

立法會
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Panel on Financial Affairs

**Minutes of special meeting
held on Friday, 17 October 2008 at 4:30 pm
in the Chamber of the Legislative Council Building**

Members present : Hon CHAN Kam-lam, SBS, JP (Chairman)
Hon Ronny TONG Ka-wah, SC (Deputy Chairman)
Hon Albert HO Chun-yan
Dr Hon David LI Kwok-po, GBM, GBS, JP
Hon James TO Kun-sun
Dr Hon Philip WONG Yu-hong, GBS
Hon Emily LAU Wai-hing, JP
Hon Abraham SHEK Lai-him, SBS, JP
Hon Jeffrey LAM Kin-fung, SBS, JP
Hon Andrew LEUNG Kwan-yuen, SBS, JP
Hon KAM Nai-wai, MH
Hon Starry LEE Wai-king
Hon Paul CHAN Mo-po, MH, JP
Hon CHAN Tanya

Members attending: Hon LEE Cheuk-yan
Dr Hon Margaret NG
Hon Albert CHAN Wai-yip
Hon WONG Kwok-hing, MH
Hon LEE Wing-tat
Hon Cyd HO Sau-lan
Dr Hon PAN Pey-chyou

Members absent : Hon WONG Ting-kwong, BBS
Hon CHIM Pui-chung
Hon CHAN Kin-por, JP

**Public officers
attending**

: Agenda Item I

Financial Services and the Treasury Bureau

Prof K C CHAN, SBS, JP
Secretary for Financial Services and the Treasury

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

Mr Stanley YING, JP
Permanent Secretary for Financial Services and the
Treasury (Treasury)

Ms Julia LEUNG, JP
Under Secretary for Financial Services and the Treasury

Mr Clement CHEUNG, JP
Commissioner of Insurance

Agenda items I and II

Hong Kong Monetary Authority

Mr CHOI Yiu-kwan, JP
Deputy Chief Executive

Mr Raymond LI, JP
Executive Director (Banking Development)

Agenda item II

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

**Attendance by
invitation**

: Agenda item I

Securities and Futures Commission

Mr Martin WHEATLEY, JP
Chief Executive Officer

Mr Brian HO

Executive Director, Corporate Finance

Ms Sonia LEUNG
Director, Corporate Finance

Clerk in attendance: Miss Polly YEUNG
Chief Council Secretary (1)5

Staff in attendance : Mr KAU Kin-wah
Assistant Legal Adviser

Mr Noel SUNG
Senior Council Secretary (1)4

Ms Sharon CHAN
Legislative Assistant (1)8

Action

I. Briefing by the Secretary for Financial Services and the Treasury on the relevant policy initiatives in the Chief Executive's 2008-2009 Policy Address

(LC Paper No. CB(1)53/08-09(01) — Administration's paper on policy initiatives of the Financial Services and the Treasury Bureau

Two booklets provided by the Administration

- (a) Address by the Chief Executive at the Legislative Council meeting on 15 October 2008 — "Embracing New Challenges"; and
- (b) The 2008-09 Policy Address — "Policy Agenda".)

Briefing by the Administration

The Secretary for Financial Services and the Treasury (SFST) briefed members on the Financial Services and the Treasury Bureau (FSTB)'s policy initiatives featured in the Chief Executive (CE)'s 2008-2009 Policy Address, and highlighted the following areas of work:

- (a) review of the regulatory regime for the financial and banking systems;
- (b) promoting asset management business;

- (c) investor protection and education;
- (d) enhancing the Mandatory Provident Fund (MPF) system;
- (e) setting up of an independent Insurance Authority;
- (f) development of insurance policy holders' protection fund;
- (g) rewrite of the Companies Ordinance; and
- (h) review of the Trustee Ordinance.

Discussion

Proposal to increase employees' control over MPF investment

2. Mr WONG Kwok-hing expressed concern that under the Administration's proposal, employees would only be allowed to transfer the accrued benefits derived from their mandatory contributions, but not the employers' contributions, from the employer-chosen scheme to an MPF scheme of their own choice at least once a year. Mr WONG considered that the proposal would not enable the employees to have full control over their MPF investment as they could neither transfer the accrued benefits derived from the employers' mandatory contributions to a scheme of their choice, nor choose the MPF scheme for making mandatory contributions. Mr WONG urged the Administration to critically review its proposal.

3. In response, SFST advised that the Administration's proposal would allow employees greater choice in selecting MPF schemes, which would help promote competition among trustees and might eventually drive down management fees. Regarding Mr WONG's suggestion to give employees full control over the investment of both the employer's and the employee's MPF contributions, SFST said that since accrued benefits derived from employers' contributions could be used to offset severance / long service payment, there was concern on the part of employers that the operation of the offsetting system would be seriously affected if employees were allowed to transfer the employers' contributions. The suggestion would also bring a fundamental change to the MPF system which was established after extensive consultation.

4. Mr WONG Kwok-hing was dissatisfied that the Administration was mainly concerned about facilitating the offsetting arrangements rather than safeguarding the interests of employees. In reply to Mr WONG's enquiry about employees' right to choose their preferred investment in respect of their MPF contributions, the Permanent Secretary for Financial Services and the Treasury (Financial Services) (PS/FS) advised that while the MPF trustee was designated by the employer, the employee could choose to invest his contributions in high-risk, medium-risk or low-risk schemes offered by the trustee.

Hong Kong Monetary Authority (HKMA)

5. Mr Albert HO recalled that some members had in the past expressed grave concern about the lack of transparency in the appointment of the Monetary Authority (MA), and whether the appointment would be subject to political considerations. He recapped some members' suggestion that in order to safeguard the independence of MA in discharging his functions and to provide for greater accountability, there should be a clearly promulgated policy on the appointment of MA. Some members had also urged for the introduction of governing legislation for HKMA, similar to that of other regulatory bodies such as the Securities and Futures Commission (SFC). Mr HO was concerned whether issues related to the appointment of MA would be re-visited in view of the recent speculation about the tenure of Mr Joseph YAM, the incumbent Chief Executive of the HKMA (CE/HKMA). Mr Abraham SHEK was also concerned about the seemingly conflicting remarks by the Chief Executive and the Financial Secretary (FS) on Mr Joseph YAM's term of office.

6. In response, SFST said that the existing regulatory framework underpinned by HKMA had served Hong Kong well in maintaining the stability of Hong Kong's monetary and banking systems. The appointment of MA was governed by the Exchange Fund Ordinance (Cap. 66) (EFO) under which FS would appoint the MA on such terms and conditions as he thought fit. In exercising his power under EFO, FS would take into consideration the overall interest of Hong Kong.

Effectiveness of the current regulatory framework

7. Mr Albert HO asked whether the Administration would review the overall financial and banking regulatory framework, and study the feasibility of establishing a super regulatory body to oversee the financial services and banking sectors. Mr Abraham SHEK shared Mr HO's concern and further stressed that in order to uphold Hong Kong's position as an international financial centre, the Government should ensure that market efficacy was firmly rooted in a sound regulatory system, instead of on individual senior officials.

8. In response, SFST remarked that the existing regulatory framework for the banking and financial sectors had proved effective. The banking sector was able to withstand the stress posed by the recent financial tsunami and remained robust. On the need or otherwise for a super regulatory body, SFST informed members that the HKMA had commissioned an independent consultant, Mr David CARSE, to review HKMA's work on maintaining the stability of the banking system. Based on the review report and the experience of past and prevailing financial crises, the Administration considered that the mere establishment of a super regulatory body might not necessarily achieve the desired objective of maintaining market stability and resolving the difficulties faced by the financial services sector. Nevertheless, the Government was prepared to examine the regulatory framework in the light of the latest global financial crisis and overseas experience. The Chief Executive Officer of SFC (CEO/SFC) added that SFC would adopt an open mind in reviewing the existing

regulatory system, taking into consideration the measures taken by overseas jurisdictions to meet the challenges of the current global financial crisis.

9. Ms Emily LAU remarked that in the face of the recent global financial crisis, some overseas countries had commenced a review of their regulatory framework. She asked whether the Administration had taken steps to review the existing financial regulatory framework, such as the need for establishing procedures for the appointment and setting the terms and conditions of employment for MA. She enquired when the Panel would be consulted on the outcome of the review on the regulatory framework for the financial and banking systems. Given that the review report on HKMA's work on banking stability was completed before the outbreak of the recent global financial crisis, Ms LAU enquired whether the report would be suitably revised to take into account the recent events in the global financial markets.

10. In response, SFST confirmed that the Government would undertake a full and systemic review of the current regulatory regime after receiving reports from HKMA and SFC arising from the Lehman Brothers minibonds incident. In doing so, the Administration would take into account all relevant factors including the development of derivative financial products and its impact on the market, as well as the latest regulatory measures taken by overseas countries. SFST nevertheless reiterated that during past and current financial crises, Hong Kong's banking system had proved to be robust and the regulatory framework, effective.

11. The Chairman enquired whether, during its overall systemic review of the regulatory framework, the Administration would review the existing arrangement of separate regulators, namely HKMA and SFC, for overseeing the sale of structured financial products by authorized institutions (AIs), and the existing definition of "professional investor". The Chairman was also concerned about the timing for completing the systemic review and public consultation. In response, SFST advised that the overall review of the regulatory framework for the financial and banking sectors would cover the functions of the supervisory bodies, and issues relating to structured financial products. The review would also identify proposed areas for improvements with a view to enhancing investor protection. Consultation with the public and the Panel would be carried out in due course.

Investor protection

12. The Deputy Chairman referred to the measures for enhancing investor protection set out in paragraphs 36 and 37 of the Administration's paper, and was concerned whether there was a dereliction of duty on the part of HKMA and SFC when some banks were found to have sold high-risk derivative financial products such as the Lehman Brothers minibonds to their elderly and illiterate customers.

13. In response, SFST advised that HKMA was still investigating into the complaints of alleged mis-selling of structured financial products by AIs. He reiterated that the SFC would take appropriate actions if AIs were found to have failed to comply with the SFC guidelines on the sale of structured financial products.

The Administration would undertake a full systemic review of the regulatory framework in the light of the findings of the complaint investigations by HKMA and SFC. One of the issues would be to consider what could be done to enhance investor protection.

14. Mr LEE Wing-tat considered that the existing disclosure-based regulatory approach adopted by SFC for financial products was mainly based on the assumption that the investors would read and understand the terms and conditions, as well as the description and explanatory notes in the sales documents for the structured financial products. In reality, however, many investors had hardly read or understood the contents of the terms and conditions, nor had the bank staff adequately apprised them of such. Recalling CEO/SFC's remark at the House Committee meeting on 13 October 2008 that the term "minibond" was regarded as a brand name only, Mr LEE sought SFC's clarification on whether it considered the use of the term "minibond" misleading.

15. In response, SFST reiterated that while the disclosure-based approach would form an integral part of the regulatory regime for investor protection, the Administration would review the existing regulatory framework in the light of the Lehman Brothers minibond incident. CEO/SFC further explained that the disclosure-based regulatory approach was founded on the assumption that the sellers of the structured financial products would explain to the buyers clearly and fully the nature and features of the products concerned, in particular the return and the risks involved. In other words, the investor should be able to rely on the advice of his agent selling the financial product, instead of making an investment decision on the basis of the name of the product only.

16. The Deputy Chairman enquired about the measures put in place by SFC and HKMA to safeguard against mis-selling and ensure that the AIs and their staff would comply with the code of conduct issued by SFC/HKMA relating to the sale of structured financial products. He was concerned about the accountability of SFC and HKMA in the Lehman Brothers minibond fiasco as SFC had approved the marketing materials for the structured financial products which appeared to have contained misleading information; while HKMA, as the frontline regulator for banks, had not stopped AIs from using and issuing the questionable marketing materials to their clients. In this regard, the Deputy Chief Executive, HKMA (DCE/HKMA) responded that the AIs were required to issue, based on the SFC code of conduct, internal instructions to their staff for the sale of structured financial products. Moreover, the marketing materials in question had to be approved by SFC.

17. Mr Abraham SHEK enquired how the disclosure-based regulatory approach was implemented. He commented that conflict of interests would arise because on one hand, AIs and their staff were paid commissions upon successfully selling structured financial products, while on the other hand, they were required to explain clearly and fully to the investors about the features and risks of the structured financial products being sold. Mr SHEK was concerned whether the AI staff owed a fiduciary duty to the AI or to the investor concerned.

18. In reply, DCE/HKMA advised that to comply with the code of conduct issued by SFC, AIs had to instruct their staff to explain clearly to the potential investors the features of the structured financial products being sold, in particular the risks involved. If a complaint of mis-selling of structured financial products was substantiated after investigation, SFC would exercise the powers under the Securities and Futures Ordinance (Cap. 571) to impose disciplinary sanctions on the non-complying AIs and the staff concerned.

19. Referring to the marketing materials of the Lehman Brothers minibonds which made a lot of reference to "bonds", Mr James TO opined that the term "minibond" was misleading as it might have misled the investors into believing that the financial product being sold was a form of capital-protected and low-risk investment. In this regard, Mr TO pointed out that SFC should not, in the first place, allow such misleading information to be featured in the marketing materials for the structured financial products. Instead, it should be a requirement that the marketing materials should highlight prominently the risks of the financial products. Dr PAN Pey-chyau shared Mr TO's concern and remarked that SFC should be more vigilant in vetting the marketing materials for structured financial products in order to protect investors. Dr PAN also drew an analogy to the use of inaccurate names for medications and said that this malpractice was strictly regulated in the medical profession.

20. In response, CEO/SFC explained that from the regulatory point of view, the term "minibond" was regarded as a brand name which carried no regulatory meaning. However, if the use of a term, which had a commonly understood connotation, gave rise to confusion or misrepresentation, SFC would review the existing arrangement for using such terms in marketing structured financial products. SFST supplemented that the Government would review the measures to prevent the dissemination of misleading information to investors. Meanwhile, efforts would be made to promote investor education in order to raise investors' awareness of their rights, the returns and risks of making investment, and to enable investors to have a better understanding of the types of financial products offered in the market.

21. Noting that under the existing practice, AIs were informed in advance of the on-site inspections conducted by HKMA, Mr LEE Wing-tat questioned the efficacy of HKMA's enforcement action in detecting irregularities or malpractice such as mis-selling. Mr James TO shared Mr LEE's concern and opined that the inspections by HKMA should be carried out without prior notification. In response, DCE/HKMA said that during on-site inspections, HKMA would carry out documentary and audio record (if any) checks to ensure the AIs' compliance with the relevant supervisory requirements. This was different from actually observing how AI staff sold financial products.

II. New measures to support confidence in the Hong Kong banking system

- (LC Paper No. CB(1)53/08-09(02) — Hong Kong Monetary Authority's paper on two measures to safeguard banking stability
- LC Paper No. FS06/08-09 — Paper on a summary of local press reports on the provision of deposit protection scheme and bank capital support facility by places outside Hong Kong to cope with the financial crisis from 3 August 2007 to 15 October 2008 prepared by Research and Library Services Division (Chinese version only)
- LC Paper No. CB(1)54/08-09 — Paper attaching information relating to new measures to support confidence in the Hong Kong banking system prepared by the Legislative Council Secretariat
- LC Paper No. CB(1)26/08-09(01) — Press release dated 14 October 2008 on "Financial Secretary announces new measures to support confidence in the Hong Kong banking system"
- LC Paper No. CB(1)26/08-09(02) — Press release dated 14 October 2008 on "Hong Kong bank deposits fully guaranteed")

Briefing by the Chief Executive of HKMA

22. The Chief Executive, HKMA (CE/HKMA) briefed members on the two new measures to safeguard banking stability in Hong Kong, i.e. full deposit protection and Contingent Bank Capital Facility (CBCF). He also highlighted the following salient points in the paper:

- (a) the full deposit protection would follow the principles of the existing Deposit Protection Scheme but would include Restricted-Licence Banks and Deposit-Taking Companies as well as Licensed Banks. The guarantee applied to both Hong Kong dollar and foreign currency deposits with AIs;
- (b) the CBCF would be made available to locally incorporated licensed banks on request and subject to supervisory scrutiny;

- (c) deposit protection schemes were strengthened in overseas jurisdictions and Hong Kong might risk an outflow of funds if it did not introduce measures to inspire confidence in the banking sector; and
- (d) the two new measures were precautionary and pre-emptive and would remain in force until the end of 2010 when a decision would be taken in the light of international financial conditions on whether they should be extended.

Discussion

Full deposit protection

23. Mr WONG Kwok-hing expressed concern that the provision of full deposit protection for more than two years might lead to distortion of the banking system. For instance, it might dampen banks' incentives for prudent risk management, affect the competitive environment for banks and make depositors less vigilant in exercising due care. In response, CE/HKMA said that the two precautionary measures to strengthen confidence in Hong Kong's banking system might have their downside risks. The best way to manage such risks was to make stakeholders fully aware of them. HKMA would closely monitor the situation and take appropriate supervisory actions. For example, new guidelines would be issued shortly advising AIs not to depart from their ongoing business strategies and switch to highly risky businesses in view of the newly introduced deposit protection measure. DCE/HKMA supplemented that HKMA would collate relevant information from AIs and communicate with the AIs concerned if any unusual business operations were identified. Where necessary, regulatory action would be taken on the AI concerned.

24. While agreeing that the risks associated with the new measures should be made known to the public, Miss Tanya CHAN opined that the relevant guidelines for regulating banks' operations should have been issued simultaneously with the introduction of the new measures. Ms Emily LAU shared Miss CHAN's concern and said that if the guidelines governing the AIs' operations could not be issued on the effective day of the new measures, they should be issued immediately afterwards and as soon as practicable. In response, CE/HKMA explained that it might not be necessary to issue the guidelines immediately upon the introduction of the new measures since the AIs should be given some time to adjust their business strategies, as a result of the new measures.

25. Miss Tanya CHAN was concerned that an enhanced deposit protection scheme might lead to increased operating costs of the AIs resulting in higher charges for depositors. She enquired about the possible direction after 2010 when the new measures expired. In response, CE/HKMA said that the Deposit Protection Board had already commenced a review on the Deposit Protection Scheme and would consult the banking industry and the public before making recommendations. It was note-worthy that Mr David CARSE, the consultant on the review of HKMA's work on banking stability, had recommended that consideration be given to increasing the

deposit protection limit to, say, \$200,000. Since any change to the original deposit protection limit of \$100,000 would require amendment of the Deposit Protection Scheme Ordinance, the LegCo would be involved in the review of the deposit protection system. Meanwhile, the present full deposit protection offered by the Government through the use of the Exchange Fund was introduced in response to recent developments in the international financial market.

26. Mr James TO said that while he supported the introduction of the two new measures to safeguard banking stability, he was concerned whether international banks would transfer their overseas deposits to the books of their Hong Kong branches as a result of the implementation of full deposit protection in Hong Kong. In response, CE/HKMA pointed out that the international banks concerned would need to actually transfer money to their Hong Kong branches in order to enjoy the deposit protection.

27. Mr Albert HO was concerned about the moral hazards involved in the new measures, as well as the impact of the cessation of the new measures in 2010 on Hong Kong's credit ratings in the international financial market, and whether this would result in an outflow of capital from Hong Kong.

28. CE/HKMA concurred that there might be concerns when the temporary measure on full deposit protection was withdrawn by 2010. The HKMA would liaise with the relevant authorities in other jurisdictions which had imposed similar measures until 2010 to devise a feasible approach broadly in line with international practice for lifting the full deposit protection after 2010. CE/HKMA also advised that as the new measures to safeguard Hong Kong's banking stability were temporary and time-limited, their impact on Hong Kong's credit ratings would be limited.

Contingent bank capital facility

29. Mr Jeffrey LAM remarked that the US government had under-estimated the impact of the collapse of the subprime market which led to the outbreak of the current international financial turmoil. He also noted that various governments had injected capital into their banking system with a view to enhancing capital liquidity. Mr LAM asked whether there would be a ceiling on the amount drawn on the Exchange Fund for replenishing the AIs' capital base.

30. In response, CE/HKMA re-affirmed that the banking system of Hong Kong was strong and robust and the chance of the failure of locally incorporated licensed banks was relatively remote. Given that the capital position of locally incorporated licensed banks was among the strongest in the world, the Administration and HKMA did not expect that the new measures would need to be triggered. HKMA would keep in close contact with AIs with a view to ensuring adequate capital liquidity in the market to sustain economic activities.

31. Mr Paul CHAN expressed concern about the liquidity position of AIs, especially those small and medium-size banks, since individual AIs might incur

losses in their investment in overseas markets, while some might need to make provisions to buy back or compensate the buyers of the Lehman Brothers minibonds and related structured financial products. CE/HKMA responded that the global financial turmoil and the downturn of the economy might adversely affect the capital position of AIs. He, however, pointed out that the capital base of the locally incorporated licensed banks was relatively small, and the need for capital from the Exchange Fund, if any, would be limited.

Implementation and review

32. Ms Emily LAU expressed her appreciation to CE/HKMA that the regulatory efforts of HKMA had helped maintain stability in the local banking system in the face of adversities. Noting that the new measures to strengthen confidence in the banking system were precautionary and pre-emptive, Ms LAU enquired about the reason for implementing the new measures until the end of 2010, and the contingent measures to be taken if there were huge claims on the Exchange Fund arising from the new measures. CE/HKMA advised that the new measures would be put in place until end of 2010 because hopefully by that time, the current stress in the financial systems of the developed markets would have subsided and conditions in the international finance markets would have returned to normal. Given that the local banking sector remained robust, CE/HKMA said that he did not expect the measures to be triggered and hence, the chance of huge claims on the Exchange Fund was slim.

33. While supporting the new measures to safeguard banking stability and the steps to be taken to arouse public awareness of the pros and cons of the measures, Ms Cyd HO asked whether an interim review would be conducted on the effectiveness of the measures. Ms HO opined that when the HKMA/Administration decided the way forward in 2010, it should promulgate the considerations underlying the decision. Ms HO was concerned about the stress on the capital base of local banks arising from the global financial turmoil and considered that the Administration should regularly brief the Panel on the operation of the new measures.

34. In this connection, CE/HKMA advised that a review of the deposit protection scheme was underway. LegCo and the public would be consulted on the proposals of the review. It was HKMA's ongoing practice to closely monitor the capital situation of banks. Currently, the bad debt ratio of the banks was low, i.e. below 1%, compared with 10% during the Asian financial crisis. He stressed that the new measures were precautionary and pre-emptive and were consistent with efforts being taken globally to restore and reinforce confidence in the banking system and stabilise the financial markets.

35. Referring to CE/HKMA's article posted in his column "Viewpoint" on HKMA's website, which analyzed the possible downside of the new measures, the Deputy Chairman doubted whether this was the appropriate timing to issue the article as it might counteract the effects of the precautionary measures. He also questioned whether it would be more appropriate for other officials, instead of CE/HKMA himself, to highlight the possible downside of the new measures to the public.

36. Mr James TO did not subscribe to the Deputy Chairman's view regarding CE/HKMA's article on the new measures. Mr TO expressed his view that over the years CE/HKMA's articles published on HKMA's website had served useful purposes in enhancing the transparency of the local financial and banking systems and the regulatory regime.

37. CE/HKMA informed members that it had been his practice in the past ten years or so to communicate with the public and the banking industry through various means, including the Internet, on issues of concern. He said that the article in question aimed at disseminating to the public and sharing his views on various aspects of the new support measures.

Lehman Brothers minibonds

38. Mr Abraham SHEK was concerned about the accountability of HKMA in the Lehman Brothers minibond fiasco as the problems related to the US subprime market had already surfaced in 2007 but the AIs were still authorised to sell the Lehman Brothers minibonds and related structured financial products to over 40 000 investors to date. Mr SHEK questioned how the Administration would propose to deal with the problems arising from the Lehman Brothers minibonds and related structured financial products as the residual value of some of the products was almost nil. Ms Emily LAU shared Mr SHEK's concern and urged the authorities concerned to work out expeditious and viable means to tackle the Lehman Brothers minibond incident.

39. DCE/HKMA responded that the AIs involved were actively pursuing the Government's proposal to buy back the Lehman Brothers minibonds. SFC and HKMA were also investigating into complaints of alleged mis-selling by banks. Disciplinary actions would be taken against the AIs involved if the complaints were substantiated.

III. Any other business

40. There being no other business, the meeting ended at 6:47 pm.