMA drew reference from market rates to determine the remuneration levels of its senior executives. Dr Marvin CHEUNG, Chairman of the GSC, responded that when HKMA was established in 1993, the Government had determined that HKMA would be able to employ staff on terms different from those of the civil service in order to attract and retain high calibre staff with the right experience and expertise. Having regard to the need for HKMA to compete with the private sector for high calibre staff, the GSC supported the policy that pay packages of HKMA staff be pitched at levels comparable to, and competitive with, those for comparable positions in the private sector. Dr CHEUNG further

pointed out that as a matter of fact, there was no uniform practice for overseas central banks and financial regulators in setting the pay levels of their staff. However, the pay packages of the staff of the Monetary Authority of Singapore were also comparable to those for comparable positions in the private sector.

56. Ms Emily LAU pointed out that while the then Secretary for Monetary Affairs had made known the Government's intention that HKMA would be able to employ staff on terms different from those of the civil service to the LegCo during the Second Reading of the Exchange Fund (Amendment) Bill 1992, he had also indicated in his speech that HKMA would remain an integral part of the Government. Ms LAU invited the GSC to make reference to the findings of the research report prepared by the Research and Library Division of the LegCo Secretariat on "The Governance of HKMA and Comparable Authorities in Hong Kong and Overseas Jurisdictions" in 2003. She pointed out that overseas central banks and financial regulators also needed to compete with the private sector for staff resources. However, they did not necessarily adopt the market-based remuneration system. Given that the remuneration level of CE/HKMA was much higher than those of the heads of other central banking institutions, Ms LAU stressed the need for HKMA to review its remuneration packages in the light of international practices. Besides, in view of the unsatisfactory investment performance of EF, the public was gravely concerned whether CE/HKMA was overpaid. In this connection, she considered it necessary for the GSC to critically review the remuneration packages of HKMA.

57. In response, Dr Marvin CHEUNG pointed out that the GSC was satisfied with HKMA's performance in managing EF. The GSC also considered that HKMA had achieved very good performance in other functions, such as maintaining the stability of the Hong Kong dollar, promoting the safety of banking system, maintaining and developing Hong Kong's financial infrastructure and promoting Hong Kong's status as an international financial centre. However, Ms Emily LAU pointed out that the heads of other central banking institutions also performed the functions as those of CE/HKMA. In this connection, she remained of the view that the remuneration level of CE/HKMA was on the high side.

Post-termination employment arrangements of HKMA and SFC

58. Mr SIN Chung-kai noted from the written reply dated 27 March 2006 from HKMA (LC Paper No. CB(1) 1186/05-06(02)) that approval had been given for its former Deputy Chief Executive, Mr Norman CHAN, to join a bank in Hong Kong as vice chairman from 1 December 2005. Given that the Deputy Chief Executive should have access to information about the banks regulated by HKMA, Mr SIN was concerned whether there was actual or potential conflict of interest between the new employment and the staff member's former duties in HKMA. In response, ED(CS)/HKMA clarified that prior permission was not required for Mr Norman CHAN to take up the post-termination employment with a bank since he took up the new employment over six months after leaving HKMA. He also pointed out that as the banking supervisory function was clearly separated from other functions of

HKMA, there was restriction on the access of information in the respective areas of responsibilities. Moreover, HKMA staff were bound by section 120 of the Banking Ordinance (Cap. 155) to preserve secrecy of the information they received in performing their duties, and a breach of the relevant provisions would incur criminal liability.

59. Mr SIN Chung-kai noted from the written reply dated 27 March 2006 from SFC (LC Paper No. CB(1) 1186/05-06(03)) that approval had been given for its former Executive Director, Mr Ashley Alder, to take up employment with a law firm during a six-month post-termination period. Mr SIN was concerned whether the law firm worked for any corporations regulated by SFC and what measures had been put in place to avoid possible conflict of interest between the new employment and the former duties of the staff. In response, Mr Martin WHEATLEY, Chairman of SFC, said that a mechanism was in place to require the Executive Directors (including the Chairman) to obtain prior permission in writing from a committee for an employment during a six-month post-termination period if the activities of the new employment had been the subject of any of the statutory functions of SFC in the period of 12 months before and/or six months after departure. The committee would consider whether there would be any conflict of interest between the new employment and the staff member's former duties in SFC. In the case of Mr Ashley Alder, SFC had sought assurance from the staff member concerned and the law firm that he would not be involved in any activities which had been the subject of any of the statutory functions of SFC during the relevant period.

60. Noting that the GSC was reviewing the post-termination employment rules applicable to HKMA staff and that SFC was also reviewing the arrangement in respect of post-termination employment of its Executive Directors, Ms Emily LAU suggested that reference be made to the improvement measures introduced by the Administration in January 2006 to tighten control on post-service employment of directorate civil servants. In particular, former directorate civil servants at D4 or above (or equivalent) were subject to a minimum 12-month sanitization period so as to forestall real or potential conflict of interest and/or negative public perception by instituting a 12-month break between the officers' government duties and outside work. As regards the prior approval required for an employee to enter business or take up employment within six months after leaving HKMA, Ms LAU considered that the approving authority should be the GSC instead of CE/HKMA.

61. Mr Martin WHEATLEY pointed out that SFC had put in place sanitization requirement similar to the improvement measures introduced by the Administration for former directorate civil servants. However, given that SFC had to recruit its staff from the private sector and normally offered a three-year employment contract, it was not appropriate to impose the 12-month sanitization requirement as it would impair SFC's ability to attract high calibre staff from the market. However, in the current review being conducted by SFC, consideration was given to add a provision in the employment contract for the purpose of forestalling conflict of interest.

GSC
SFC

62. Dr Marvin CHEUNG said that after completing the review, the GSC would make recommendations to FS through EFAC. Responding to Miss Mandy TAM's enquiry, Dr CHEUNG advised that the review was expected to be completed within a few months and the GSC would inform the Panel of the outcome of the review in writing in due course. The Chairman also requested SFC to inform the Panel of the outcome of its review in writing in due course.

Funding mechanism

63. Given that HKMA had five main functions, Ms Emily LAU was of the view that consideration should be given to revising the funding mechanism of HKMA to the effect that the expenditure involved in performing its function related to the management of EF be charged to EF, and the expenditure involved in performing its other functions be treated separately and subject to the resource allocation mechanism applicable to other government departments.

64. In response, Dr Marvin CHEUNG said that as the primary function of HKMA was to maintain the stability of the Hong Kong dollar, there were ample justifications for using EF to meet the costs involved. CE/HKMA reiterated that EF was unlike ordinary investment funds. The statutory objectives of EF under Article 113 of the Basic Law and the Exchange Fund Ordinance (Cap. 66) were to safeguard the exchange value of the currency of Hong Kong and maintain the stability and integrity of the monetary and financial systems of Hong Kong. Given that the five main functions of HKMA were directly or indirectly related to EF, it was inappropriate for HKMA to draw part of its expenditure from EF for the expenditure involved in performing its function related to the management of EF and leave the rest of the expenditure to be charged to the resource allocation mechanism applicable to other government departments.

Regulatory framework and transparency of HKMA

65. Mr SIN Chung-kai pointed out that under the existing arrangement, the powers, functions and responsibilities of the Monetary Authority were set out in different ordinances. The Democratic Party (DP) had all along considered this arrangement unsatisfactory and suggested that a new piece of legislation be enacted to set out clearly the powers, functions and responsibilities of HKMA, its governance structure and accountability arrangements, just like the Securities and Futures Ordinance for SFC. Mr SIN urged that the GSC should review the existing arrangement and consider DP's suggestion. Ms Emily LAU supported Mr SIN's view. In her view, achieving higher transparency and accountability would not undermine the independence of HKMA. On the contrary, it could enhance the credibility of HKMA. In response, Dr Marvin CHEUNG advised that the DP's suggestion was not within the scope of the terms of reference of the GSC, an advisory body established under EFAC.

66. Referring to the information provided by HKMA in response to his list of questions about the substantial increase in the general operating costs of EF from 1997 to 2005, Mr SIN Chung-kai was concerned that the information provided could not fully address the list of questions. He urged that the GSC should further enhance HKMA's transparency. Dr Marvin CHEUNG assured members that the GSC would keep the issues related to HKMA's transparency under continued review.

VII. Briefing on the development of capital and disclosure rules to be made under the Banking (Amendment) Ordinance 2005

(LC Paper No. CB(1)1338/05-06(10) — Paper provided by HKMA

Hardcopy of the following parts of the paper were issued to members:

- Main text of the paper;
- Annex A (Sections 4 and 2 of the Banking (Amendment) Ordinance 2005);
- Annex B (Basic features of Basel II);
- Annex C (Structure of the Rules);
- First part of Annex G (Policy paper on Disclosure Rules); and
- Last part of Annex G (Guideline on Operation of the Disclosure Rules)

— Hardcopy of the following parts of the paper were not issued to members:

- Annex D (Latest draft of the first batch of the Capital Rules);
- Annex E (Latest draft of the second batch of the Capital Rules);
- Annex F (Consultative draft of the third batch of the Capital Rules); and
- Attachment to Annex G (Draft Disclosure Rules)

LC Paper No. CB(1)1372/05-06(05) — Powerpoint presentation material provided by HKMA

LC Paper No. CB(1)1338/05-06(11) — Background brief prepared by the Legislative Council Secretariat)

Briefing by HKMA

67. At the invitation of the Chairman, the Deputy Chief Executive (Banking), HKMA (DCE(B)/HKMA) and the Executive Director (Banking Policy), HKMA (ED(BP)/HKMA) gave a power-point presentation on HKMA's preparation for the implementation of Basel II in Hong Kong. DCE(B)/HKMA briefed members on the overall features of Basel II, with a three-pillar structure to deal with the capital requirement for covering risks; the requirement to review capital planning; and the disclosure by banks on their risk profile, capital adequacy and other financial information. He also briefed members on the scope of and timeline for implementation of Basel II in Hong Kong. ED(BP)/HKMA advised that the Banking (Amendment) Ordinance 2005 (BAO 2005) provided the Monetary Authority (MA) with the rule-making power to make the Capital Rules and Disclosure Rules, which would be promulgated in the form of subsidiary legislation subject to negative vetting of LegCo. The Capital Rules would set out the manner for calculating the capital adequacy ratio (CAR) which authorized institutions (AIs) incorporated in Hong Kong must maintain under section 98 of the Banking Ordinance. The Disclosure Rules would set out the requirements for the public disclosure which AIs must make in respect of their profit and loss, state of affairs and CAR. He also highlighted the following progress in preparation for implementation of Basel II in Hong Kong:

(a) Policy setting

- All Basel II implementation proposals issued by HKMA had been endorsed by the banking industry. Hence, the policy-setting stage of the implementation plan had been completed. In converting the Basel II requirements into implementation proposals, HKMA's work had benefited from the advice of the Basel II Consultation Group which comprised representatives from the banking industry, the accounting profession and other interested parties, including the two statutory advisory committees (i.e. the Banking Advisory Committee (BAC) and the Deposit-taking Companies Advisory Committee).

(b) Development of Rules

- Given the length and complexity of the Basel II requirements, the Capital Rules had been prepared in four batches and had been issued for preliminary industry consultation. There had been no major dissent from the banking industry on the draft rules. After the preliminary consultation, the whole set of the Capital Rules would then be revised for a second round consultation. The Capital Rules

were technical in that they provided, in addition to the primary legislation, details for implementation of the Basel II requirements. It was expected that the rules would be ready for gazette in September 2006 and tabling before LegCo in October for negative vetting.

- The Disclosure Rules were being developed under the guidance of the Working Party on Financial Disclosure and Basel II Consultation Group. The rules would replace the existing HKMA disclosure guidelines for reporting periods beginning 1 January 2007. It was expected that the drafting and consultation of the rules would be completed in time for introduction to LegCo at the same time as the Capital Rules.

(c) Dialogue with industry

- HKMA had maintained close dialogue with the industry to ensure that the revised framework and the implementation approach were tailored to Hong Kong's circumstances while meeting international standards, and that AIs could achieve compliance by 1 January 2007.

(d) Establishment of the Capital Adequacy Review Tribunal (CART)

- CART would be established under BAO 2005 to review certain decisions of MA made under the Capital Rules which were specified in the rules as appealable. The right of appeal would only lie in respect of the fundamental decision as to which approach to capital adequacy calculation an AI might adopt, which might have a material impact on the AI's capital requirement. CART would be established towards the end of 2006 and was expected to commence operation at the same time when the Capital Rules became effective.

Discussion

Consultation and dialogue with AIs

68. Ms Emily LAU said that she was given to know that there were concerns among some AIs as to whether the implementation timetable was too aggressive. In this connection, Ms LAU enquired whether the implementation plan was endorsed by the banking industry as a whole.

69. The Chairman informed members that Dr David LI, LegCo Member of the finance constituency, was unable to attend the meeting as he was out of town. On behalf of Dr LI, the Chairman advised that the banking sector was in support of the implementation proposals of Basel II.

70. ED(BP)/HKMA advised that the implementation approach and timetable had been developed in close collaboration with the banking industry. He pointed out that extensive discussion on the Basel II implementation proposals was made at the last BAC meeting and FS had sought confirmation from the industry representatives of their support. HKMA was aware of the concerns of some AIs. For example, AIs which had noted slower implementation plans in their home jurisdictions preferred to have an implementation timetable in line with those of their home jurisdictions. To accommodate their respective needs, flexibility would be allowed for AIs to make minimum changes during the period from January 2007 and the implementation of Basel II in their home jurisdictions. HKMA would continue its dialogue with AIs on their preparation for implementation, and stand ready to provide assistance if necessary. DCE(B)/HKMA added that HKMA also noted that there were different views on the home-host issues concerning application of Basel II to banking groups across the globe.

HKMA

71. Ms Emily LAU was pleased to note that HKMA recognized the concerns of AIs in relation to the implementation plan. In order to ensure that they were able to comply with the requirements of Basel II, Ms LAU stressed the need for HKMA to fully address AIs' concerns in developing the implementation plan. She also expressed concern about the appointment of BAC members, with some members in office for terms exceeding the normal six-year rule for advisory committees. Mr SIN Chung-kai shared her concern. DCE(B)/HKMA noted the concern and advised that HKMA would take this into account in making nominations to FS for appointment of BAC members in future.

72. The Chairman said that some AIs might be reluctant to express their concerns in public as this might give the public an impression that their capital was inadequate to meet the requirements of Basel II. DCE(B)/HKMA responded that noting the possible resistance of some AIs to give their views freely in open forums, HKMA was prepared to meet with AIs individually so that they could express their concerns at ease.

73. Ms Emily LAU shared the view that some AIs might be reluctant to express their views in public given the sensitivity of the issue. In this connection, she considered that it would be helpful for HKMA to arrange bilateral meetings with AIs so as to enable them to express their real concerns at ease. HKMA should also assure AIs that their interest would not be adversely affected even if they expressed divergent views during the bilateral meetings.

Way forward

74. Mr SIN Chung-kai noted that the Capital Rules and Disclosure Rules would be tabled before LegCo for negative vetting in October 2006. He envisaged that a subcommittee would be formed by the House Committee to examine the two sets of rules. Mr SIN urged HKMA to fully address the concerns of the banking industry during its industry consultation and statutory consultation. If the Capital Rules and

Disclosure Rules had been endorsed by the industry as a whole when they were tabled before LegCo for negative vetting, it would expedite the legislative process and facilitate the timely implementation of the new requirements under Basel II. In response, DCE(B)/HKMA advised that HKMA was mindful of the need to engage full consultation with the industry in developing the rules and had plans for extensive consultation during summer. HKMA was prepared to update the Panel on the progress of the consultation.

75. To facilitate members' consideration of the need for further deliberation on the draft Capital Rules and Disclosure Rules before the gazettal of the two sets of rules in September/October 2006, the Chairman requested HKMA to update the Panel in writing, by 24 June 2006, on the progress of its preparation of the two sets of rules, including the outcome of its consultation with the banking industry.

(Post-meeting note: The supplementary information provided by HKMA was circulated to members vide LC Paper No. CB(1)1887/05-06(01) on 28 June 2006. Letter dated 28 June 2006 from the Clerk to Panel seeking further information from the Administration on the subject and the Administration's response dated 30 June were also circulated for members' reference vide LC Paper Nos. CB(1)1900/05-06(01) and (02) on 30 June 2006.)

VIII. Any other business

76. There being no other business, the meeting ended at 12:35 pm.

Council Business Division 1
Legislative Council Secretariat
5 September 2006