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Legislative Council

LC Paper No. CB(1)614/05-06
(These minutes have been seen
by the Administration)

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Panel on Financial Affairs

Minutes of meeting
held on Monday, 7 November 2005 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 Dr Hon David LI Kwok-po, GBS, JP Hon CHAN Kam-lam, SBS, JP Hon Emily LAU Wai-hing, JP Hon Abraham SHEK Lai-him, JP Hon Jeffrey LAM Kin-fung, SBS, JP Hon Andrew LEUNG Kwan-yuen, SBS, JP Hon WONG Ting-kwong, BBS Hon CHIM Pui-chung Hon Albert Jinghan CHENG Hon TAM Heung-man
Members attending	:	Hon Mrs Selina CHOW LIANG Shuk-yee, GBS, JP Hon CHAN Yuen-han, JP Hon WONG Kwok-hing, MH Hon LEUNG Kwok-hung
Members absent	:	Hon James TO Kun-sun Hon SIN Chung-kai, JP

Public officers attending : Agenda item IV

Hong Kong Monetary Authority

Mr Joseph YAM, GBS, JP
Chief Executive

Mr William RYBACK, JP
Deputy Chief Executive

Mr Y K CHOI, JP
Deputy Chief Executive

Ms Julia LEUNG, JP
Deputy Chief Executive (Acting)

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)

Mr Albert LAM
Deputy Secretary for Financial Services and the Treasury (Financial Services)2

Mr Gordon W E JONES, JP
Registrar of Companies

Mr Charles W C BARR
Deputy Law Officer (Civil Law)
Department of Justice

Agenda item VI

Mr Henry TANG, GBS, JP
Financial Secretary

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

Mr Alan LAI, GBS, JP

Permanent Secretary for Financial Services and the Treasury (Treasury)

Miss Shirley YUEN
Administrative Assistant to Financial Secretary

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

Staff in attendance : Ms Connie SZETO
Senior Council Secretary (1)4

Ms Rosalind MA
Senior Council Secretary (1)8

Ms May LEUNG
Legislative Assistant (1)8

Action

I. Confirmation of minutes of meeting

(LC Paper No. CB(1)192/05-06 — Minutes of meeting on 13 October 2005)

The minutes of the meeting held on 13 October 2005 were confirmed.

II. Information papers issued since the regular meeting held on 4 July 2005

2. Members noted the following information papers issued since the regular meeting held on 4 July 2005:

(a) Process Review Panel for the Securities and Futures Commission Annual Report to the Financial Secretary for 2004 (LC Paper No. CB(1)1956/04-05);

(b) Securities and Futures Commission Quarterly Report for April to June 2005 (LC Paper No. CB(1)2187/04-05);

(c) Half-yearly Economic Report 2005 and the press release (LC Paper No. CB(1)2215/04-05);

(d) Mandatory Provident Fund Schemes Statistical Digest — June 2005 (LC Paper No. CB(1)2218/04-05);

(e) Six submissions on review of the Inland Revenue Ordinance and the Administration's written response (LC Paper Nos. CB(1)2260/04-05(01) to (07)); and

(f) Fourth progress report on the operation of the Loan Guarantee Scheme for Severe Acute Respiratory Syndrome Impacted Industries (LC Paper No. CB(1)164/05-06(01)).

III. Date of next meeting and items for discussion

(LC Paper No. CB(1)193/05-06(01) — List of outstanding items for discussion

LC Paper No. CB(1)193/05-06(02) — List of follow-up actions)

3. The Chairman informed members that the Administration had proposed the following items for discussion at the next regular meeting of the Panel to be held on Monday, 5 December 2005:

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

(b) Proposed introduction of a new category of "travel insurance agents".

4. On item (a) above, the Chairman pointed out that in accordance with established practice, 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. On item (b), the Chairman said that when the Panel was briefed on 4 July 2005 on the Administration's proposal to introduce a new category of "travel insurance agents", members had expressed reservation on whether the proposal was the best option to achieve the policy objective of encouraging Hong Kong people to take out travel insurance before they traveled, and requested the Administration to give further thought to the proposal and consider how the grave concern expressed by the insurance intermediaries could be addressed. The Chairman said that he understood from the insurance industry that it had accepted the proposal after further discussion with the Administration. In this connection, the Administration had prepared an information paper reporting to the Panel on the progress of the Insurance Authority's discussion with the insurance industry. The paper would be issued to members shortly. The Chairman invited members to consider whether there was a need for the Panel to discuss the item at the next meeting after studying the information paper. Ms Emily LAU suggested that the Panel should discuss the item at the next meeting.

5. Members agreed that items (a) and (b) above be placed on the agenda for the meeting on 5 December 2005. Given that FS had other official commitment after

11:00 am that day, members agreed that the Panel meeting be held from 9:00 am to 12:00 noon.

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

(LC Paper No. CB(1)193/05-06(03) — Paper provided by the Hong Kong Monetary Authority

LC Paper No. CB(1)217/05-06(01) — Press release on "Expansion of renminbi business" issued by the Hong Kong Monetary Authority on 1 November 2005

LC Paper No. CB(1)224/05-06(01) — Background brief on "Deregulation of interest rate rules" prepared by the Legislative Council Secretariat)

Briefing by the Hong Kong Monetary Authority

6. At the invitation of the Chairman, the Chief Executive of the Hong Kong Monetary Authority (CE/HKMA) gave a power-point presentation on HKMA's key areas of work. CE/HKMA highlighted the following points:

(a) On currency stability, the three refinements to the Linked Exchange Rate (LER) system introduced in May 2005 had achieved the purposes they were designed for. The three refinements had been effective in removing the easy monetary conditions in the preceding 18 months and thereafter in keeping the Aggregate Balance and money market conditions stable. They also re-established the traditional tight link between Hong Kong dollar and the United States (US) dollar interest rates, dampened speculative capital inflows related to market expectations on a renminbi (RMB) appreciation, and enabled the Hong Kong dollar exchange rate to react calmly to the announcement of the People's Bank of China on the reform of the RMB exchange rate regime on 21 July 2005. The discount in the one-year forward exchange rate narrowed from around 1 000 pips in January 2005 to about 50 pips currently, reflecting enhanced market confidence in the LER system after the implementation of the three refinements.

(b) On the external factors affecting currency stability, high oil prices were the key factor. Further increase in oil prices would have significant impact on global growth. For example, a stronger feeding through to core inflation might trigger more aggressive monetary tightening by major central banks, such as the US. Moreover, further increase in oil prices would result in the transfer of foreign reserves from the oil importing countries to the oil exporting countries, thus affecting the global distribution of foreign reserves and the international financial markets. Given that Hong Kong economy was service-oriented and did not rely heavily on oil, the direct impact of higher oil prices on the Hong Kong economy would be relatively small.

(c) Two other external factors were US current account deficits and RMB exchange rate. The US current account deficits, which had continued to grow and reached 6.3% of GDP in the second quarter of 2005, might have impact on the global monetary stability. In October 2005, some officers of the US Federal Reserves Board had indicated that the current account deficits revealed that there was a stable disequilibrium of the global trade and financial conditions, and CE/HKMA was concerned that an unstable process might have to be gone through before restoring equilibrium. As regards RMB exchange rate, it had remained strong after the introduction of the reform of the exchange rate regime on 21 July 2005.

(d) On the Hong Kong interest rate hikes in excess of the US interest rate increases, it should be noted that individual banks were free to determine their deposit and lending interest rates since the deregulation of interest rate rules (IRRs) in 2001. In other words, the interest rates were determined by competitive market forces. The decision to deregulate IRRs, which was supported by the general public and LegCo, was a correct decision. It had encouraged competition, which resulted in the reduction in net interest margin of banks from 2.3% in 1996 to 1.6% in 2005, and the decrease in mortgage rate and the narrowing interest rate spread (saving deposit rate minus mortgage rate). As a whole, the deregulation of IRRs had benefited the depositors and borrowers.

(e) On the domestic factors affecting currency stability, Hong Kong's economic recovery remained robust. Real GDP grew by 6.8% in the second quarter of 2005 over a year earlier. While the Composite Consumer Price Index rose modestly in recent months, the risk of a sharp increase in inflation remained low. Property prices had increased significantly from the trough in 2003 despite some moderation in recent months. While a graphical presentation of key real estate indicators suggested that the property market was still some way off from its previous high in 1997, the risk of a bubble could not be ruled out. Such a risk had been lessened with the dampening effect of the interest rate hikes since March 2005 on property market activities. Alongside the economic recovery, the Government's fiscal position had improved since the fourth quarter of 2003.

(f) On banking sector performance, the banking sector remained well-capitalized despite keen competition. There was a slight decline in total domestic lending in the third quarter of 2005, which might be caused by the interest rate hikes. The quality of banks' consumer portfolio improved, as demonstrated by the declining trend in credit card charge-off and delinquencies. The number of residential mortgage loans in negative equity increased slightly by about 300 cases to some 9 000 cases with an aggregate value of HK$16 billion, at the end of September 2005. Despite the increase, the problem of negative equity had eased substantially by 91% from the peak of about 106 000 cases in June 2003. HKMA would continue to monitor the number of cases and the aggregate value relating to residential mortgage loans in negative equity.

(g) On the progress of the implementation of Basel II in Hong Kong, four packages of proposals had been released for consultation, covering various implementation issues and weighting framework at the core of Basel II. Proposals on the revised capital standards were being translated in Capital rules and Disclosure Rules, which were subsidiary legislation. As regards prevention of money laundering, HKMA introduced a structured self-assessment framework in June 2005 to strengthen further the monitoring of anti-money laundering compliance within the banking industry. To further strengthen security controls in internet banking transactions, HKMA required banks offering high-risk retail internet banking transactions to implement two-factor authentication. By the end of June 2005, around 250 000 customers had registered for the service. On the other hand, preparation for the launch of the Deposit Protection Scheme had made good progress and it was expected that the Scheme would start collecting contributions in the second half of 2006.

(h) The Financial Infrastructure Sub-Committee of the Exchange Fund Advisory Committee had completed its review of financial infrastructure development. Having regard to the major opportunities and challenges that Hong Kong was expected to face in the coming years, it was considered that the strategy should be to develop a safe and efficient financial infrastructure based on a multi-currency, multi-dimensional platform. The implementation of the recommendations arising from the review was making good progress.

(i) As regards the reinforcement of the position of Hong Kong as an international financial centre, HKMA had been driving the design and implementation of the Asian Bond Fund 2. Moreover, co-operation and co-ordination with the Mainland's financial authorities had advanced well and would become increasingly important. HKMA would continue discussion with Mainland authorities on using RMB to settle cross-border trade and issuance of RMB bonds in Hong Kong. Other projects for promotion of the local bond market and improvement of important clearing and settlement systems were also in good progress.

(j) Regarding the performance of the Exchange Fund (EF), the investment outlook of EF was full of challenges given the volatility of the financial markets. The Treasury's share of the EF investment income in the first three quarters of 2005 amounted to only $7.7 billion. Given that the investment outlook for the fourth quarter was not so certain, it might be difficult to meet the target of $14.1 billion set by the Treasury.

(*Post-meeting note:* Updated version of the power-point presentation material was issued to members and non-Panel Members vide LC Paper No. CB(1)240/04-05 on 8 November 2005.)

Discussion

Revaluation of RMB and expansion of RMB banking business

7. Given the frequent economic activities between Hong Kong and the Mainland, Mr Jeffrey LAM was concerned that in the event of further revaluation of RMB, the resulting capital inflow to Hong Kong would affect the stability of the Hong Kong dollar and cause inflation.

8. In reply, CE/HKMA said that there had been repeated episodes of capital inflow in the past with market speculation of RMB revaluation, which had resulted in low levels of Hong Kong dollar interest rates and loose monetary conditions. The three refinements to the LER system introduced in May 2005 had helped to remove the easy monetary conditions and reduce the impact of the reform of RMB exchange rate regime announced in July on the exchange rate of Hong Kong dollar. It was expected that the revaluation of RMB would not have any significant impact on Hong Kong dollar unless the revaluation was sudden and drastic. The LER System in Hong Kong should be able to cope with the challenges of short-term capital inflows and interest rate fluctuations.

9. Pointing out that expansion of RMB business would be beneficial to the economy of Hong Kong, Mr Andrew LEUNG enquired about the efforts made by HKMA in facilitating the rapid development of RMB business.

10. In response, CE/HKMA said that the capability of Hong Kong in handling transactions in RMB was the pre-requisite for it to play a meaningful role in facilitating financial intermediation in the Mainland, i.e. to mobilize and effectively channel domestic savings in the Mainland into the hands of those raising funds for their economic activities in the Mainland. This was also crucial to reinforcing the status of Hong Kong as an international financial centre. CE/HKMA advised that in seeking expansion in the scope of RMB business, people in Hong Kong must also appreciate the risks that rapid financial liberalization might pose to the stability of the

financial system in the Mainland, which were relatively high under the influence of globalization and revolution of information technology. It was understandable that Mainland authorities were concerned about the impact of outflow of RMB on the financial and currency stability in the Mainland. Not only HKMA but also the Chief Executive and government officials had made a lot of efforts in discussing with Mainland authorities on the further expansion of RMB business in Hong Kong.

11. Ir Dr Raymond HO opined that the increase in cross-border economic activities and further liberalization of RMB exchange rate regime might increase the circulation of RMB in Hong Kong. He was concerned that the volume of circulation of RMB, up to a certain level, might have adverse impact on the economy of Hong Kong. In this connection, he enquired whether measures could be taken to minimize the impact. Mr Jeffrey LAM expressed similar concern about the impact of the development of RMB business on the international status of Hong Kong dollar.

12. In reply, CE/HKMA said that it was anticipated that in the long run, with further liberalization of the RMB exchange rate regime and the acceptance of RMB for trade settlement in the global markets, there would be a higher volume of cross-border transactions being settled by RMB in Hong Kong, thus increasing the circulation of RMB. CE/HKMA however pointed out that the rationale for the promotion of RMB business in Hong Kong was no different from that for other major foreign currencies, i.e. to facilitate the orderly transaction of economic activities. Hong Kong, being an externally-originated economy, had all along been settling transactions with its business partners from all over the world in different types of foreign currencies. There was nothing mysterious about a currency and its major function was to act as a medium of exchange. Hence, the use of RMB for settling cross-border transactions or the increase in its circulation would unlikely pose any threats to the Hong Kong dollar or the economy of Hong Kong. On the contrary, there might be benefits gained from the facilitation of business transactions in Hong Kong.

Interest rate hikes

13. While stating her support for the removal of IRRs, Ms Emily LAU noted CE/HKMA's comment reported by the media that the recent interest rate hikes in excess of the US interest rate increases were out of expectation. In this connection, Ms LAU sought CE/HKMA's views on the recent interest rate adjustment. Miss TAM Heung-man was also concerned whether the gap between the interest rates offered by banks in Hong Kong and the US interest rates, if persisted, would affect the monetary stability of Hong Kong.

14. CE/HKMA explained that he had no strong views on banks' decisions to increase their interest rates in excess of the US interest rates increases. The difference in interest rates offered by individual banks would not have any significant impact on the monetary stability of Hong Kong. The comments that he made on the issue was an attempt to manage the possible risks to the financial market and to draw the

attention of banks to avoid giving the public perception of "leap frogging" in interest rate adjustments. CE/HKMA stressed that HKMA had a clear stance in support of the removal of IRRs and for interest rates to be determined by competitive market forces, as this would be in the interest of depositors as well as borrowers.

15. Mr Ronny TONG agreed that interest rates should best be determined by competitive market forces. Nevertheless, he considered it crucial for HKMA to pay special attention to the determination of interest rates through agreement among banks, which would be against the principle of fair competition. In reply, CE/HKMA assured members that HKMA attached importance to the maintenance of fair competition in the banking sector. He pointed out that during his contacts with the representatives of the Hong Kong Association of Banks in a recent visit to Beijing, he had passed on a very clear message to the banking sector to avoid giving the public perception of "leap frogging" in interest rate adjustments.

16. Responding to Ms Emily LAU's enquiry on HKMA's study on an alternative reference rate for setting mortgage rates, CE/HKMA said that the alternative reference rate, or the so called "composite rate", was computed with reference to the cost of funds of banks. The "composite rate" would be more conducive to risk management of banks, while would at the same time enhance transparency in the determination of mortgage rates for borrowers' reference. He pointed out that while HKMA had planned to make available to the public the prevailing "composite rate" for reference, individual banks could make their own decisions on the reference rate to be used for setting mortgage rates.

Residential mortgages in negative equity

17. Mr Andrew LEUNG expressed concern about the recent interest rate hikes and the decline in residential property prices. Noting that there was a slight increase in the number of residential mortgages in negative equity, Mr LEUNG was concerned about the existence of a property bubble and whether the banking sector could cope with the risk if the bubble burst. In reply, CE/HKMA said that the risk of a property bubble burst was not high at the present stage given that property prices had declined by some 60% from the peak in 1997 and were still well below the peak levels despite the increases in the recent years. As to the risk management capability of the banking sector, CE/HKMA said that the banking sector had maintained very good capital adequacy ratio and performed well in risk management in collaboration with HKMA.

18. Mr CHAN Kam-lam was concerned about the impact of the rise in the number of residential mortgages in negative equity on the financial stability of Hong Kong and those who relied on mortgage loans for fund raising to support their business operations. In this connection, Mr CHAN sought up-to-date information on the number of cases and the aggregate value of the residential mortgages in negative equity.

19. In reply, CE/HKMA advised that the number of cases increased slightly by about 300 cases to some 9 000 cases with an aggregate value of HK$16 billion as at the end of September 2005. While the situation had improved significantly from the peak of about 106 000 cases in June 2003 with an aggregate value of over HK$100 billion, CE/HKMA agreed that the impact of the increase in the number of mortgages in negative equity should not be underestimated. For property buyers with mortgages in negative equity, it was understandable that the problem and anxiety was real. Moreover, the wealth of property buyers in Hong Kong at present might not be comparable with that of those back in 1997 to tide them over the difficult period. Notwithstanding the increase, provided that the economic recovery continued and the conditions of employment remained stable or continued to improve, property buyers would be able to repay their mortgage installments. Responding to Mr CHAN Kam-lam's further enquiry, CE/HKMA said that HKMA would examine what it could do in terms of educational work to facilitate property buyers in relieving their financial burdens.

20. Mr Ronny TONG was concerned that the increase in the number of mortgages in negative equity was a result of the intensified competition for mortgage business in the banking sector during the period of low domestic credit demand. He doubted whether this would threaten the stability of the banking system. In this connection, Mr TONG asked whether HKMA had provided the banking sector with any guidelines on risk management on residential mortgage business, in particular, in approving loans for second mortgages.

21. In response, CE/HKMA said that as the increase in the number of mortgages in negative equity was only recorded in the last quarter, it would be too early to say whether there would be an increasing trend and to assess the potential threats on the banking sector. He pointed out that given the keen competition of the banking sector and the low interest rate environment earlier this year, the mortgage rate had fallen to a low level of prime minus 2.8%. With the normalization of Hong Kong dollar interest rates, some banks had found it difficult to maintain a reasonable net interest margin on existing mortgages and thus had sought to increase the prime rate in excess of the increase in the US interest rates. As interest rates were determined by competitive market forces, banks would adjust the discount of the mortgage rate against the prime rate accordingly. In any case, banks had to observe the well-established guideline on the 70% loan-to-value ratio for mortgage loans. The capital adequacy ratios of banks were maintained at a healthy level and there was no concern on banking stability.

Economic growth

22. Miss TAM Heung-man was concerned that if the demand for goods and services dropped as a result of rising oil prices and unbalanced growth in the global economy, the economic recovery of Hong Kong, which was mainly driven by increases in net exports, might be adversely affected. In reply, CE/HKMA said that the growth of the global economy was not bad in general, despite the unbalanced

growth amongst economies in different regions. The rising oil prices could pose threats to the global economy. The impact on the economy of Hong Kong would hopefully be lessened with benefits from the economic growth in the Mainland. Nevertheless, Hong Kong should maintain its flexibility, especially the current flexibility in the labour market, in preparing itself for future shocks to its economic growth.

23. Ir Dr Raymond HO enquired whether there was an optimum interest rate level for Hong Kong to maintain the equilibrium between controlling inflation and reinforcing economic growth. In response, CE/HKMA said that under the LER system, Hong Kong did not have any interest rate policy. While it was expected that major central banks would give priority to controlling inflation by increasing interest rates if they had to make a choice, HKMA's responsibility was to deliver the monetary policy objective of exchange rate stability by maintaining a tight link with the US interest rates.

24. In the absence of interest rate policy, Ir Dr Raymond HO enquired about the possible measures to control any unbalanced growth of the Hong Kong economy. Noting that the circulation of US dollars in other economies had facilitated the development of the US economy, Ir Dr HO asked whether the Hong Kong economy could gain similar benefits through increasing the circulation of Hong Kong dollar in the global markets.

25. CE/HKMA responded that as the US was the largest market in the global economy, US dollar had been widely used as a medium of exchange in different countries. Nevertheless, the international status of a particular currency might be subject to changes having regard to factors such as the level of indebtness of the jurisdiction concerned, which might vary with global economic development. The limited amount of fiscal reserves and large amount of public debts of the US Government might have impact on the amount that capital investors wished to hold in US dollar in the long run.

Possible influenza pandemic

26. Referring to page 11 of the presentation material, Ms Emily LAU sought information on further details about HKMA's contingency plans in the event of an influenza pandemic. In response, CE/HKMA said that in the event of an influenza pandemic which would have widespread impact on social and economic activities, it would be crucial to ensure the continued operation of critical functions and services such as the clearing and settlement systems. He advised that HKMA would devise appropriate business contingency plan in this regard, with reference to the experience of the outbreak of the Severe Acute Respiratory Syndrome in 2003. This would cover not only HKMA itself but also banks and other critical service providers in the banking sector.

Involvement of the banking sector in non-banking businesses

27. Referring to the recent promotion of “commission free” securities transaction services by some securities subsidiaries of banks, Mr CHIM Pui-chung was gravely concerned that this would undermine the principle of fair competition in the securities industry as other securities intermediaries were not having the same scale and scope of business to offer “commission free” services to their customers. Mr CHIM also disagreed with the present arrangement for the regulation of securities business of banks and other intermediaries by different regulators, namely HKMA and the Securities and Futures Commission respectively. He pointed out that the securities industry objected to this arrangement and was considering some actions, such as demonstrations, to express their views. Mr CHIM was of the view that it was important for regulatory arrangement of the securities industry to strike a balance between maintenance of the status of Hong Kong as an international financial centre and interest of the majority of securities intermediaries.

28. In reply, CE/HKMA said that the prime objective of an international financial centre was to achieve efficient intermediation of funds. He pointed out that the current regulatory arrangements had been endorsed by the LegCo in the enactment of the Securities and Futures Ordinance. If the current regulatory arrangement was to be replaced, the question of one business corporation to be regulated by two regulators would have to be resolved. CE/HKMA also pointed out that the interest of securities intermediaries should not override the interest of the public at large. In general, consumers would benefit from increased competition in an industry as they would have more choices in the services provided. Small and medium securities intermediaries might consider enhancing their competitiveness through provision of quality and tailor-made services to their customers.

29. The Chairman pointed out that the problem raised by Mr CHIM Pui-chung also existed in the insurance industry. As a result of the expansion of insurance business of banks, insurance subsidiaries of banks had dominated the market share for insurance products. The Chairman was concerned that the low net interest margin of banks (at a level of only 1.6% in September 2005 as shown in page 14a of the presentation material provided by HKMA) would drive the banking sector to further expand their non-banking businesses for profit maximizing. He opined that fierce competition would threaten the stability of an industry when large number of competitors tried to fight for a larger market share by adopting low pricing strategies.

30. In response, CE/HKMA agreed that higher risks were involved for both borrowers and banks under extremely keen competition. Nevertheless, the low level of net interest margin of banks would certainly benefit investors and depositors alike. It would be the responsibility of regulators to advise the industries concerned to maintain a balance between profit making and risk management. As far as the supervision of the banking sector was concerned, CE/HKMA assured members that a proper balance had been maintained in risk management despite the keen competition.

V. Rewrite of the Companies Ordinance

(LC Paper No. CB(1)193/05-06(04) — Paper provided by the Administration

LC Paper No. CB(1)193/05-06(05) — Background brief prepared by the Legislative Council Secretariat)

31. The Chairman pointed out that according to the agreed arrangement between LegCo and the Administration, the Administration was required to provide a paper for a discussion item at least five clear days before the relevant Panel meeting. For this discussion item, the Administration had missed the agreed deadline (i.e. 31 October) by one day. The Chairman said that subject to there being no objection from members, the item would be discussed at this meeting. He however requested the Administration to endeavour to meet the agreed deadline for submission of papers in future. Ms Emily LAU supported the Chairman's request.

Briefing by the Administration

32. Upon the Chairman's invitation, the Secretary for Financial Services and the Treasury (SFST) briefed members on the staffing requirements, in particular the need to create four supernumerary directorate posts (two in the Financial Services and the Treasury Bureau (Financial Services Branch), and one each in the Companies Registry (CR) and the Department of Justice (DoJ)), for undertaking the rewrite of the Companies Ordinance (CO) (Cap.32). He highlighted the following points:

(a) The existing CO was largely based on the major United Kingdom (UK) company law reforms contained in the Companies Act 1948 and some subsequent reforms such as those contained in the Companies Act 1976. However, the CO no longer suited present day circumstances. While action had been taken to amend the CO from time to time, it had reached a stage where a rewrite of the Ordinance was considered necessary. This view was echoed by the Standing Committee on Company Law Reform (SCCLR) and the Bills Committees established to scrutinize the companies amendment bills in recent years. Members also indicated support for the rewrite exercise when the Panel was briefed on the subject at its meeting on 4 July 2005;

(b) The rewrite of the CO would bring about significant benefits to Hong Kong. The new CO would provide Hong Kong with a legal infrastructure which met its needs and was commensurate with its status as a major international business and financial centre, and provide investors with better protection. With streamlined and modernized regulation, Hong Kong company law would meet more fully the needs of, and help save compliance costs incurred by, more than half a million companies, both local and overseas, registered in Hong Kong. For instance, the wider use of electronic communications and the simplification of procedures for the conduct of company businesses would result in substantial savings for companies registered in Hong Kong;

(c) Given that the CO was one of the longest and most complex pieces of legislation in Hong Kong with over 600 sections and subsections and 20 schedules, the rewrite would be a major exercise involving a significant amount of work, including extensive legal/policy research into the existing provisions of the CO and the corresponding provisions as well as developments in company law taken place in other major common law jurisdictions, etc. DoJ had advised that the rewrite would probably be the largest ever conducted in respect of one ordinance in Hong Kong. Given that the key issues involved could be controversial, the Administration would conduct public consultations in stages;

(d) Having critically assessed the minimum staffing resources required for accomplishing the extensive and complex tasks in the rewrite exercise, the Administration considered that a total of seven supernumerary directorate staff plus 15 time-limited non-directorate staff were required for the rewrite. However, relevant bureaux and departments would meet over one third of the staffing requirements through internal deployment, i.e. three directorate posts and five non-directorate posts. As a result and at this stage, the Administration proposed to create four directorate posts and ten non-directorate posts. All the proposed posts were limited to a period between 24 months and 60 months; and

(e) The Administration fully agreed with members' views previously expressed about the need of ensuring cost-effectiveness of the rewrite exercise, expediting the exercise and allowing sufficient time for LegCo to scrutinize the new Companies Bill. The Administration had reviewed the proposed timeframe and considered it a reasonable estimate for the rewrite exercise to be completed in five years' time.

33. SFST said that the Administration intended to submit the proposals relating to the creation/re-deployment of directorate posts to take forward the rewrite exercise for endorsement by the Establishment Subcommittee (ESC) at its meeting in December 2005.

Discussion

Resource requirements for the rewrite exercise

34. While indicating support for the proposal of rewriting the CO, Ms Emily LAU considered that the estimated total cost of about $101 million was on the high side. In particular, she expressed grave concern about the need to create four supernumerary

directorate posts and ten non-directorate posts for a period of up to five years involving an estimated cost of $79 million. She was also concerned whether there would be any overlap between the work of the internal staff and that of the external consultant to be employed at an estimated cost of $19 to $22 million. Miss Mandy TAM also enquired about the need to engage an external consultant to assist in the rewrite exercise.

35. In response, SFST pointed out that given the complexity and enormous scale of the rewrite exercise, the proposed cost of $101 million was a stringent provision. He stressed that the cost would be spent over a period of five years. As regards the distribution of work, the Companies Bill Team (CBT) would have two integrated Policy and Legal Research Divisions, to be assisted by an external consultant who should be an expert in company law. The Permanent Secretary for Financial Services and the Treasury (Financial Services) (PSFS) added that the external consultant would advise on the review and rewrite of the relevant provisions on subjects which were highly complex and technical, such as share capital, capital maintenance, charges and security interests, etc. The consultant was expected to have suitable background, qualifications and experience in handling relevant complex legal issues, which/who might be a law firm, a legal professional such as an academic, a practising lawyer, or a retired judge.

36. Mr James TIEN indicated support of the LegCo Members of the Liberal Party (LP) for the proposal to rewrite the CO with a view to up-dating the Ordinance to meet present day circumstances and improve the business environment of Hong Kong. However, they queried the need to engage seven supernumerary directorate staff and 15 time-limited non-directorate staff for the rewrite exercise. Mr TIEN considered that the Administration should meet the staffing requirements, in particular the seven supernumerary directorate posts, through internal deployment. In this connection, he pointed out that the Coalition formed by the then eight political parties/groups in LegCo had reached an agreement in principle in 2002 on freezing the size of the directorate establishment. Under the agreement, the number of directorate posts in the civil service should be maintained at the 2002-03 level in order to contain public expenditure. As regards the duration for the new posts, Mr TIEN noted from Enclosure 3 of the paper provided by the Administration that, with the exception of one non-directorate solicitor post to be created in the CR for a period of 24 months, the duration for the remaining posts ranged from 36 months to 60 months. He queried the need for providing such a long duration for the posts.

37. SFST pointed out that the proposed staffing requirements were well justified and much needed to ensure that the new Companies Bill would be a quality piece of work and available within a reasonable timeframe. In fact, the Administration had critically examined the workload of the existing staff over the coming years and concluded that the relevant bureaux and departments would be able to meet over one third of the staffing requirements through internal deployment. Given the extensive nature and complexity of the rewrite which involved a complete overhaul of the existing CO, internal deployment could not cope with all the workload arising from

the exercise. It was therefore necessary to create four supernumerary directorate posts and ten non-directorate posts.

38. The Registrar of Companies (R of C) also pointed out that consideration had been given to setting up a CBT with one composite Division as opposed to two integrated Policy and Legal Research Divisions. However, it was considered not possible for one Division to be responsible for all the policy or research work to be undertaken by the CBT. First, the span of responsibility assumed by the legal and policy directorate officers of the sole Division for all the policy and legal officers working in the CBT would become far too wide having regard to the spectrum of the CBT's duties. This would certainly not be conducive to the effective and efficient supervision of the CBT's work which, in turn, would adversely affect the quality of the rewrite exercise. Secondly, a substantial part of the review was in connection with subjects which were highly complex and technical, such as share capital, capital maintenance, charges and security interests, etc., many of which basically had not been subject to any review. The setting up of two integrated Policy and Legal Research Divisions would enable work to proceed in parallel on a number of different fronts at the same time and ensure that sufficient time and resources would be available to consider particularly complex issues. R of C further pointed out that other jurisdictions like the UK, Australia, Singapore and Malaysia had set up dedicated teams of staff including staff whose ranks were pitched at senior level to undertake their company law reform exercises. Some of the jurisdictions had also engaged external consultants to assist in the work. R of C advised that, as the rewrite exercise would be funded by the Companies Registry Trading Fund (CRTF), the CR had a keen interest in ensuring that the exercise would be conducted in a cost-effective manner. He added that the CRTF had made a net profit of about $85 million in 2004-05. Against this background, it was envisaged that sufficient provision would be available under the CRTF to meet the estimated total cost of $101 million expected to be incurred in a period of five years for the rewrite exercise.

39. The Deputy Law Officer (Civil Law), DoJ (DLO(CL)) supplemented that the rewrite of the CO was a multi-year task with far-reaching impact on Hong Kong's company regulatory regime. It was necessary to avoid precarious planning to ensure successful implementation of the exercise. He stressed that there were a number of complicated and controversial legal issues involved in the rewrite which would require in-depth research, detailed examination, and wide consultation. These issues included provisions relating to company investigations, distribution of companies' profits, and human rights issues, etc. In drafting the new Companies Bill, DoJ would also need to ensure that the provisions would comply with the Basic Law and the Bill of Rights. DLO(CL) pointed out that given the existing workload of DoJ, there was concern that without the provision of new manpower resources, it would be impossible to accomplish the task and that the quality of the rewrite exercise would be adversely affected.

40. Mr James TIEN was concerned that the CBT might lack the expertise in company law required to conduct the rewrite exercise in an effective and efficient

manner. In this connection, he enquired whether the Administration would consider recruiting experienced people from outside the civil service to the CBT.

41. SFST stressed that the Administration fully recognized the need to set up a CBT with people who had the relevant expertise in company law and the right calibre to ensure the quality of the rewrite exercise. As such, the possibility of recruiting from outside the civil service would not be ruled out.

42. Mr Jeffrey LAM shared the Administration's view that it would be more cost-effective to rewrite the CO than amending it in a "piecemeal" fashion. In this connection, he enquired about the annual provision for amending the CO in previous years and whether such resources would be used for undertaking the proposed rewrite exercise. Mr LAM also enquired about how far the research and experience gathered from previous amendment exercises of the CO would be used for the proposed rewrite exercise so as to minimize the need for engaging external consultant and reduce the cost for the rewrite.

43. SFST said that the SCCLR had been formed in 1984 to advise on the necessary amendments to the CO on a continuous basis. Members of the SCCLR included representatives from government departments, market regulators, business sector and professional bodies. While the Administration had succeeded in taking forward a number of bills to amend the CO in recent years, it was impossible to quantify the resources involved for the work in this area. As regards the proposed rewrite exercise, the SCCLR would play an important role in keeping an overview of the exercise and advising on all the major proposals or recommendations arising from the rewrite. However, given the extensive nature and complexity of the exercise and the fact that members of the SCCLR served on part-time basis, it was well justified to establish a dedicated team of staff with support from an external consultant to undertake the various tasks in the exercise.

44. Mr Ronny TONG pointed out that, as far as he knew, there were two major outstanding issues needed to be tackled in the rewrite of the CO, namely, the provisions relating to shareholders' disputes and winding-up of companies. To facilitate the rewrite exercise, Mr TONG suggested that the SCCLR/Law Reform Commission (LRC) should be invited to make recommendations on the above issues and that the Securities and Futures Commission (SFC) being the major stakeholder in the course of the rewrite, should set out clearly its requirements for the new Companies Bill. Mr TONG was of the view that with the assistance of the SCCLR/LRC and the SFC, the manpower and resources requirements for the rewrite exercise could be reduced.

45. R of C advised that the SCCLR was the appropriate body to advise on company law matters. Members of the committee were part-time members, who met once a month. The Company Law Reform Division of the CR was responsible for providing support to the SCCLR, including undertaking background research and preparing discussion papers for deliberation. As such, the pace and extent of work of

the SCCLR were totally dependent on the available support from the CR which, in turn, was affected by the CR's workload. R of C also stressed the importance of putting in place the right structure and providing the required manpower resources for the rewrite exercise. Additional manpower resources were required to undertake the various tasks of the rewrite exercise, such as conducting research into complex issues.

46. Ms Emily LAU enquired about the comparison of the resource requirements for the proposed rewrite exercise with the exercise leading to the enactment of the Securities and Futures Ordinance (SFO) (Cap. 571). PSFS advised that it had taken more than four years to prepare the Securities and Futures Bill (SF Bill) and enacting the SFO. The SFC had been heavily involved in the exercise and had relieved a great deal of the Administration's workload by conducting relevant research and providing assistance in drafting the SF Bill. The Administration was aware that, in addition to existing staff, the SFC had also engaged a total of six outside experts, including lawyers and consultants, to assist in the various tasks of the exercise. SFST also pointed out that the UK Department of Trade and Industry had established a dedicated team of staff to undertake the review of the UK Companies Act. During the heaviest middle phase of the project, the team, excluding clerical and other support staff, comprised a total of approximately 22 staff of whom 12 were policy staff and ten were lawyers, whom were pitched at either senior, deputy, or assistant directorate level.

Company law reform in other jurisdictions

47. Given that the existing CO was largely based on the UK Companies Act, Mr James TIEN was of the view that the new CO could be based on the outcome of the current UK Company Law Reform so as to enhance the cost-effectiveness of the rewrite exercise. In this connection, Ms Emily LAU pointed out that the UK had issued a White Paper on its Company Law Reform Bill for public consultation in March 2005. She urged the Administration to make reference to the outcome of the UK Company Law Reform and the relevant provisions of the UK legislation.

48. In response, PSFS stressed that, while review and reform of company laws in the UK and other jurisdictions would serve as good reference for the proposed rewrite exercise, given the economic and social differences between those jurisdictions and Hong Kong, instead of copying the provisions into the new Companies Bill, it was necessary for the CBT to conduct extensive research and analysis of the policy and legal background to the company laws of the jurisdictions to examine whether they should be adopted in Hong Kong.

49. SFST re-iterated that the CBT would make reference to the new Company Law Reform Bill of the UK. However, given that the business environment of Hong Kong was different from that of the UK, it would be inappropriate to copy the provisions of the UK Bill to the new Companies Bill in Hong Kong. R of C supplemented that the Administration had just received the draft UK Bill in early November 2005 which was divided into 37 parts consisting of a total of 885 sections

and 15 schedules. Due to the differences between the regulatory, political and economic situations of Hong Kong and the UK, it was necessary for the Administration to research into the background against which the UK proposals had been formulated before considering whether they should be adopted in Hong Kong.

Timeframe for the rewrite exercise

50. Miss Mandy TAM expressed concern that, according to the Administration's tentative timetable, it would take at least six years to have the new CO in place (i.e. from 2006 to 2012). She enquired whether the Administration had set a target commencement date for the new CO.

51. In reply, PSFS stressed that the Administration was committed to complete the rewrite exercise as early as practicable so that Hong Kong's company regulatory regime could keep pace with international developments. However, given that the exercise would be a very complex task involving extensive legal and policy research and numerous parties, the proposed timeframe for completing the rewrite exercise in five years was already very optimistic. In order to allow time for relevant stakeholders to make preparation for the new CO, the Administration would consider the need of prescribing different commencement dates for different provisions of the new Ordinance where necessary.

52. In view of the complex legal and technical issues involved in the rewrite exercise, Ms Emily LAU and Mr Ronny TONG were concerned that, if the Bill was introduced into LegCo in the third quarter of 2010, there would not be sufficient time for Members to complete scrutiny of the Bill before the expiry of the LegCo term in July 2012. Mr TONG also considered that it might be necessary for LegCo to engage an expert in company law to assist Members in scrutinizing the Bill. He was concerned whether LegCo would have the resources for engaging such an expert.

53. SFST said that the Administration fully agreed that sufficient time should be allowed for Members to scrutinize the new Companies Bill. As regards concern about LegCo's resources for scrutinizing the Bill, SFST believed that LegCo would allocate its resources in a manner as it saw fit.

54. Mr CHAN Kam-lam stressed the importance for Hong Kong's company regulatory regime to be on par with international standards. He urged that the Administration should consider expediting the rewrite exercise by identifying major areas for reform, developing proposals for public consultation and drafting the new Companies Bill in stages.

55. Noting that the proposed posts for the rewrite exercise would be for a maximum of 60 months, Miss Mandy TAM expressed concern on whether the Administration would have sufficient manpower resources to assist LegCo to scrutinize the Bill and implement the new CO.

56. PSFS advised that the proposed CBT would undertake work in relation to the preparation of the White Bill and the drafting of the new Companies Bill, including the conduct of relevant research and public consultations. It was envisaged that the follow-up work, such as assisting LegCo in scrutinizing the Bill and implementation of the new CO, would be undertaken by existing staff in the relevant bureaux and departments if necessary.

Conclusion

57. Mr CHAN Kam-lam indicated support of the LegCo Members of the Democratic Alliance for Betterment and Progress of Hong Kong (DAB) for the proposal to rewrite the CO.

58. Mr James TIEN re-iterated support of the LegCo Members of the LP for the proposal of rewriting the CO. However, they did not support the proposed creation of four supernumerary directorate posts.

59. Ms Emily LAU said that while she supported the proposal of rewriting the CO, she did not support the proposed staffing requirements for the exercise. She considered that the Administration should engage experts and relevant stakeholders, such as the SCCLR, to undertake the rewrite exercise instead of expanding the civil service establishment. Ms LAU also expressed concern about deferring the review of the winding-up provisions of the CO to the second phase of the rewrite exercise.

60. Dr Raymond HO remarked that some of the LegCo Members of the Alliance were of the view that while it might be necessary to create some new posts for the rewrite exercise, the Administration should assure Members that it would engage experts with the relevant expertise and experience and ensure the cost-effectiveness of the rewrite exercise.

61. The Chairman urged the Administration to take note of and address members' concerns.

VI. The 2006-07 Budget consultation

(LC Paper No. CB(1)193/05-06(06) — Information pack for the Financial Secretary's consultations on the 2006-07 Budget)

Briefing by FS

62. At the invitation of the Chairman, FS gave a power-point presentation on the background information for the 2006-07 Budget consultation.

(*Post-meeting note:* The information pack for FS' consultations on the 2006-07 Budget was tabled at the meeting and circulated to Panel members and non-Panel Members vide LC Paper No. CB(1)193/05-06(06) on 8 November 2005.)

63. FS highlighted the following points:

(a) The Government would continue to follow the principle stipulated in Article 107 of the Basic Law (BL107), i.e. the principle of keeping expenditure within the limits of revenues in drawing up the budget, and strive to achieve a fiscal balance, avoid deficits and keep the budget commensurate with the growth rate of Hong Kong's gross domestic product (GDP). It would also adhere to a low and simple tax regime and always work towards maintaining the stability and integrity of the monetary system (Chart 2 of the information pack).

(b) On economic positioning of Hong Kong, the Administration's broad principles were to access the Mainland market, foster economic co-operation, and capitalize on the opportunities offered by the Closer Economic Partnership Arrangement; maintain the "Market leads, Government facilitates" principle; build on Hong Kong's strengths, and enhance competitiveness of the key industries; develop Hong Kong's human resources and promote employment; maintain a robust market structure and promote fair competition (Chart 3).

(c) The Hong Kong economy continued with a broad-based expansion in the second quarter of 2005. With the upbeat outturn of GDP growth rate of 6.5% in the first half of 2005, the forecast GDP growth in real terms for 2005 as a whole was likely to be close to the upper end of the range forecast of 4.5% - 5.5%. Overall unemployment rate continued to improve and had fallen from the peak of 8.6% in mid 2003 to 5.5% in the third quarter of 2005. Despite that consumer price inflation had edged up in recent months along with the increasingly entrenched economic recovery, overall inflationary pressure remained moderate. The forecast Composite Consumer Price Index for 2005 remained at 1.5%. Although the global economy looked set for further expansion in the period ahead, the economy faced a number of uncertainties including surging oil prices, rising interest rates in the United States (US), development in US asset prices and consumer confidence, movements of US dollar and Renminbi, persistent current account deficit in the US and on-going trade tension with Asia/Mainland, sustainability of Japan's economic recovery, and success in steering a soft-landing in the Mainland economy (Charts 4 - 9).

(d) On the management of public finance, with the strong economic performance in 2004-05, the financial position of the Government had gradually improved. For the first time since 1999-2000, the Consolidated Account for 2004-05 recorded a surplus of $21.4 billion.

Nonetheless, a deficit of $4 billion remained after discounting the proceeds from bond issuances. The Operating Account remained in deficit in 2004-05 for the seventh consecutive year. Over the past seven years, fiscal reserves had shrunk from $457.5 billion as of 31 March 1998, equivalent to 28 months of the then government expenditure, to $296 billion as of 31 March 2005, equivalent to 15 months of government expenditure. Based on the forecast in March 2005, fiscal reserves would drop to $284.2 billion by end 2006-07, equivalent to 14 months of government expenditure, and rose gradually to $357.5 billion by end 2009-10, equivalent to 17 months of government expenditure (Charts 10 – 11).

(e) On recurrent expenditure, expenditure on education, social welfare, health and security together would account for about 68.1% of the total recurrent spending in 2005-06 Original Estimates. The growth in total recurrent expenditure had increased by 56.8% over the past ten years, while recurrent spending on education and social welfare had outpaced other policy areas, with growth at 61% and 172% respectively. The increase in social security payments was 184%. After excluding social security payments, the increase in recurrent expenditure for social welfare was 149%. As regards capital works projects, the Government was delivering the pledge in the 2004-05 Budget to make provision for an average annual allocation of about $29 billion a year for works projects in the next few years (Charts 12 - 14).

(f) On the revenue side, profits tax and income tax on individuals (i.e. salaries tax, personal assessment and property tax) were the two most important sources of revenue for 2005-06 accounting for some 40.9% of Government's total revenue. Total operating revenue, covering taxes, stamp duties and government fees and charges, etc. would account for 79.2% of Government's total revenue for 2005-06, while capital revenue account for 20.8%. Total operating revenue had only increased by 25.1% over the past ten years. Capital revenue, with land premium being a key component, and investment income, had fluctuated a lot and could not be relied upon to resolve the operating deficit problem. Over the past seven years, government revenue oscillated around $170 billion to $270 billion. The drop in actual government spending from $247.5 billion in 2003-04 to $242.2 billion in 2004-05 had not come easily as there was a degree of rigidity in government spending and it was generally difficult to cut expenditure even in deflationary settings (Charts 15 - 17).

(g) The taxpaying population was expected to drop from 1.33 million in 1997-98 to 1.22 million in 2005-06 although the working population had increased from 3.16 million to 3.37 million over the same period. The top 100 000 taxpayers contributed 54.8% of the total revenue from salaries tax in 1997-98. The share contributed by this group was 61% in 2003-04 and was estimated to be 58.2% in 2005-06. On the corporate taxpaying population, 60% of profits tax revenue in 2003-04 was contributed by the top 600 taxpaying corporations out of more than 57 000 corporations. Most small businesses paid little or no tax. The phenomena in Charts 18 and 19 raised the issue about whether the current contributions on salaries and profits taxes were in line with the principle of affordability (Charts 18 – 19).

(h) Despite gradual improvement in the financial position of the Government, fiscal balance was yet to be restored. The Government must observe strict fiscal discipline and avoid substantially increasing expenditure and reducing taxes just because of the good results in one or two years. On the other hand, the Government should respond promptly to the reasonable calls of the community. As such, the Government required a broader, sizeable and steady income source to underpin its revenue and meet its expenditure requirements. A broad-based Goods and Services Tax (GST) was a reasonable and equitable way to smooth bumps in revenue stream and secure fiscal stability for the future. The Government had already completed its study on the implementation of a GST in Hong Kong and would launch a public consultation on whether and how best it should be implemented. It was important to build a consensus with the community on this important issue before deciding the next step forward (Charts 20 – 21).

(i) The Government would, in accordance with the principle of "Big Market, Small Government", continue to identify suitable assets for sale or securitization in order to reduce the share of the public sector in the economy and gave more scope for the private sector to develop. In the process, the Government would endeavour to ensure that the interests of the stakeholders would not be adversely affected. The downsizing of the Government's shareholding in the Tradelink Electronic Commerce Limited (the Tradelink) had been completed recently. There was also plan to sell part of the student loans to interested parties. Discussion on the possible merger of the two railway corporations was on-going. On the proposed partial privatization of the Airport Authority (AA), the public consultation ended on 31 May 2005. The Government would continue to discuss with stakeholders and ensure that the various concerns raised during the public consultation were addressed satisfactorily before privatizing the AA (Chart 22).

64. FS said that he would start consulting LegCo Members and representatives from various sectors of the community in the coming months in preparing for the 2006-07 Budget. He welcomed views and suggestions from Members and the public. A website had been set up to receive written submissions for this purpose.

Discussion

Tax relief for the general public

65. Mr WONG Kwok-hing expressed concern that despite the strong performance of Hong Kong's economy in 2004-05, the general public had not benefited from the economic recovery. He urged that FS should, in drawing up the 2006-07 Budget, consider the following suggestions put forward by the Hong Kong Federation of Trade Unions (HKFTU) for providing tax relief to the general public:

(a) To revert the personal tax allowances to the 2002-03 level;

(b) To increase the tax allowance for maintaining parents or grandparents;

(c) To increase the deductions for self-education expenses to encourage continuous self-learning and enhance the quality of Hong Kong's human resources; and

(d) To provide deduction for voluntary contributions to mandatory provident fund schemes.

66. FS said that he and the Chief Executive (CE) had undertaken in the resumption of the Second Reading debate on the Appropriation Bill 2005 and the CE election campaign respectively that when the economic recovery took stronger root, the Administration would consider reducing taxes to relieve the burden of the public. He remarked that with gradual improvement in Hong Kong's economy in the first half of 2005, there appeared to be room for tax reduction. Nonetheless, uncertainties in recent months, such as the risk of an influenza pandemic in Hong Kong requiring more resources on health programmes, and rising interest rates and oil prices, might put pressure on government's fiscal position. The Administration needed to adopt a prudent approach. FS said that the Administration would take into account the economic performance of the second half of 2005 in examining whether there was room for the subject of tax reduction. He assured Members that he would take into account all views and suggestions on tax measures in preparing the 2006-07 Budget.

Addressing unemployment problem in the construction sector

67. While expressing appreciation for the Administration in sustaining its capital expenditure in the past few years, Mr WONG Kwok-hing noted that the annual provision on works projects for the year 2005-06 was only $27.6 billion which fell short of the pledged amount of $29 billion. Mr WONG also expressed concern about the increasing trend that works in capital works projects were undertaken outside Hong Kong, such as the making of prefabricated building components. Moreover, as a result of the application of the World Trade Organization's Government Procurement Agreement (GPA) in Hong Kong, increasing number of capital works projects was undertaken by overseas companies. With a view to addressing the

unemployment problem in the construction sector and protecting interests of local workers, Mr WONG called on the Administration to consider imposing rules requiring that at least half of the works procedures of a construction project should be undertaken in Hong Kong.

68. Dr Raymond HO expressed concern about the high unemployment rate of over 13% in the construction sector against the overall unemployment rate of 5.5%. He shared the concerns that works in capital works projects were undertaken outside Hong Kong and application of the GPA had undermined the opportunities for small and medium sized enterprises in bidding capital works projects.

69. Miss Mandy TAM enquired whether the Administration would consider increasing capital expenditure to expedite implementation of infrastructural projects in coming years so as to promote employment in the construction sector and the economic development of Hong Kong.

70. On addressing the unemployment problem in the construction sector, FS advised that the CE's Policy Address 2005-06 had stressed the importance of continuous infrastructural development as a means to address the problem. In this regard, the Administration would expedite the implementation of public works projects where possible. Nonetheless, FS pointed out that as infrastructural development projects only accounted for half of the total contract value of the construction sector and that building projects were capable of creating more employment opportunities than infrastructural projects, robust development in the property market of Hong Kong would be vital in resolving the unemployment problem in the construction sector.

71. On capital expenditure, FS re-iterated the Administration's pledge in the 2004-05 Budget to make provision for an average annual allocation of about $29 billion a year for works projects in the next few years. Upon request of Dr Raymond HO, FS undertook to provide after the meeting a breakdown of government expenditure on works projects and the changes in percentage for each of the past ten years (i.e. covering the financial years of 1995-96 to 2004-05). He pointed out that the information might not provide an accurate picture of Government's commitment on infrastructural projects as a number of large scale public works projects, such as the Airport Core Programme, were not commenced during the said period.

> (*Post-meeting note:* Information provided by the Administration was circulated to Panel members and non-Panel Members vide LC Paper No. CB(1)356/05-06(02) on 22 November 2005.)

72. As regards concern about application of the GPA in Hong Kong, FS advised that the Agreement provided that any government contract for procurement of goods or specified non-works services exceeding a value of $1.3 million and of works services exceeding $50 million had to be invited through global tendering. In

complying with the GPA requirements, the Administration would endeavour to ensure that the procured goods or services were value for money.

Management of public finance

73. Ms Emily LAU stressed that it was the responsibility of the Government to take care of the poor and the less privileged in the society. She considered that the Administration should increase public expenditure in areas including education, health and welfare to help these people and address their needs. On the other hand, Ms LAU urged that the Administration should exercise stringency in containing the size of the civil service and avoid creating new directorate posts. In this connection, Ms LAU said that it was the consensus of LegCo Members that the Administration should consider deploying part of the accumulated surplus of the Exchange Fund for improving the livelihood of the general public. Moreover, recent concerns about a possible outbreak of an influenza pandemic and the sustainability of economic growth in Hong Kong had exerted pressure on the Government's fiscal position. She considered that there might be limited room for reducing taxes in the 2006-07 Budget.

74. FS said that it was important for the Administration to improve the business environment of Hong Kong and promote economic development with a view to raising more government revenue. As regards the possible outbreak of an influenza pandemic in Hong Kong, FS pointed out that while there was no sign that the disease had become infectious through human contact, the Administration would remain highly alert about the risk and make necessary preparations.

75. On the concern about the additional manpower resources required for undertaking on-going and new policy initiatives, FS assured members that the Administration would examine the feasibility of meeting the staffing requirements through internal deployment. The Administration would also ensure that the proposals of creating new posts were fully justified. As regards concern about number of directorate posts in the civil service, FS said that the some 1 500 existing directorate posts represented less than 1% of the total establishment. Such a percentage was on the low side when compared with that of the top management in a large corporation.

76. Miss Mandy TAM sought FS' view on the respective weights he would put on the community's request for reducing taxes and the need for addressing the fiscal deficit problem in working out the 2006-07 Budget.

77. FS re-iterated that in working out the budget, he would adhere to the principles enshrined in BL 107. He stressed that during the process, the Administration would take into account the public's affordability and aspirations, the need for maintaining a healthy level of reserves and leaving wealth with the people. The Administration would also assess the economic performance, and risks and uncertainties that Hong Kong was faced with. FS emphasized that he welcomed views from various sectors

of the community on revenue measures to be adopted and how fiscal balance could be achieved.

Addressing problems of poverty and widened gap between the rich and the poor

78. Ms CHAN Yuen-han pointed out that the problem of low wages for non-skilled workers was getting worse. She expressed concern that the problem coupled with the problems of unemployment and aging population would push up demand for public health and welfare services, thus exerting immense pressure on government recurrent expenditure. Ms CHAN stressed that it was vital for the Administration to acknowledge these problems and devise appropriate measures to address them. She considered that the Administration should increase expenditure on social welfare to meet the needs of the poor and the less privileged. She further urged that the Commission on Strategic Development should study these issues and consult relevant stakeholders, as well as make reference to the successful experience of countries in the Northern Europe in developing appropriate policies and measures to resolve the problems. Ms CHAN also called on the Administration to maintain an open mind on suggestions for re-developing Hong Kong's manufacturing industries as a means to address the unemployment problem of the low-skilled workers.

79. Ms Emily LAU pointed out that Charts 18 and 19 had revealed that the problem of a widened gap between the rich and the poor was becoming more acute. She called on the Administration to take urgent measures to address the problem.

80. Mr LEUNG Kwok-hung expressed disappointment about the slow progress made by the Administration in addressing the problems of poverty and promoting economic development in Hong Kong.

81. FS stressed that the Administration fully recognized the needs of the poor and the less privileged in the society. The establishment of the Commission on Poverty had reflected the Government's determination to help and address the needs of these people. He advised that the Commission had agreed that multiple means and channels should be used to address the problem of poverty. The Commission would involve the community actively in its work and co-ordinate the efforts of different parties in alleviating poverty in Hong Kong. FS added that the countries in Northern Europe had imposed very high tax rates on individuals and corporations, and their experience might not be relevant to Hong Kong.

82. Mr Ronny TONG remarked that the phenomenon in Chart 18 (i.e. the drop of the taxpaying population along increase in the working population) could be the result of decreasing income earned by taxpayers in the low-income group. He urged that the Administration should address the problem.

83. FS advised that decrease in taxpaying population during the period from 1997-98 to 2005-06 was attributed by two factors. Firstly, salaries of the majority of the workforce had been substantially reduced. Secondly, the adjustment in salaries

tax band for the years 1997-98 to 2002-03 had resulted in a number of taxpayers dropping out of the tax net. FS added that with the tax band reverting to the 1997-98 level in two phases in 2003-04 and 2004-05, the taxpaying population had started to increase.

84. Mr LEE Cheuk-yan expressed concern about the poverty problem in Hong Kong. He stressed the importance for the Administration to address the problem and suggested that this should be a main theme of the 2006-07 Budget. With the Consolidated Account restoring balance and GDP achieving real growth, Mr LEE asked whether the Administration would consider providing new resources in the 2006-07 Budget to uphold the principle in BL 107 of keeping the budget commensurate with the growth rate of GDP. In this connection, Mr LEE pointed out that it was essential to provide new resources for education, health and welfare sectors to address existing inadequacy of services and to meet changing needs of the community.

85. FS attributed the success in restoring balance in the Consolidated Account to the concerted efforts of the Administration and the public. He re-iterated the Administration's commitment to further consolidate Hong Kong's economic recovery, reinforce existing strengths and promote economic development. As regards government expenditure in 2006-07, FS said that the Administration aimed at filling resources gaps arising from expenditure cuts in the past few years. FS assured members that there would be new resources in the 2006-07 Budget for pursuing new and on-going policy initiatives.

86. Mr Andrew LEUNG expressed concern that expenditure on education, social welfare, health and security had accounted for the majority of the government recurrent expenditure. In particular, education and social welfare had outpaced other policy areas in term of growth in recurrent spending. Mr LEUNG enquired whether the Administration had critically reviewed expenditure on the two sectors to ensure cost-effectiveness of the allocation of resources.

87. FS stressed that the Administration was committed to enhancing the quality of human resources and helping the needy through continuous investments in education and provision of social welfare services. He added that the Administration had been closely monitoring expenditure on the two sectors and welcomed views from Members and the public on means to further enhance the cost-effectiveness of the provision of resources.

Strategies for developing Hong Kong's economy

88. Mr CHAN Kam-lam said that it was the view of the Democratic Alliance for the DAB that the Administration should promote the development of new industries in Hong Kong. Given the growing aspiration of the community for improving the quality of living environment, Mr CHAN considered that there were great potentials for environmental protection industry to develop in Hong Kong. He suggested that

the Administration should consider providing incentives and assistance in land and necessary human resources, financial support and tax concessions to encourage development of the industry in Hong Kong. He also urged the Administration to consult the industry extensively in mapping out the strategies for development.

89. FS said that the Administration recognized the important role played by industries in Hong Kong's economic development. The direction of development must focus on industries which Hong Kong had competitive edge and were complementary to developments in the Pan-Pearl River Delta. FS stressed the importance for Hong Kong to develop industries with high value-added, high-technology and creativity contents, including multi-media production, product design, and environmental protection industries. The development of environmental protection industry in Hong Kong would not only respond to the community's call for improving the quality of living environment, but also help address the unemployment problem. To facilitate the development of environmental protection industry, the Administration would consider relaxing letting policy in government industrial estates. FS said that the Administration welcomed the DAB to put forward views and suggestions for development of new industries in Hong Kong.

90. Mr Andrew LEUNG said that the Federation of Hong Kong Industries had put forward a suggestion for the Administration to provide tax concessions to research and development (R&D) activities undertaken by industries in order to encourage enterprises to move their R&D activities back to Hong Kong and further promote development of creative industries.

91. FS recognized the important role played by R&D activities in continuous development of industries and acknowledged that such investments involved risks and capital. As regards the suggestion for providing tax concessions for R&D activities, FS said that the Administration welcomed industrial bodies and the business community to propose concrete proposals for developing a clear definition of such activities to prevent possible abuses.

Measures for broadening Hong Kong's tax base

92. On measures for broadening Hong Kong's tax base, Mr WONG Kwok-hing said that HKFTU objected to the introduction of GST in Hong Kong, as the tax was regressive in nature, unfair to the general public and not in line with the principle of affordability.

93. Despite improvement in the fiscal position in the first half of 2005, Mr Ronny TONG expressed concern that the structural deficit problem remained unresolved. Given vulnerabilities in the global investment environment, the Treasury's share of the Exchange Fund investment income was unlikely to meet the target of $14.1 billion set in the 2005-06 Budget. Mr TONG considered it necessary for the Government to identify steadier sources of revenue. In this regard, he pointed out that LegCo Members of the Article 45 Concern Group kept an open mind on

introducing a GST in Hong Kong and considered that there should be measures to address concerns about the regressive nature of the tax. He urged the Administration to provide a concrete timetable for consulting the public on the GST.

94. FS re-iterated that a broad-based GST was a reasonable and equitable way to smooth out bumps in revenue stream and secure fiscal stability for Hong Kong's future. Given that the subject was very controversial, the Administration would conduct extensive public consultation on whether and how best GST should be implemented in Hong Kong, including whether the tax should be all-embracing and whether exemption should be provided, the need for relief/offset package, and timeframe for introduction. The Administration would strive to build a consensus with the community before deciding on the way forward. FS advised that he would provide the relevant details in the 2006-07 Budget.

95. Miss Mandy TAM enquired whether the Administration would undertake studies on other new taxes in order to widen Hong Kong's tax base. FS advised that the Advisory Committee on New Broad-based Taxes had conducted studies on various taxes and considered that a GST was the only new tax with the long-term capability of broadening the tax base. FS said that experience from other jurisdictions had confirmed that implementation of GSTs had not damaged their competitiveness.

96. Ms Emily LAU said that the Frontier was of the view that consideration should be given to increase the tax rates for profits tax so that those corporations earning higher profits would be required to pay more taxes.

97. Ms CHAN Yuen-han said that HKFTU supported introducing capital gains tax in Hong Kong for broadening Hong Kong's tax base and promoting a steadier source of revenue. Mr WONG Kwok-hing added that it was HKFTU's view that the Administration should consider raising the tax rate for profits tax by 1% to 2%, which should be affordable by the business sector. Moreover, consideration should be given to introducing a progressive tax regime in respect of profits tax so that corporations with annual profits more than $10 million would be required to pay more taxes. It would be in line with the principle of affordability as small businesses would be required to pay less profits tax.

98. Mr LEUNG Kwok-hung stressed the need to raise more revenue to enable the Administration to increase the recurrent expenditure on education and social welfare. In this connection, he urged that the Administration should consider introducing capital gains tax in Hong Kong and raising the tax rate for profits tax to 25%. Mr LEUNG further stated that he did not support abolition of estate duty as this would reduce government revenue.

99. FS re-iterated that the Administration believed that a broad-based GST was an appropriate means to ensure a steady revenue stream and secure fiscal stability for Hong Kong's future. He welcomed views and suggestions from Members and the public on Hong Kong's taxation regime and whether and what changes should be

introduced. FS added that it was necessary to address the needs of different parts of the community and balance a series of conflicting demands and interest in preparing the budget.

100. Mr LEE Cheuk-yan pointed out that the "high land price policy" in Hong Kong had pushed up property prices, and in turn, increased the burden of the middle class. While expressing support for the Administration to maintain the tax rate for profits tax for small businesses, Mr LEE suggested that with a view to raising more revenue, the Administration should consider raising the tax rate for corporations with annual profits over $50 million. Given that these corporations were making huge sum of profits, Mr LEE considered that his suggestion would be in line with the principle of affordability. He further requested the Administration to provide a breakdown of the profits tax revenue contributed by the top 600 taxpaying corporations for the Year of Assessment 2003-04.

> (*Post-meeting note:* Information provided by the Administration was circulated to Panel members and non-Panel Members vide LC Paper No. CB(1)356/05-06(02) on 22 November 2005.)

101. In response, FS said that revenue from land premium, which had dropped from $71 billion in 1997-98 to $5.4 billion in 2003-04, was an unstable source of government income. However, the sale of Government land had contributed to the growth of the property market and eased the unemployment problem of the construction industry. FS re-iterated that in considering the revenue measures in the 2006-07 Budget, the Administration would pay due regard to the principle of affordability.

102. Referring to Charts 18 and 19, Mr James TIEN pointed out that the top 100 000 taxpayers and 600 taxpaying corporations had contributed to the majority of the total revenue from salaries tax and profits tax respectively. He was concerned that any reduction of income of these taxpayers and corporations would have significant impact on the total revenue from salaries tax and profits tax. Mr TIEN therefore suggested that the Administration should explore measures for improving the business environment of the small and medium enterprises so that they might be able to contribute more to the revenue from profits tax.

103. FS appreciated Mr James TIEN's concern. He said that as shown in Chart 19, the top 3 000 taxpaying corporations earning profits over $10 million a year had contributed about 80% of the total profits tax income vis-à-vis some 54 800 taxpaying corporations contributing the remaining 20%. The Administration would review whether the phenomena revealed from Charts 18 and 19 were in line with the principle of affordability. The Administration would also strengthen enforcement actions against tax evasion.

104. Mr James TIEN pointed out that the interest rate hike in the US resulting in rises in mortgage and corporate lending rates in Hong Kong had increased the burden

of mortgagees and businesses. The business sector was concerned about the damping effects on consumer spending and corporate profits. Mr TIEN expressed concern about the impact on government revenue.

105. On the concern about negative impact of the interest rate hike on local consumption, FS said that the Administration had so far not seen any sign of moderation in consumer demand and that latest economic indicators indicated that there had been considerable year-to-year growth in retail businesses.

106. Referring to Chart 18, the Chairman expressed concern that about two-third of the working population in Hong Kong was not required to pay salaries tax and about 80% of the taxpaying population contributed only 5% of the total revenue from salaries tax. As far as he knew, other jurisdictions which incurred significant expenditure on social welfare services imposed higher tax rates than Hong Kong.

107. FS advised that an individual earning $100,000 or less a year was not required to pay salaries tax in Hong Kong, while in the Mainland, the same level of income would be subject to the highest tax rate of 45%. The corresponding taxpaying thresholds for a single individual in the US, the United Kingdom, Thailand and Japan were some $37,600, $69,800, $20,800, and $26,800 respectively in Hong Kong dollar equivalent. In New Zealand, all income earned by individual was subject to tax. As for Singapore, while the threshold of some $97,200 in Hong Kong dollar equivalent was comparable to that of Hong Kong, there were six tax bands with tax rates ranging from 3.75% to 21% in Singapore, while there were four tax bands in Hong Kong with rates ranging from 2% to 20%. The above information illustrated that Hong Kong had put in place a taxation regime with very low tax rates vis-à-vis other jurisdictions. FS welcomed views from Members on the need for change.

Sale and securitization of government assets

108. Referring to Chart 22, Mr WONG Kwok-hing questioned the need for the Administration to sell its assets when they were achieving good investment returns. He was concerned about the Administration's plans for downsizing the Government's shareholding in the Tradelink and selling part of the student loans to interested parties, and whether the latter proposal would result in the increase in interest rates paid by the students concerned. Mr WONG further expressed concern that other relevant proposals, such as privatization of the AA and merger of the two railway corporations, would result in staff redundancies and adversely affect the interests and benefits of existing staff.

109. The Secretary for Financial Services and the Treasury (SFST) advised that Government's investment in Tradelink was started in 1992. The Government had in total invested some $60 million in the company for the purpose of promoting the development of electronic commerce. With the listing of the Tradelink, the Administration had downsized its shareholding in the company to just over 10%. The sale of shares had generated net proceeds of over $200 million. As regards the

proposal of selling part of the student loan, SFST assured members that the Administration would carefully assess the impact on students and address students' concerns before implementing the proposal.

VII. Any other business

110. There being no other business, the meeting ended at 12:50 pm.

Council Business Division 1
Legislative Council Secretariat
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