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Panel on Financial Affairs

Minutes of meeting
held on Friday, 6 May 2005 at 9:30 am
in the Chamber of the Legislative Council Building

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

Public officers attending	**:**	Agenda Item IV Hong Kong Monetary Authority Mr Joseph YAM, GBS, JP Chief Executive Mr William RYBACK, JP Deputy Chief Executive Ms Amy YIP, BBS, JP Deputy Chief Executive (Acting) Mr Raymond LI, JP Executive Director (Corporate Services) Agenda Item V Mr Frederick MA, JP Secretary for Financial Services and the Treasury Mr Kevin HO, JP Permanent Secretary for Financial Services and the Treasury (Financial Services) Ms Emma LAU, JP Deputy Secretary for Financial Services and the Treasury (Financial Services) Mr Gordon JONES, JP Registrar of Companies Agenda Item VI Mrs Dorothy MA Principal Assistant Secretary for Financial Services and the Treasury (Financial Services) 1

Attendance by invitation	:	Agenda Item VI Securities and Futures Commission Mr Peter AU-YANG Chief Operating Officer Mr Keith LUI Senior Director (Supervision of Markets) Ms Daphne DOO Director (Supervision of Markets) Mr Anthony WOOD Senior Counsel
Clerk in attendance	:	Miss Salumi CHAN Chief Council Secretary (1)5
Staff in attendance	:	Ms Pauline NG Assistant Secretary General 1 Ms Connie SZETO Senior Council Secretary (1)4 Ms May LEUNG Legislative Assistant

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I. Confirmation of minutes of meeting

(LC Paper No. CB(1)1311/04-05 — Minutes of meeting on 7 March 2005)

The minutes of the meeting held on 7 March 2005 were confirmed.

II. Information paper issued since the last meeting

2. Members noted that an information paper on "Third progress report on the operation of the Loan Guarantee Scheme for Severe Acute Respiratory Syndrome

Impacted Industries" (LC Paper No. CB(1)1420/04-05(01)) had been issued since the last regular meeting held on 4 April 2005.

III. Date of next meeting and items for discussion

(LC Paper No. CB(1)1312/04-05(01) — List of outstanding items for discussion

LC Paper No. CB(1)1312/04-05(02) — List of follow-up actions)

Items for discussion at the next meeting

3. Members agreed that the following items be discussed at the next regular meeting of the Panel to be held on Monday, 6 June 2005, from 9:00 am to 12:45 pm:

(a) Briefing by the Financial Secretary on Hong Kong's latest overall economic situation;

(b) Proposal to revise fees and charges for services not directly affecting people's livelihood under the purview of the Treasury Branch; and

(c) Proposal to write off a judgement debt.

4. On paragraph 3(a) above, members noted that the Financial Secretary (FS) would brief the Panel on Hong Kong's latest overall economic situation. At the request of the Panel, FS would discuss with members on the use of the accumulated surplus of the Exchange Fund (EF). As regards paragraph 3(b), members noted that the Administration would consult the Panel on the proposals relating to the revision of fees and charges which did not directly affect people's livelihood or general business activities, and that some of the proposals would require legislative amendments. The Administration would consider Members' views in determining whether and when the fees should be revised and when the necessary legislative amendments would be presented to the Legislative Council (LegCo). On paragraph 3(c), members noted that the Administration would consult the Panel on a proposal to write off a judgement debt which could not be recovered. The debt arose from the failure of a contracted auctioneer to pay to the Government the proceeds from previous auctions of surplus government stores and confiscated goods. A High Court judgement was obtained by the Government in 1999 for recovery of the debt. Given that the auctioneer had gone into bankruptcy, the Administration considered that the debt had become irrecoverable and should be written off. The total amount, inclusive of legal costs and interest calculated up to 24 June 2005, was $16.8 million. The Administration planned to seek approval from the Finance Committee at its meeting on 24 June 2005 for writing off the debt.

5. To facilitate discussion on the use of the accumulated surplus of EF at the meeting on 6 June 2005, Ms Emily LAU requested the LegCo Secretariat to prepare a

background brief covering previous discussions on the subject by LegCo, and statistics in respect of the accumulated surplus of EF, investment income of EF, and Treasury's share of EF's investment income for the past years. Mr James TIEN requested that information on the mechanism for determining the amount of Treasury's share of EF's investment income be included in the background brief. In response, the Clerk to Panel (the Clerk) said that preparation of the background brief was underway, and the brief would cover the information requested by Ms LAU and Mr TIEN.

Other proposed discussion item

6. The Chairman informed members that the Administration would like to brief the Panel on its proposal of introducing a new category of insurance agents - travel insurance agents, including responses of the insurance industry and travel industry on the proposal, and the timetable of implementation. As the subject matter fell within the purview of this Panel and the Panel on Economic Services (the ES Panel), the Chairman suggested and members agreed that a joint meeting with the ES Panel be arranged for discussing the subject. The Chairman directed the Clerk to follow up accordingly.

Clerk

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

(LC Paper No. CB(1)1312/04-05(03)	— Letter dated 19 April 2005 from the Chief Executive of the Hong Kong Monetary Authority to the Chairman of the Panel
LC Paper No. CB(1)1312/04-05(04)	— Hong Kong Monetary Authority — Annual Report 2004
LC Paper No. CB(1)1312/04-05(05)	— Requests previously raised by members of the Panel
LC Paper No. CB(1)1312/04-05(06)	— Powerpoint presentation material provided by the Hong Kong Monetary Authority)

Briefing by the Hong Kong Monetary Authority

7. 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 2004 (Annual Report 2004) and the updates on its key areas of work. On the Annual Report 2004, CE/HKMA highlighted the following points:

(a) On the monetary side, the Linked Exchange Rate (LER) system operated smoothly and the exchange rate of the Hong Kong dollar remained stable in 2004 despite the depreciation of the US dollar, market speculation about revaluation of the renminbi (RMB), and interest rate increases in the US.

(b) HKMA and the banking sector continued to prepare for the implementation of Basel II and to improve the supervisory framework for preventing money laundering and terrorist financing. Moreover, the Hong Kong Deposit Protection Board (HKDPB) was formed in July 2004 to oversee the project for establishing the Deposit Protection Scheme (DPS). The Commercial Credit Reference Agency was launched in November 2004 and had been operating smoothly.

(c) There were robust developments in market infrastructure, including improvements made to the clearing and settlement systems through the implementation of the Clearing and Settlement Systems Ordinance in 2004, and improvements made to the Hong Kong dollar payment system to ease banks' liquidity pressure at times of large fund flows related to initial public offerings.

(d) The further development of the Asian Bond Fund and the introduction of RMB banking services had helped reinforcing Hong Kong's status as an international financial centre.

(e) As regards performance of the Exchange Fund (EF) in 2004, the Fund achieved an investment return of $56.7 billion or 5.7% despite considerable volatility in the bond, equity and currency markets. The rate of return met the investment benchmark. The Treasury's share amounted to $14.5 billion, which exceeded the amount of $12.3 billion budgeted in the fiscal year 2004-05.

(f) The Governance Sub-Committee (GSC) of the Exchange Fund Advisory Committee (EFAC) had reviewed the disclosure of information on HKMA's operating expenditure. GSC's recommendations for greater disclosure had been approved by the Financial Secretary (FS) on the advice of EFAC. The recommendations took into account the governance arrangements for HKMA, practices among other central banking institutions, and the practices of private and public-sector organizations in Hong Kong. The major recommendations of GSC were disclosure in HKMA's annual report: a breakdown of the HKMA's operating expenses for the past year in the EF Accounts; a breakdown of HKMA's budgeted administrative expenditure for the current year; and the staff establishment and strength of HKMA by department with a breakdown between senior staff and other staff. The relevant details were set out in pages 104, 132 and 131 of Annual Report 2004 respectively. Such details would also be included in future annual reports. GSC would continue to keep disclosure arrangements under review.

8. CE/HKMA also updated the Panel on HKMA's key areas of work, as follows:

(a) On currency stability, in the fourth quarter of 2004, the sales of Hong Kong dollars by HKMA following renewed upward pressure on the Hong Kong dollar led to a rise in the Aggregate Balance (AB) to $15.8 billion on 10 December 2004. The Convertibility Undertaking was then triggered a number of times and AB contracted accordingly, and interest rates began to climb in early 2005. The Federal funds target rate in the US was raised by seven times by a total of 175 basis points between June 2004 and March 2005. Market generally expected the increasing trend to continue. Domestic monetary conditions would continue to be affected by two factors pulling in different directions: the trend of higher US interest rates and a possible RMB exchange rate regime change. Volatility was expected and overshooting in interest rate adjustment was possible. Banks needed to manage interest rate risks. Borrowers should also beware.

(b) On external factors affecting the risks and vulnerabilities of the Hong Kong dollar, there had been increasing market expectations of a more aggressive pace of monetary tightening in the US. Strong economic data for the Mainland in the first two months of 2005 had renewed fears about overheating pressures and increased speculation in financial markets about a change in RMB exchange rate regime. The Mainland authorities had indicated the need of introducing more flexibility to RMB exchange rate regime in a progressive and practical manner. It was expected that the extent of appreciation of RMB, if any, would not be large.

(c) On the domestic side, Hong Kong's economic recovery remained robust. Real Gross Domestic Product (GDP) grew by 7.1% in the fourth quarter of 2004. For 2004 as a whole, real GDP expanded by 8.1%, the highest annual growth since 2000. The Composite Consumer Price Index (CCPI) rose modestly in recent months. Inflation might gather momentum if the current loose monetary conditions persisted. The unemployment rate eased steadily to 6.1% in the three months ending March 2005, from a record high of 8.6% in the May-July 2003 period. Property prices had increased significantly from the trough in 2003, contributing to the recovery of the economy through the wealth effect. Despite the sharp increase in prices, the risk of a property bubble was not high at present, since the price increase had been accompanied by improvement in fundamentals.

(d) The Government's fiscal position had improved considerably. The fiscal deficit for 2004-05 narrowed markedly on strong revenue.

(e) On banking sector performance, the overall asset quality of retail banks continued to improve. The number of residential mortgage loans in negative equity declined to some 14 000 cases at end of March 2005 from 19 200 cases at the end of 2004. Compared with the peak of around 106 000 cases in June 2003, the decline was about 87%. The change to a rising interest rate environment would have impacts on banks, and HKMA was closely monitoring the risk management of banks, including conducting on-site examinations on residential mortgage lending business of individual Authorized Institutions (AIs) to review their compliance with the 70% loan-to-value ratio guideline (the 70% guideline), and assess the quality of their credit underwriting standards and risk management arrangements for such business.

(f) On protection of interests of bank customers, arising from the incident of distruction of safe deposit box (SDB) by the DBS Bank (Hong Kong) Limited, HKMA had required all AIs to undertake review of the exemption of liability clauses in contracts for SDB service. Of the 27 AIs providing SDB service, 24 were required to amend their SDB agreements to comply with the Code of Banking Practice. 22 of the 24 AIs had amended their exemption of liability clauses such that they would not seek to exclude or restrict their liability in cases where the damage was caused by AIs' own negligence, and the remaining two AIs had decided to terminate their SDB services shortly. On the other hand, to further strengthen the security controls in order to address the problem of internet banking fraud, HKMA issued a circular in June 2004 to require banks offering high-risk retail internet banking transactions to implement two-factor authentication by June 2005. The project was progressing well.

(g) In the light of the new opportunities presented by the Mainland developments and the changing financial landscape and technology standards, the Financial Infrastructure Sub-Committee of EFAC had started a review to map out a strategy to guide future financial infrastructure development.

(h) As regards work on reinforcing the position of Hong Kong as an international financial centre, various projects for the further development of RMB business in Hong Kong, promotion of the local bond market and improvement of important clearing and settlement systems were in good progress.

(i) Regarding the performance of EF, the fund recorded a loss of $2.1 billion at end of March 2005 due to the fall in the Hong Kong equity market and the strengthening of the US dollar against other currencies. In view of the purpose of EF which required high liquidity and security, it was more appropriate to view the investment income of EF from a longer-term perspective. It was expected that uncertainties in currency, equity and bond markets would continue and the investment outlook of EF in the rest of 2005 was full of risks and challenges.

(*Post-meeting note:* Updated pages of the power-point presentation material were circulated to members and non-Panel Members vide LC Paper No. CB(1)1312/04-05(06) on 9 May 2005.)

Discussion

Increase in HKMA's staff costs

9. Ms Emily LAU noted from Table 3 on page 132 of Annual Report 2004 that while HKMA's actual staff expenses in 2004 was lower than the 2004 Budget, the costs would increase from the actual expenditure of $446 million in 2004 to $490 million in the 2005 Budget. She also noticed that while the strength of senior staff for 2004 was 13 as shown in Table 1 on page 131 of Annual Report 2004, the number of senior executives in 2004 was 14 as shown in Table 2 on page 132 of Annual Report 2004. Ms LAU enquired about the reasons for the increase in HKMA's staff costs in 2005 and the difference in the number of senior staff in the two tables.

10. On the increase in HKMA's staff costs in 2005, CE/HKMA advised that this was to cater for the expansion in HKMA's activities, increase in workload arising from existing duties, and increase in complexity of work. He stressed that the increase in manpower had been approved by FS on the advice of EFAC taking into account the operational needs and staffing position of HKMA. He added that in the past few years , HKMA had frozen the number of establishment and coped with the increasing workload by re-organization of work and internal deployment of staff. To address the problems of staff recruitment and retention, HKMA planned to fill the vacancies in its establishment in 2005, including the vacant post of an Executive Director. As regards the number of senior executives in 2004, CE/HKMA confirmed that while the establishment stood at 14, the actual strength remained at 13. The difference in the number as shown in Table 1 and Table 2 was due to staffing changes involving the posts of a Deputy Chief Executive and an Executive Director during the year.

11. Upon further enquiry by Ms Emily LAU, CE/HKMA advised that at the end of 2004, the total establishment of HKMA were 604 and the actual strength was 575. As regards HKMA's current strength, CE/HKMA undertook to provide the information after the meeting.

(*Post-meeting note:* The information on the actual staff strength of HKMA as at 30 April 2005 was circulated to members and non-Panel Members vide LC Paper No. CB(1)1492/04-05(01) on 10 May 2005.)

12. Ms Emily LAU considered that the increase in HKMA's staff costs would be against the general trend in the public sector which had taken efforts to contain growth in staff costs and staff number. Ms LAU urged that HKMA, as an integral part of the Administration, should take stringent measures to control staff expenses. CE/HKMA considered it inappropriate to a make direct comparison between HKMA and Government bureaux and departments because of their differences in work nature and objectives.

Variable pay for HKMA's staff

13. Mr SIN Chung-kai noted from Table 2 on page 132 of Annual report 2004 that in 2004, the level of variable pay for CE/HKMA was up to 30% of the fixed pay of the post, while the levels for the posts of Deputy Executive Director and Executive Director were about 20% and 13% respectively. Mr SIN enquired about the reasons for adopting different percentages of variable pay for different ranks of staff in HKMA.

14. In response, CE/HKMA advised that under the current practice, different benchmarks were adopted for awarding variable pay to different ranks of staff in HKMA and in general, higher benchmarks were adopted for senior rank staff. He added that matters relating to remuneration of HKMA's senior staff were determined by EFAC on the recommendation of GSC and that he had not attended any meetings of GSC or EFAC when such discussions took place.

Budget of HKMA

15. Ms Emily LAU noted from the "operating expenses of EF" on page 104 of Annual Report 2004 that in 2004, \$543 million (under the "Fund" account) and \$547 million (under the "Group" account) were spent on management and custodian fees. According to the information provided by HKMA to the Panel in April 2004 (the footnote in LC Paper No. CB(1)1686/03-04(01)), such fees were market expenses of EF which covered trading and custodian costs and fees for hiring external managers to mange EF. Ms LAU expressed concern that the fees were on the high side. She further questioned the need for employing external managers to manage EF since HKMA was responsible for managing EF.

16. CE/HKMA advised that about one third of the total assets of EF was managed by external managers, while the remaining was managed by the Reserves Management Department of HKMA, which had an establishment of 46 staff. On the concern about the substantial fees for hiring external managers to manage EF, CE/HKMA pointed out that the fees were below 1% of the total assets of EF being managed by the external managers. The rate was substantially lower than that

charged by fund mangers for managing funds of comparable size in the market, which usually ranged from a rate of 1% to 2% of the total assets managed in the funds.

17. Ms Emily LAU was pleased to note that HKMA had, in response to her request raised last year, disclosed information on its expenses in the annual report. However, she considered that the information was not presented in a user-friendly manner and did not give a comprehensive picture of HKMA's budget. In this connection, she pointed out that while Table 3 on page 132 of Annual Report 2004 showed the "administration expenditure" of HKMA, the information was different from that set out in the "operating expenses of EF" on page 104 of Annual Report 2004. Ms LAU considered that information relating to HKMA's expenditure should be consolidated and presented clearly in future annual reports to facilitate Members' perusal. For instance, she suggested that all administrative and operating expenses of HKMA should be consolidated and presented in one table.

18. In response, CE/HKMA explained that the "administrative expenditure" as shown in Table 3 on page 132 of Annual Report 2004 represented the expenses incurred by HKMA for undertaking its own activities. The Table had provided information on HKMA's expenses in the 2004 Budget, the actual expenses in 2004 and the estimates in the 2005 Budget. The Table had excluded items such as "management and custodian fees" which were expenses incurred by EF. He explained that as HKMA's activities were funded by EF, the "operating expenses of EF" in 2004 on page 104 of Annual Report 2004 had included the "administrative expenditure" of HKMA for that year, which was set out under the heading of "Fund". In response to further enquiry by Ms Emily LAU, CE/HKMA explained that the figures shown under the heading of "Group" on page 104 of Annual Report 2004 represented the group accounts of EF which had consolidated the accounts of all subsidiaries of EF. The details of these subsidiaries were given under note 10 on page 107 of Annual Report 2004.

19. Referring to the existing arrangements under which the Administration would submit the draft estimates to the LegCo and the Securities and Futures Commission would present its annual budget to the Panel for information in March each year, Ms Emily LAU suggested that CE/HKMA should consider presenting HKMA's annual budget at his briefing to the Panel in February each year.

20. In response, CE/HKMA re-iterated that FS, on the advice of EFAC and GSC, had approved disclosure of information on HKMA's administrative budget for the current financial year in the context of HKMA's annual report starting from Annual Report 2004. He added that it had been a standing practice that HKMA's annual report be published in May each year.

Exchange rate policy of RMB and inflation in Hong Kong

21. Mr Jeffrey LAM enquired about any possible change in RMB exchange rate. CE/HKMA said that while market expectation about appreciation of RMB had

continued for over 18 months, any change had yet to materialize. He was of the opinion that changes in RMB exchange rate would be toward the direction of introducing more flexibility in the regime and such changes would take place in a measured pace. The extent of appreciation of RMB, if any, would not be large. As regards the impact on Hong Kong, CE/HKMA said that while appreciation of RMB would increase the competitiveness of Hong Kong's products, increases in prices of Mainland products might exert an upward pressure on consumer prices in Hong Kong.

22. Mr Jeffrey LAM noted that renewed market expectation of appreciation in the value of RMB had resulted in continuous capital inflows and kept Hong Kong dollar interest rates low. Mr LAM expressed concern about the risk of a rapid pick-up in inflation as easy monetary conditions in Hong Kong continued.

23. CE/HKMA said that the low interest rates and easy monetary environment had benefited Hong Kong's economic recovery and, to some extent, contributed to the increase in property prices and rentals in recent months. If the current easy monetary conditions persisted, there was risk that inflation might gather momentum. The CCPI for 2005 might increase from the moderate 1.5% as forecasted at end of 2004 to 2.5% by the end of 2005. CE/HKMA said that a large interest rate differential between the US dollar and the Hong Kong dollar should theoretically reverse capital inflows, thus helping to bring the monetary conditions back to normal. There would then be less risk of increasing inflationary pressure.

24. As a result of recovery in the property market, Mr LEE Cheuk-yan noted that prices of offices and retail shops had increased markedly by 111% and 77% from their trough levels respectively. Mr LEE expressed concern about the risk of increasing inflationary pressure and the likely negative impact of aggravating the poverty problem in Hong Kong. He urged the Administration to take early action to tackle the inflation problem and enquired what measures HKMA would take in this respect.

25. CE/HKMA stressed that it was essential for Hong Kong to adopt a credible monetary policy which best served it needs and suited the local situations. Given that the current objective of Hong Kong's monetary policy was to maintain stability of the exchange rate of the Hong Kong dollar through the operation of the Currency Board system under LER system, CE/HKMA pointed out that it would be inevitable that Hong Kong might experience volatilities in interest rates and domestic prices. He re-iterated that despite continuous capital inflows sustaining easy monetary conditions, there was not yet any sign of a significant pick-up in inflation pressure, hence there should not be immediate concern about the worsening of inflation problem in Hong Kong.

26. As regards the measures that HKMA would take to reverse capital flow and tackle the inflation problem, CE/HKMA stressed that LER system was operated according to rule-based Currency Board arrangements under which HKMA was

given little discretionary power. At banks' requests, HKMA had to sell Hong Kong dollar against US dollar when the exchange rate was on the strong side of the Link. Nonetheless, HKMA would closely monitor the situation of capital inflows and if necessary might take appropriate measures to refine existing arrangements to facilitate smoother operation of LER system. CE/HKMA also pointed out that he had been discussing the subject with FS, and that HKMA had been conducting research and studies on related topics. HKMA had also reminded banks of the importance of managing the interest rate risks properly and alerting borrowers to be aware of possible sharp increases in interest rates.

Impact of the development of property market on banking sector

27. Referring to HKMA's graphical analysis on page 28 of the power-point presentation material and improvement in the asset quality of banks as shown by the continuous decline in the number of residential mortgage loans in negative equity, Mr CHAN Kam-lam sought CE/HKMA's views on risks associated with the robust growth in the property market and the possible impacts on the banking sector.

28. CE/HKMA remarked that it would be extremely difficult to provide a scientific analysis of the development of Hong Kong's property market. He stressed that the purpose of the graphical analysis was to show the effect of five key property market indicators by using a pentagon, namely real property prices, transaction volume, buy-rent gap, income gearing and real new mortgages, at three periods of time from mid-1997. CE/HKMA pointed out that by early 2005, the size of the pentagon was substantially smaller than that for the period of April to September 1997 where market conditions were clearly out of line with the fundamentals at that time. Whilst this might suggest that the risk of a property bubble remained low at the moment, there was concern that if the US interest rates increased further, mortgage rates might rise more sharply than currently expected. CE/HKMA remarked that competition in the residential mortgage lending market had kept interest rates low, and there was concern about the risks banks were exposing themselves to in the use of large cash rebates when competing for new residential mortgage lending business, in particular when the mortgage borrowers could seek additional financing through mortgage insurance. This would enable borrowers to pay nil or nominal down payment in the purchase of property. In this connection, HKMA had stepped up its efforts in supervising bank's risk management by issuing a circular in February 2005 to all AIs reminding them of the need to monitor carefully the risks associated with residential mortgage lending and setting out the treatment of cash rebates and interest/repayment holidays within the context of the 70% guideline.

29. With a view to promoting the healthy development of the property market and enhancing transparency in the market, Mr CHAN Kam-lam suggested that HKMA should consider formulating a risk indicator for the property market based on the graphical analysis. The indicator would draw the public's attention to risks in the property market and give an early warning of a bubble market.

30. CE/HKMA cautioned that it would be inappropriate for HKMA to provide a risk indicator for the property market as this would lead to moral hazard. He stressed that mortgage borrowers should make their decisions on purchase of property with regard to their financial position and affordability. He added that the graphical analysis could be improved by adding new indicators, such as the proportion of confirmor transactions among the total number of transactions made over a period of time. Such an indicator would help demonstrate the extent of speculative activity in the market. For instance, the number of confirmer transactions accounted for 4% of total transactions in recent months as compared with the high level of 8.4% in mid-1997. This might suggest lower risk of a property bubble at the moment.

Performance of Exchange Fund

31. Mr Ronny TONG noted that FS would, in preparing the Government's budget, project the annual investment return for the fiscal reserves placed in EF, i.e. the Treasury's share in the overall investment return of EF. In this connection, an amount of $14 billion was projected in the 2005-06 Budget. Mr TONG was concerned whether FS had consulted CE/HKMA with a view to working out an accurate projection.

32. In reply, CE/HKMA explained that the existing arrangement under which the fiscal reserves placed with EF shared the same rate of investment return achieved by the entire EF in a year was introduced in 1998. CE/HKMA stressed that while FS would seek his views in working out the target investment return for the fiscal reserves placed with EF when preparing his Budget, the estimated investment return as set out in the Budget was only a target. It would be impossible to make an accurate estimate on such target as the investment income of EF was subject to volatility in the global financial market.

33. Given that the investment return of EF was subject to volatility in the global financial market, Mr Ronny TONG pointed out that there would be fluctuations in the Treasury's share, thus creating difficulties for the Government to project its income. In this connection, Mr TONG enquired whether the Administration/HKMA would consider alternative arrangements for calculating the Treasury's share so as to provide the Government with a more stable source of income. For instance, adopting a fixed sum or fixed rate of return, or transferring part of the accumulated surplus of EF to the general revenue.

34. CE/HKMA agreed that there were other means for calculating the Treasury's share, such as adopting an average rate of investment return achieved by EF over a period of time, with a view to reducing the volatility in the investment income for the fiscal reserves. He said that the matter was under on-going review by FS. As regards the use of the fiscal reserves placed with EF and the accumulated surplus of EF, CE/HKMA stressed that these assets were owned by Hong Kong people and it was justified to use them for the benefits of the public. Nonetheless, these assets were placed with EF for strengthening its resources in maintaining the stability of the Hong

Kong dollar. While theoretically, it was sufficient to maintain the size of EF at a level equivalent to the level providing full backing for the Monetary Base, the Government had in 1998 deployed a much higher amount than the Monetary Base at that time in defending the Hong Kong dollar against manipulative attacks. The experience indicated the need for maintaining a sizable EF for Hong Kong to withstand currency attacks and meet risks and vulnerabilities in the external monetary environment. As the Monetary Authority, CE/HKMA considered it necessary for him to adopt a prudent approach in maintaining the level of EF. However, CE/HKMA stressed that the use of EF was governed by the Exchange Fund Ordinance (EFO) (Cap. 66), which provided that the Fund should be under the control of FS, and be used primarily for such purposes as FS thought fit for affecting the exchange value of the currency of Hong Kong and other purposes incidental thereto. He added that, apart from these primary purposes, FS might, after consulting EFAC and with the prior approval of the Chief Executive in Council, transfer from EF to the general revenue any sum or part of any sum where he was satisfied that such transfer was not likely to affect adversely his ability to fulfill any purposes for which EF was required to be or might be used under EFO.

Deposit Protection Scheme

35. Mr SIN Chung-kai enquired about the progress of the preparatory work for the implementation of DPS in Hong Kong. CE/HKMA said that HKDPB, which was established in July 2004 following the enactment of the Deposit Protection Scheme Ordinance in May 2004, had achieved good progress in making the necessary preparations for launching DPS. It was expected that DPS would be ready to start providing deposit protection in the second half of 2006. On a further enquiry by Mr SIN about the coverage of DPS, CE/HKMA confirmed that the Scheme would not provide protection in respect of deposits taken by banks from depositors at their overseas branches outside Hong Kong.

Internet banking fraud

36. Mr CHIM Pui-chung noted from a recent complaint that due to deficiencies in security control in an AI's internet banking system, a customer of the AI had suffered a substantial financial loss as a result. The case was subsequently settled between the AI and the customer. Mr CHIM was concerned whether HKMA was aware of the incident and enquired about the follow-up actions taken by HKMA.

37. In response, CE/HKMA said that HKMA had the responsibility to regulate the banking sector with the objectives of maintaining the stability and integrity of the banking system of Hong Kong and promoting protection of depositors' interests. There were provisions in statutory guidelines issued by HKMA requiring AIs to put in place sound and effective systems for safeguarding interests of their customers and properly managing risks arising from their business operations. Moreover, AIs were required to notify HKMA on breaches of requirements so that HKMA would decide whether and what follow-up actions should be taken. CE/HKMA stressed that

HKMA would ensure AIs' compliance with all necessary requirements through taking supervisory actions on a continuous basis. As regards the case referred to by Mr CHIM Pui-chung, CE/HKMA said that section 125 of the Banking Ordinance (Cap. 155) prohibited staff of HKMA from disclosing information relating to individual AIs gathered during the course of supervisory actions.

V. Consultation conclusions on legislative proposals to establish Financial Reporting Council

(LC Paper No. CB(1)1312/04-05(07) — Paper provided by the Administration

LC Paper No. CB(1)1020/04-05(04) — Paper provided by the Administration (with consultation paper on the legislative proposals to establish the Financial Reporting Council)

LC Paper No. CB(1)1020/04-05(05) — Background brief prepared by the Legislative Council Secretariat

LC Paper No. CB(1)1311/04-05 — Minutes of meeting on 7 March 2005 (Agenda Item V))

Briefing by the Administration

38. At the Chairman's invitation, the Secretary for Financial Services and the Treasury (SFST) briefed members on the outcome of the public consultation on the legislative proposals to establish the Financial Reporting Council (FRC) and the Administration's proposed way forward. He highlighted the following points:

(a) As the Administration briefed members on 7 March 2005, it had launched a public consultation on the FRC proposal on 28 February 2005 through a "Consultation Paper on the Legislative Proposals to Establish the Financial Reporting Council" (the Consultation Paper) which set out the detailed proposals in respect of the composition and funding of the FRC, its powers and functions, checks and balances, as well as miscellaneous matters.

(b) The consultation closed on 15 April 2005. As at 5 May 2005, the Administration received a total of 28 submissions. The overwhelming majority of the respondents indicated support for the establishment of the FRC. They considered that the proposal was in the right direction and would help strengthen the oversight of auditors and enhance the quality of financial reporting of listed entities in Hong Kong.

(c) At the Panel meeting on 7 March 2005, members sought further information on three matters namely, the circumstances in Hong Kong that justified the establishment of the FRC; the question of possible "regulatory overlap" (i.e. division of roles and responsibilities among the relevant bodies); and a comparison of the FRC proposal with similar set-up in other jurisdictions. The Administration's responses were set out in paragraphs 8 to 16 of its paper (LC Paper No. CB(1)1312/04-05(07)).

(d) Regarding regulatory regimes for the accounting profession in other jurisdictions, a comparison table covering Hong Kong, Australia, the United Kingdom (UK) and the United States (US) was provided in Annex C to the Administration's paper. There was a general trend in all jurisdictions towards greater independence from the accounting profession in the oversight of auditors and listed companies' financial reporting. As far as the FRC proposal was concerned, the part of the proposal related to the Financial Reporting Review Committee (FRRC) was generally modelled on the similar set-up in the UK, in terms of its functions, powers and composition. As for the proposed Audit Investigation Board (AIB), the Administration's proposals were similar to Australia, UK and US in areas such as investigatory work being conducted by bodies other than the professional associations, but different in one aspect, i.e. AIB's role and functions being confined to investigation only rather than encompassing disciplinary proceedings against an auditor.

(e) The FRC proposal recognized the importance of reassuring the market and the investing public that Hong Kong's financial reporting and corporate governance frameworks were and would continue to be robust. The proposal had the full support of the Hong Kong Institute of Certified Public Accountants (HKICPA), Securities and Futures Commission (SFC), and Hong Kong Exchanges and Clearing Limited (HKEx). The Administration and these parties had agreed to contribute to the funding of the FRC on an equal share basis. In the light of the overwhelming support received during the recent public consultation, the Administration aimed at introducing a bill into LegCo within the 2004-05 session to take forward the FRC proposal.

39. Upon the Chairman's invitation, <u>the Deputy Secretary for Financial Services and the Treasury (Financial Services) (DS/FST(FS))</u> took members through the summary of written submissions and the Administration's responses in Annex B to the paper. She said that the Administration took note of the views and suggestions in the submissions and where appropriate would incorporate them in the bill.

<u>Discussion</u>

Proposal to establish the FRC

40. Mr Ronny TONG re-iterated his concern expressed at the Panel meeting on 7 March 2005 that given that HKICPA was empowered under the Professional Accountants Ordinance (PAO) (Cap.50) to investigate into cases of misconduct and irregularities of the accounting profession, the proposed FRC would overlap with the investigation duties of HKICPA.

41. In response, SFST advised that on any suspected breaches of the professional ethics and standards specified by HKICPA, the Council of HKICPA (HKICPA Council) might constitute an Investigation Committee to undertake investigation of the case where it reasonably suspected or believed that there were justifications for doing so. An Investigation Committee was required by law to report the outcome of its investigation to the HKICPA Council. On the basis of the Investigation Committee's findings, the HKICPA Council might constitute a Disciplinary Committee to determine whether disciplinary action should be taken and if it should, the appropriate disciplinary action. For suspected criminal offences committed by auditors, the HKICPA Council would refer them to the law enforcement agency for appropriate action. SFST added that the Professional Accountants (Amendment) Ordinance 2004 enacted in July 2004 had expanded the membership and composition of Investigation Committee and the Disciplinary Committee to include more lay persons.

42. On the concern about possible overlap of investigatory functions of the FRC and HKICPA, SFST pointed out that upon its establishment, AIB under the FRC would investigate auditors' irregularities involving listed entities, whereas HKICPA would continue to deal with cases in the non-listed sector. In a nutshell, the FRC would simply take over from HKICPA the responsibility for investigating the irregularities of auditors concerning listed corporations and listed collective investment schemes. Moreover, as a transitional arrangement, the FRC would not deal with those cases which took place before its establishment and had been received by HKICPA. Hence, there would not be any overlap of the investigatory functions of the FRC and HKICPA. SFST also pointed out that the set-up and investigatory power of AIB would address the need to enhance the independence of investigation of the audits of listed corporations and the concern about the lack of adequate power under PAO to require non-HKICPA members to produce documents or provide information, thus enhancing the effectiveness and efficiency of the investigation of auditors' irregularities. Furthermore, the proposed FRRC would fill the existing gap of the lack of statutory powers of HKICPA and HKEx to enquire into non-compliance of financial reports of listed companies and request companies to take necessary rectifications.

43. Given the existing transparent self-regulatory regime of the accounting profession and the fact that HKICPA was empowered under PAO to investigate into cases of misconduct and irregularities of the accounting profession, Mr Ronny TONG queried the role to be played by the proposed FRC. Moreover, as the function of the

FRC was purely investigatory and that it might, upon completion of the investigation, refer a case of auditors' irregularities to HKICPA for disciplinary action or to the law enforcement bodies for criminal investigation, Mr TONG was concerned that the investigation reports of FRC were not connected with the subsequent "prosecution" work of HKICPA or the law enforcement bodies. As a result, HKICPA or the law enforcement bodies might have to conduct its own investigation to collect the required evidence and use the investigation reports of FRC as a reference only. This would result in duplication of efforts and wastage of resources. As such, the FRC would not expedite the investigation and handling of auditors' irregularities. Mr TONG urged the Administration to address this concern and consider the following two possible options:

(a) To empower the FRC to undertake "prosecution" after investigation; or

(b) To put in place a mechanism for HKICPA or the law enforcement body to set out the suspected irregularities, including stating all possible offences of an auditor, for the FRC to undertake investigation to collect the relevant evidence.

44. SFST advised that during the first consultation conducted in late 2003, the vast majority of the respondents supported that the function of the FRC should remain purely investigatory. SFST stressed that the FRC would not be a regulatory body per se. The power to impose disciplinary and criminal sanctions on the auditors who had committed irregularities should continue to be vested with HKICPA and the relevant law enforcement bodies respectively. Given that the accounting profession was subject to a self-regulatory regime, HKICPA rather than the Government was responsible for regulating the profession.

45. DS/FST(FS) supplemented that the proposal of establishing the FRC was put forward by HKICPA and had the support from the public, SFC and HKEx. She further explained that under the present proposal, AIB would initiate investigation on suspected auditor's irregularities of listed corporations where justified on receiving complaints or referrals from relevant bodies. AIB would carry out investigation with its statutory powers. The investigation report would be submitted to the FRC which would then decide on the necessary follow-up actions, including referring the case or disclosing the relevant information to HKICPA for consideration of disciplinary actions if the case was related to auditors' professional standards or ethics; or to law enforcement bodies, such as the Police, for consideration of prosecution if the case was related to criminal offences. For a case referred to HKICPA, its Council would decide whether further investigation would be needed and whether disciplinary action should be taken under PAO. In order to facilitate the disciplinary proceedings of HKICPA, AIB would provide the necessary assistance to HKICPA, such as disclosing the evidence obtained during the investigation to HKICPA and giving evidence during the proceedings. As for a case referred to law enforcement bodies, AIB would also provide assistance in the prosecution process or follow-up investigation where appropriate.

46. Mr CHAN Kam-lam echoed Mr Ronny TONG's concern that if the function of the FRC was purely investigatory, it would become a toothless tiger. It was highly likely that HKICPA or the law enforcement bodies would have to conduct its own investigation to collect the required evidence and use the investigation reports of the FRC as a reference only. To address this concern, Mr CHAN suggested that, in addition to referring its investigation reports to HKICPA or the law enforcement bodies, the FRC should be empowered to make recommendations on the necessary follow-up actions to be taken on the cases. This arrangement would enhance the credibility of the FRC's work and avoid the complication of involving AIB in the disciplinary proceedings of HKICPA or the prosecution process of the law enforcement bodies.

47. In response, SFST pointed out that Mr CHAN Kam-lam's suggestion would have the implication of subjecting the accounting profession to the regulation of the Government, and would also have wide implications on the self-regulatory regimes of other professions. In fact, the self-regulatory regime of the accounting profession had been enhanced by the enactment of the Professional Accountants (Amendment) Ordinance 2004 in July 2004 and would be further enhanced by the present proposal of establishing the FRC. SFST stressed the importance of making improvements to the regime step by step and reviewing it from time to time.

48. Mr Ronny TONG expressed support for maintaining the self-regulatory regime for the accounting profession. However, he re-iterated his concern about the lack of connection between the investigatory work of the FRC and the disciplinary work of HKICPA and prosecution work of the law enforcement bodies.

49. Ms Emily LAU and Miss Mandy TAM expressed support for the proposal of establishing the FRC in principle and maintaining the self-regulatory regime for the accounting profession. Ms LAU also urged the Administration to refine the details of the proposal and examine how the concerns expressed by Mr Ronny TONG could be addressed.

50. SFST took note of Mr Ronny TONG's concerns and suggestions expressed in paragraph 43 above and undertook to explore, in consultation with HKICPA, how the concerns could be addressed.

> (*Post-meeting note:* The Administration's responses were circulated to members and non-Panel Members vide LC Paper No. CB(1)1805/04-05(02) on 16 June 2005.)

51. Mr SIN Chung-kai said that the LegCo Members of the Democratic Party supported the proposal of establishing the FRC in principle. He considered that the Administration should further refine the details of the proposal and consider how the concerns expressed at this meeting could be addressed. In this connection, Mr SIN pointed out that the proposal was introduced to address the public concern about the

integrity of the auditing profession and accuracy of financial reporting given the corporate scandals in the US and suspected cases involving false financial reports of listed companies in Hong Kong in recent years. He considered that apart from putting forward the present proposal, the Administration should also enhance the disclosure requirements on listed corporations by making reference to the disclosure regime adopted in the US.

Admin

52. Mr CHIM Pui-chung was concerned that the proposal of establishing the FRC might impose more obligations on auditors of listed corporations and might therefore have cost implications on listed corporations because their auditors might charge higher fees for providing better services. He also requested the Administration to consider whether it was fair for the proposal to aim at enhancing the regulation of the accounting profession only but not the regulation of HKEx.

53. In response, SFST pointed out that at present, professional accountants were required to comply with the relevant professional standards and statutory requirements. The proposal of establishing the FRC would not impose additional obligations on auditors in their work for listed corporations. He further pointed out that SFC, as the regulator, had the duty to monitor the work of HKEx, and both parties had their own duties over listing under the dual filing system.

Summary of written submissions on the legislative proposals of establishing the FRC

54. Ms Emily LAU noted from Annex A to the Administration's paper that one of the respondents to the consultation had requested its name not to be disclosed. She enquired whether the respondent's views had been incorporated in the summary provided in Annex B to the Administration's paper.

55. In response, DS/FST(FS) explained that in general, if the respondents to a public consultation exercise did not request for not disclosing their views, the Administration would consolidate and present their views in the summary of submissions. For the present case, DS/FST(FS) undertook to check and confirm whether the views expressed by the respondent referred to by Ms Emily LAU had been incorporated in the summary provided in Annex B to the Administration's paper.

(*Post-meeting note:* The Administration confirmed that the views expressed by the respondent had been incorporated in the summary (LC Paper No. CB(1)1805/04-05(02) issued on 16 June 2005).)

56. In this connection, Ms Emily LAU expressed concern that in the event that some respondents to a public consultation exercise requested their names and views not to be disclosed, the public would not have a full picture of the views collected during consultation and would not know whether the Administration had taken on board their views. She opined that the Administration should consider how such a situation should be handled.

Admin

57. Ms Emily LAU enquired about the Administration's responses to the comments on the modus operandi of the FRC in paragraphs 17 and 18 of Annex B to the Administration's paper about the implication of the publication of FRC's investigation/enquiry reports and the need to provide auditors with statutory immunity in reporting to the FRC on any suspected fraud or irregularities in audits. DS/FST(FS) said that the Administration had noted the comments. It was envisaged that the FRC would consider the need to work out appropriate guidelines governing the publication of FRC's investigation/enquiry reports and would incorporate in the relevant bill the provisions to provide statutory immunity to auditors where appropriate.

Conclusion

58. The Chairman concluded that a great majority of the members present supported the Administration's proposal of establishing the FRC. He urged the Administration to discuss with HKICPA in order to address Mr Ronny TONG's concerns.

59. Responding to the Chairman' enquiry about the legislative timetable for the relevant bill, SFST said that subject to the outcome of further consultation with HKICPA, the Administration would introduce the bill into LegCo within the 2004-05 session.

VI. Review of the disclosure of interests regime under Part XV of the Securities and Futures Ordinance

(LC Paper No. CB(1)1312/04-05(08) — Paper provided by the Securities and Futures Commission)

Briefing by the Securities and Futures Commission

60. Upon invitation by the Chairman, Mr Peter AU-YANG, Chief Operating Officer, SFC briefed members on SFC's main recommendations for improving the disclosure of interest regime based on the responses to the consultation paper on "Review of the Disclosure of Interests Regime under Part XV of the Securities and Futures Ordinance" (the Consultation Paper) published by SFC on 20 January 2005. He advised that there was general support for many of the proposals in the Consultation Paper. The main items in the Consultation Paper and SFC's recommendations were set out in paragraphs 7 to 12 of SFC's paper (LC Paper No. CB(1)1312/04-05(08)).

61. On the way forward, Mr AU-YANG said that implementation of SFC's proposals would include amendments to the Securities and Futures Ordinance (SFO) (Cap. 571), related rules and regulations, forms and codes, and certain guidelines on Part XV of SFO. In respect of changes to SFO, SFC was working with the Administration to include the more technical changes discussed in the Consultation Paper, including those discussed in paragraphs 7.1 to 7.5 of SFC's paper, into the Securities and Futures (Amendment) (No. 2) Bill 2005. For areas that were more complicated, including the three areas discussed in paragraph 8.1 (the de minimis exception), paragraph 9.1 (aggregation exemption) and paragraph 9.2 (credit derivatives) respectively, SFC would work closely with market players on the detail of the proposals so that legislative changes could achieve the intended purpose whilst keeping the relevant level of transparency. SFC would recommend the detailed changes required as soon as reasonably practicable. Where appropriate, SFC would also introduce changes to rules and regulations, forms and codes and certain guidelines, including those related to stock borrowing and lending disclosure regime discussed in paragraph 12 of SFC's paper.

(*Post-meeting note:* Mr Peter AU-YANG's speaking note was issued to members and non-Panel Members vide LC Paper No. CB(1)1472/04-05(01) on 9 May 2005.)

Discussion

Disclosure of share pledges

62. Mr CHIM Pui-chung pointed out that under Part XV of SFO, when security interests were given to "qualified lenders" (mainly licensed banks and brokers), no disclosure was necessary. It was only at the point that steps were taken to enforce the

security interests that disclosure was required. He indicated support for mandating the disclosure of security interests should the shares pledged reach a certain percentage of the issued share capital of a listed company in order to enhance protection for the interests of small investors. Mr CHIM noted that although the Consultation Paper had raised the issue, SFC had not recommended any improvement measures in this area. He enquired about SFC's plan on how the issue would be followed up.

63. In response, Mr Peter AU-YANG said that there were various arguments for and against disclosing security interests when the security interest was created. On the one hand there was the argument that investors had the right to know the existence of the security interest. On the other hand, there was the argument that the informational value of such disclosures did not justify the burden imposed on the market. In view of the lack of consensus on this issue among the various interest groups, no fundamental changes were being proposed at the present stage. SFC would set up a working group comprising market participants, investors and the lending industry to consider if there were better alternatives that would be beneficial to all. This would allow more time for a thoroughly considered decision to be made.

64. Mr CHIM Pui-chung pointed out that some US companies which were not licensed by SFC had been soliciting substantial shareholders of companies to lend shares for short selling in the market. He expressed concern about regulation of these lenders by SFC.

65. Mr Peter AU-YANG explained that under Part XV of SFO, qualified lenders and substantial shareholders were not required to make a disclosure when the shares were pledged by virtue of the "exempt security interests" provision. Ms Daphne DOO, Director (Supervision of Markets), SFC supplemented that qualified lenders included institutions properly regulated by authorities in recognized jurisdictions. Mr AU-YANG stated that it was not clear whether those US companies referred to in paragraph 64 above would be covered by the exemption provision in Part XV of SFO. He added that SFC had not received complaints about these companies. Moreover, shareholders of companies should consider whether it was appropriate to deal with these companies and the risks involved in pledging shares with them.

66. Mr Ronny TONG pointed out that the Companies (Amendment) Bill 2004 currently scrutinized by the relevant Bills Committee of LegCo would entail changes to the concept of share holdings of companies under the Companies Ordinance (Cap. 32). He drew SFC's attention to the amendments enshrined in the Bill. Mr Peter AU-YANG took note of Mr TONG's view and said that the SFC would examine the issue and bear this in mind when proposing changes to Part XV.

Conclusion

67. There being no further question from members, the Chairman concluded the discussion. He said that the Panel supported in principle the legislative proposals as set out in the SFC's paper.

VII. Any other business

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

Council Business Division 1
Legislative Council Secretariat
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