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Legislative Council

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Panel on Financial Affairs

Minutes of meeting
held on Tuesday, 29 January 2008 at 10:00 am
in the Chamber of the Legislative Council Building

Members present :

Hon CHAN Kam-lam, SBS, JP (Chairman)
Hon Ronny TONG Ka-wah, SC (Deputy Chairman)
Hon James TIEN Pei-chun, GBS, JP
Hon Albert HO Chun-yan
Hon James TO Kun-sun
Hon Emily LAU Wai-hing, JP
Hon Abraham SHEK Lai-him, SBS, JP
Hon Jeffrey LAM Kin-fung, SBS, JP
Hon Andrew LEUNG Kwan-yuen, SBS, JP
Hon WONG Ting-kwong, BBS
Hon CHIM Pui-chung
Hon TAM Heung-man

Members attending :

Hon Mrs Selina CHOW LIANG Shuk-yee, GBS, JP
Hon Howard YOUNG, SBS, JP
Hon LAU Kong-wah, JP

Members absent :

Ir Dr Hon Raymond HO Chung-tai, SBS, S.B.St.J., JP
Dr Hon David LI Kwok-po, GBM, GBS, JP
Hon Bernard CHAN, GBS, JP
Hon SIN Chung-kai, SBS, JP

Public officers attending :	Agenda Item IV Hong Kong Monetary Authority Mr Joseph YAM, GBS, JP Chief Executive Mr Eddie YUE, JP Deputy Chief Executive Mr Raymond LI, JP Acting Deputy Chief Executive Ms Julia LEUNG, JP Acting Deputy Chief Executive Agenda Item V Hong Kong Monetary Authority Mr Arthur YUEN, JP Executive Director (Banking Supervision) Mr Nelson MAN Head (Banking Supervision) Civil Service Bureau Ms LEE Mei-mei, Mimi Deputy Secretary for the Civil Service 3
Clerk in attendance:	Miss Polly YEUNG Chief Council Secretary (1)5
Staff in attendance:	Ms Pauline NG Assistant Secretary General 1 Ms Rosalind MA Senior Council Secretary (1)8 Mr Justin TAM Council Secretary (1)3

Ms Sharon CHAN
Legislative Assistant (1)8

Action

I. Confirmation of minutes of meeting and matters arising

(LC Paper No. CB(1)663/07-08 — Minutes of meeting on 3 December 2007

LC Paper No. CB(1)704/07-08 — Minutes of meeting on 7 January 2008)

The minutes of the meetings held on 3 December 2007 and 7 January 2008 were confirmed.

II. Information papers issued since the last meeting

(LC Paper No. CB(1)563/07-08(01) — Mr David CARSE's letter on review of the Hong Kong Monetary Authority's work on banking stability dated 7 January 2008

LC Paper No. CB(1)568/07-08(01) — Administration's paper on fourth quarterly report of 2007 on "Employees Compensation Insurance — Reinsurance Coverage for Terrorism"

LC Paper No. CB(1)590/07-08(01) — Administration's paper on review of the personalized vehicle registration marks scheme

LC Paper No. CB(1)665/07-08(01) — Letter dated 15 January 2008 on review of the Hong Kong Monetary Authority's work on banking stability from the Panel Chairman to Mr David CARSE

LC Paper No. CB(1)665/07-08(02) — Hong Kong Monetary Authority's reply dated 22 January 2008 on review of its work on banking stability)

2. Members noted that the above papers had been issued for the Panel's information.

III. Date of next meeting and items for discussion

(LC Paper No. CB(1)662/07-08(01) — List of outstanding items for discussion

LC Paper No. CB(1)662/07-08(02) — List of follow-up actions)

Regular meeting in March 2008

3. Members agreed that the Panel meeting originally scheduled for 3 March 2008 would be re-scheduled to be held on Thursday, 28 February 2008 at 8:30 am and that the following items be scheduled for discussion:

(a) Budget of the Securities and Futures Commission for the financial year of 2008-2009; and

(b) Review of the Personalized Vehicle Registration Marks Scheme.

(*Post meeting note*: Notice of the meeting re-scheduled for 28 February 2008 was issued to members vide LC Paper No. CB(1)727/07-08 on 1 February 2008.)

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

(LC Paper No. CB(1)662/07-08(03) (Updated version) — Paper provided by the Hong Kong Monetary Authority

LC Paper No. CB(1)726/07-08(01) — Speaking note of Mr Joseph YAM, Chief Executive of the Hong Kong Monetary Authority)

4. The Chairman informed member that the written information provided by the Hong Kong Monetary Authority (HKMA) was received on 24 January 2008, instead of 22 January 2008 which was the deadline for the provision of papers for the Panel meeting. The Chairman noted that the late provision of paper was due to the necessity of incorporating information on the latest development of the financial markets in the United States (US) and Europe, which happened on 22 January European time and US time, and the reaction of the Hong Kong market on 23 January 2008. The Chief Executive of the Hong Kong Monetary Authority (CE/HKMA) agreed with the Chairman that papers should be submitted to the Panel in a timely manner in accordance with the established practice as far as practicable.

Briefing by the Hong Kong Monetary Authority

5. At the invitation of the Chairman, CE/HKMA gave a power-point presentation on HKMA's key areas of work. In this connection, he also recapped that at the last meeting in November 2007, he had cautioned about the widespread impact of the US sub-prime crisis and stressed the need for proper risk management.

(a) On currency stability, HKMA had conducted market operations to buy US dollars and sell Hong Kong dollars when the spot exchange rate strengthened towards the strong-side Convertibility Undertaking and when the Undertaking was triggered in late October. As a result, the Aggregate Balance expanded, interbank interest rates declined and their negative spreads against US dollar interest rates widened. Since November 2007, the Hong Kong dollar spot exchange rate had weakened to around the central rate of 7.80, the discount of the 12-month forward exchange rate from the spot exchange rate had been roughly stable, showing that the Link Exchange Rate (LER) System was operating effectively.

(b) On the monetary and financial conditions of Hong Kong, HKMA launched a tap issue of 91-day Exchange Fund (EF) Bills, totalling HK$6 billion on 11 January 2008, which had helped to meet the increased demand for EF papers and satisfy banks' intraday liquidity needs. The Monetary Base remained fully backed by foreign reserves as the additional issuance of the EF Bills simply represented a shift within the Monetary Base from the Aggregate Balance to the EF Bills. The gap between the 1-month Hong Kong interbank offered rate and the yield of the EF paper with a remaining maturity of one month had narrowed to about 100 basis points in mid-January 2008 from about 400 basis points in mid-December 2007. Nevertheless, the stability of the currency of Hong Kong was still facing a number of potential risks and vulnerabilities, including the US sub-prime crisis, the monetary and financial conditions on the Mainland and inflation.

(c) On the US sub-prime crisis, property prices in the US would probably continue to go down. Various relief measures including the proposed "fiscal stimulus package" proposed by the US Government might help to reduce the impact of the sub-prime crisis on the US economy, thereby reducing the adverse impact on the trading partners of US through the trade channel. The recent financial turbulence had not caused any systemic concerns on Hong Kong's banking system and the real economy. Nevertheless, given the uncertainties in the developments of the global financial markets and the global economy, Hong Kong could be affected through both the real-economy and the financial-market channels. Under the trend of globalization, the "decoupling theory" which tried to differentiate the performance of emerging markets in Asia from that of the developed markets in the US and Europe would be unlikely to apply in reality. HKMA had put in place guidelines on risk management for authorized institutions (AIs) and provided its expert analyses on financial issues to market participants and investors. With proper risk-management, the monetary and financial systems of Hong Kong should be capable of coping with market volatilities arising from global uncertainties.

(d) As to the Mainland factor, administrative measures implemented on the Mainland, while being able to achieve the desired results of stabilizing prices under the current economic structure of the Mainland, might increase the cost for tackling the problem of inflation in the long run. The financial markets of Hong Kong might remain volatile in response to news and developments on the Mainland but these would be unlikely to cause systemic problems to the robust financial system in Hong Kong. Nevertheless, people with businesses on the Mainland should stay alert to the possible impact of various administrative measures on their business operations, such as a sudden cut in the source of capital.

(e) Regarding inflation in Hong Kong, the year-on-year headline inflation rate increased to about 3.4% in November 2007. Key drivers of inflation included surges in food prices and rents. Being an externally oriented economy, inflation in Hong Kong would inevitably be in line with the global trend, notably its major trading partners. Moreover, robust economic growth would give rise to inflation and maintaining the growth in labour productivity could partly offset the inflationary pressure. Consumer prices were expected to rise further, alongside with the positive economic outlook of Hong Kong, continued reduction in unemployment rate, strong domestic demand and the higher inflation rates of the two largest trading partners of Hong Kong, i.e. US and the Mainland.

(f) On banking sector performance, the average consolidated capital-adequacy ratio of banks was 13.6% as at end September 2007, indicating that the capital position of the banking industry remained strong and well above the international standard. The number of residential mortgages in negative equity continued to decline as property prices rose. Hong Kong banking sector's asset quality remained in very good shape amid the financial turbulence in the US arising from the sub-prime crisis. While the US sub-prime crisis would be unlikely to have a systemic impact on the Hong Kong banking sector, the profitability of individual banks with exposures to sub-prime or structured investment vehicles would be affected after taking into account the provisions to be set aside for these exposures. Hong Kong's banking system was robust, healthy and well regulated but HKMA considered it a good time to review how it could further strengthen its work in regulating the banking system. It had informed members of its plan to conduct a "health check" on the banking system at the last briefing. HKMA had appointed Mr David CARSE as consultant to conduct the review, which was expected to be completed in the second quarter of 2008.

(g) On the financial market infrastructure, the electronic trading platform for EF Bills and Notes was launched on 11 December 2007. The payment system maintained its smooth and efficient operation. Daily average Hong Kong dollar real time gross settlement turnover in 2007 grew by 52% to $879 billion, compared with $579 billion in 2006. HKMA's work of overseeing the clearing and settlement systems was subject to review by an independent Process Review Committee which reported to the Financial Secretary (FS) on an annual basis.

(h) On maintaining the status of Hong Kong as an international financial centre, HKMA's work focused on enhancing regional and Mainland cooperation. HKMA participated actively in promoting the development of a mutually-assisting, complementary and interactive relationship between the financial markets of Hong Kong and the Mainland. Concrete proposals in this regard included promoting Renminbi business in Hong Kong and using Hong Kong as a platform for the orderly outflow of Mainland capital.

(i) On management of EF, it should be noted that EF was not a pure investment fund and its investment strategy had to be consistent with the statutory objectives of the Fund. The performance of EF should be assessed against the investment benchmark set by the Financial Secretary on the advice of the Exchange Fund Advisory Committee (EFAC). The investment return of EF had exceeded the investment benchmark since 1999 when the benchmark was introduced. The outstanding investment performance of EF in 2007 had just been announced but the outlook for 2008 would not be so favourable in the light of global market uncertainties.

6. CE/HKMA took the opportunity to express his concern about high staff turnover in HKMA in the recent years, notably in divisions responsible for overseeing the financial markets and the banking industry. It was gratifying to note that notwithstanding the increasing workload and pressure resulting from a tight manpower situation, staff of HKMA had exercised professionalism and made the best endeavours to perform their duties, as evidenced partly by the good performance of EF last year. CE/HKMA informed members that he would invite the Governance Sub-committee of EFAC to examine and address the manpower problem in accordance with the established mechanism.

Discussion

Impact of external factors on the economy of Hong Kong

7. Regarding the US sub-prime crisis on the US economy and the administrative measures implemented by the Mainland authorities, Mr Jeffrey LAM was concerned about the difficulties faced by businessmen in assessing and coping with the risks of these pulling forces on the economy of Hong Kong. He sought CE/HKMA's view on the impact of the aforesaid factors on the economic development of Hong Kong and the outlook of Hong Kong's economy for 2008. Mr Andrew LEUNG expressed similar concern about the inflationary pressure faced by Hong Kong alongside the inflation on the Mainland and in the US. Mr WONG Ting-kwong was concerned about the adverse impact arising from negative interest rate in Hong Kong like that in the 1990s in the wake of successive and sharp cuts in interest rates in US.

8. In response, CE/HKMA advised that the economic forecast for 2008 would be provided in the upcoming 2008-2009 Budget to be announced in February. From the perspective of maintaining monetary and banking stability, HKMA had done some analyses on the economic and financial developments on the Mainland and in the US. He pointed out that credit tightening arising from the US sub-prime crisis would slow down the US economy and the possibility of a recession could not be ruled out. The economic development on the Mainland might also slow down as a result of the implementation of the administrative tightening measures. The economy of Hong Kong would inevitably be affected by the economic developments of these two largest trading partners. Hence, 2008 was expected to be a more difficult year for Hong Kong and when compared with that in 2007, the economic growth would likely slow down.

9. As to the concern about negative interest rate, CE/HKMA advised that while this phenomenon was unusual, Hong Kong would inevitably be subject to the impact of the economic developments of the US and the Mainland, given its externally oriented economy. If the US sub-prime crisis worsened and triggered off economic recession in the US, consumer prices would be under pressure to drop and the interest rate would be cut further down. He nevertheless pointed out that in a situation of negative interest rate in which interest on savings deposits was lower than consumer price inflation, consumption would likely be boosted and this would add to inflationary pressure. Such pressure however would be cushioned against the background of a slowing down economy. CE/HKMA also drew members' attention to the phenomenon of mortgage interest rates being lower than the rate of increase in residential property prices, resulting in negative mortgage interest rate. In the past decades, real mortgage interest rates had been very volatile, reflecting the volatility of property prices in Hong Kong. This volatility probably had something to do with the limited supply of land and the relatively long time lag for the supply of property to catch up with demand.

10. Mr Jeffrey LAM was concerned about the impact on the business and banking sectors of Hong Kong if the US sub-prime crisis worsened. He enquired about HKMA's measures in assisting the banking sector to face the uncertainties and in ensuring banking stability. In reply, CE/HKMA advised that the recent financial turbulence arising from the sub-prime crisis would not have any systemic impact on Hong Kong's banking sector. Based on the information submitted by locally incorporated banks, their aggregate exposure to the US sub-prime mortgage market was limited, constituting less than 1% of the total assets of the banking sector. Nevertheless, in case of a hard-landing of the US economy and if the housing difficulties spilled over to other sectors of the economy, such impact on the Hong Kong economy could be more significant. HKMA had called on banks to put in place proper risk-management in their business operation.

11. Mr CHIM Pui-chung also expressed concern about the impact of the US sub-prime crisis on the financial markets of Hong Kong and its developments. In response, CE/HKMA explained that sub-prime mortgages referred to mortgage loans given to borrowers whose repayment ability was doubtful. The sub-prime mortgage market had developed in the US against the background of rapid financial innovation and a search-for-yield behaviour in a low-interest-rate environment in the face of rising property prices in the recent years. CE/HKMA recapped that he had provided an extensive analysis on the US sub-prime crisis in his last briefing for the Panel held on 8 November 2007. He also invited interested members and the public to refer to a number of Viewpoint articles on the subject available on HKMA's website. At the request of the Chairman, HKMA undertook to provide a list of the relevant Viewpoint articles for members' reference after the meeting.

(*Post-meeting note*: Eight Viewpoint articles related to the US sub-prime mortgage problem provided by HKMA was issued to members vide LC Paper No.CB(1)757/07-08 on 1 February 2008.)

12. Referring to the proposed "fiscal stimulus package" announced by the US President in mid-January 2008, Mr Andrew LEUNG was concerned whether these proposed measures could effectively counter the escalating risks of economic slowdown in the US and the possible impact, if any, on the economy of Hong Kong. In response, CE/HKMA said that if the proposed measures under the "fiscal stimulus package" could effectively avert recession in the US, the economy of Hong Kong could benefit both through the trade channel and the financial-markets channel. While the effectiveness of the proposed measures in relieving families in repaying their mortgage loans and in boosting the housing market was yet to be ascertained pending the announcement of further details, the US housing market was confronted by other threats in the development of the sub-prime crisis when reports on an increasing number of foreclosure were released.

13. Referring to recent speculations that the "through train" scheme for individual Mainland investors to invest in Hong Kong equities (the "through train" scheme) would be launched shortly, Mr Ronny TONG enquired whether CE/HKMA had any latest information in this regard. Mr TONG noted that the investing public had been

looking forward to the positive effect of the capital inflow under the scheme on the stock market of Hong Kong. He was concerned whether the launching of the scheme had been held up due to policy or technical considerations of the Mainland authorities.

14. In reply, CE/HKMA said that he did not have information on when the "through train" scheme would be launched. He pointed out that while the investing public might have their expectations on the benefits of the "through train" scheme on the Hong Kong stock market, from the perspective of the Mainland authorities, the scheme was regarded as one of the measures to facilitate the orderly outflow of capital. He advised that the orderly outflow of capital would be necessary for the monetary and financial developments on the Mainland, which could be achieved through the implementation of a number of measures such as the Qualified Domestic Institutional Investors Scheme and the proposed "through train" scheme. The recent financial turbulence arising from the US sub-prime crisis and the uncertainties facing the global economy might cause concern to the Mainland authorities about the risks of transmitting these financial problems through the financial-markets channel if new measures were implemented to facilitate the outflow of capital at this point of time. On whether the "through train" scheme would be launched within 2008, CE/HKMA reiterated that he did not have information in this regard.

Coping with risks during market volatilities

15. Mr Jeffrey LAM was concerned about the volatility of the stock market and how investors could exercise proper risk-management if market volatility would continue through 2008. In reply, CE/HKMA said that given the changing market sentiments in response to new developments in the global markets, it was expected that the stock market would remain volatile in the near future. CE/HKMA pointed out that all relevant parties including individuals, institutional investors and financial regulators needed to stay alert under such volatile market environment. In this connection, it was important for financial institutions to conduct regular stress-testing to ensure proper risk-management. Responding to Mr Jeffrey LAM's further enquiry on the Government's holding of the shares of the Hong Kong Exchanges and Clearing Limited (HKEx), CE/HKMA stressed that the HKEx shares had been acquired as part of the strategic holding of EF, instead of an investment of EF to seek short-term gain.

16. Noting the impact of the financial turbulence arising from the US sub-prime crisis and the recent volatility of the Hong Kong stock market, Ms Emily LAU enquired whether the recent developments had caused any regulatory concern. She also asked whether the Government had any plan for market intervention and if so, the threshold that would trigger such intervention. In reply, CE/HKMA advised that whether the Government would intervene into the financial market was a matter for the decision of FS. He highlighted that notwithstanding market volatilities, there was so far no structural problem in the financial markets which warranted market intervention by the Government similar to what had taken place during the Asian financial crisis in 1997-98 when there was double play by the speculators in both the

equity futures market and interbank market. HKMA had from time to time reminded investors to ensure proper risk-management in their investment. HKMA's banking supervision work focused on ensuring that AIs had put in place proper risk-management systems and practices. Responding to Ms Emily LAU's question on whether the impact of the sub-prime crisis would be covered in the review of HKMA's work on banking stability, CE/HKMA advised that HKMA had conducted internal studies on the impact of the sub-prime crisis. Nevertheless, for the purpose of the review, the sub-prime crisis would likely be one of the test cases for examining the resilience of the banking sector to different crisis situations as well as the handling by HKMA from the supervisory perspective, rather than as a subject under review.

17. Mr Albert HO was concerned whether the development of derivatives products had helped some institutional investors to hedge their investment risks on the one hand, but made small investors with insufficient knowledge about the products to suffer greater losses on the other. Mr HO expressed concern about investor education in this regard and enquired whether HKMA and/or the Securities and Futures Commission (SFC) had detected any sign of market manipulation through investment in derivatives.

18. In reply, CE/HKMA advised that the prices of derivatives were subject to greater fluctuations than equity prices in a volatile market and it could be used by investors for hedging and managing their risks. Signs of market manipulation, if any, could be assessed from the trend of investment in the market as to whether there was high concentration in a certain derivative. HKMA was keeping track of the investment trend in derivatives and so far, had not detected any sign of concentration which gave rise to regulatory concern. While investor education was under the purview of SFC, HKMA stood ready to assist SFC in the promotion of investor education where appropriate.

19. Miss TAM Heung-man was concerned whether the recent volatilities of the stock market was the result of withdrawal of capital by overseas institutional investors to cope with the tight credit position in their home countries. She asked whether HKMA was aware of the problem of any capital outflows and measures, if any, to assist the banking sector to cope with the problem.

20. In response, CE/HKMA remarked that the possibility of overseas institutions trying to recall funds from the Hong Kong financial markets could not be ruled out given that there were free flows of capital in and out of the Hong Kong market. He nevertheless highlighted that under Hong Kong's free economy, market forces played a vital role in stock prices and in bringing them to reasonable levels. The strong exchange rate of the Hong Kong dollar vis-à-vis the US dollar indicated that at the present stage, capital outflow was not an issue of concern for Hong Kong.

HKMA's work on banking supervision

21. Mr Ronny TONG referred to the recent incident in which a trader of Societe Generale was allegedly involved in conducting fraudulent stock market transactions. He expressed concern about the regulatory safeguards in place in Hong Kong to prevent similar illicit deals in the operation of AIs. In response, CE/HKMA advised that through the collaborated efforts of HKMA and the banking industry, good industry practices as well as industry codes and guidelines had been put in place to ensure proper management of operational risks of AIs. CE/HKMA nevertheless pointed out that despite laws or regulations, it could not be guaranteed that illicit acts and breaches would never occur.

22. Mr Albert HO was concerned about the provision of basic banking services to the general public, notably those in the lower income strata, in the light of banks' branch closures for cost reduction and for concentration of resources in providing services to high-net-worth customers. In this connection, Mr HO was of the view that HKMA's mandate in banking supervision should be expanded to cover customer protection and welfare. He asked whether this would be examined in the current review on HKMA's work on banking stability. In response, CE/HKMA answered that the review would also look into these issues.

Inflation in Hong Kong

23. Mr Albert HO noted with concern that given its externally oriented economy and the limited scope under the LER System for an autonomous interest rate policy to achieve consumer-price stability, little could be done to contain the inflationary pressure faced by Hong Kong. In this connection, Mr HO enquired whether controlling the levels of Government fees would be a feasible measure to curb inflation, in addition to implementing infrastructure projects to boost economic growth. In reply, CE/HKMA said that Government expenditure and revenue measures would have an impact on the economy. FS was responsible for the management of public finances and would oversee the economic development of Hong Kong from a macro-perspective. He believed that the Government would continue to devise appropriate measures to facilitate various economic sectors to cope with challenges posed by uncertainties in the global economy.

Management of the Exchange Fund

24. Miss TAM Heung-man pointed out that the Government had accumulated a substantial amount of surplus in the fiscal reserves account and the accumulated surplus of EF. She was concerned whether HKMA would assess the adequate level of foreign reserves to be maintained in EF so that the Government could consider transferring the amount in excess to the General Revenue Account for implementing measures to return wealth to the people. While appreciating that HKMA had achieved a good investment return for EF in 2007, Ms Emily LAU expressed similar concern about the large surplus topping $1,000 billion held by the Government.

25. In reply, CE/HKMA advised that the issue of maintaining an "adequate" level of foreign reserves for safeguarding currency stability of Hong Kong was a complicated one given the uncertainties in the global markets which might give rise to unpredictable impacts on the financial markets of Hong Kong. For instance, the impact of the sub-prime crisis had spilled over to areas other than mortgage lending. It was not clear when the turmoil in the US and Europe would subside. So far the contagious effects on the emerging markets in Asia had been limited, presumably because financial innovation through securitization had not taken hold as much in Asia as in developed markets. Moreover, banks in Hong Kong had managed their risks in mortgage business in a cautious manner. However, if the global economy was exposed to the serious adverse impact of the developed markets, a substantial amount of fiscal reserves might be needed for Hong Kong to maintain its financial and monetary stability in a highly turbulent environment.

26. The Chairman asked whether the revised income-sharing arrangement between the fiscal reserves and EF was a more desirable one in terms of stability for the Treasury's share of investment income. In reply, CE/HKMA advised that under the revised income-sharing arrangement, the fiscal reserves placed with EF would be paid an annual fee at a pre-determined rate fixed each year, being the higher of the average annual rate of return of EF's investment portfolio in the past six years, or the average annual yield of three-year EF Notes of the preceding year. The fixed rate of fee payment to Treasury for 2007 was 7% and the full-year payment was $27.6 billion. The revised income-sharing arrangement would provide stability and predictability to the Treasury's share of investment income. While the Treasury's share would have been more than $27.6 billion for 2007 under the previous income-sharing arrangement as the investment return of EF for 2007 was higher than 7%, the fixed rate of fee payment to the Treasury for 2008 would be higher than 7% as the lower rate recorded in 2001 would be discarded and the good return of 2007 would be taken into account in the computation of the fixed rate of fee payment for 2008 and subsequent years.

Staff turnover in HKMA

27. Noting CE/HKMA's remarks that HKMA was facing the problem of high staff turnover, Ms Emily LAU enquired about the possible measures to be considered by the Governance Sub-committee of EFAC to tackle the problem. Pointing out that the remuneration of HKMA staff was already on the high side compared with the staff of other financial regulators, Ms LAU was concerned whether pay rise would be contemplated as one of the measures to attract and retain staff. In reply, CE/HKMA advised that the problem of staff turnover faced by HKMA was quite acute, with an overall turnover rate of about 10% and even higher rates in certain grades. The Governance Sub-committee would examine measures to tackle the problem of staff turnover and make recommendations in due course.

V. The 70% mortgage cap on residential property

(LC Paper No. CB(1)662/07-08(04) — Hong Kong Monetary Authority's written response on issues and questions to be addressed in connection with the 70% mortgage cap on residential property

LC Paper No. CB(1)662/07-08(05) — The Hong Kong Association of Banks' written response on the 70% mortgage cap on residential property

LC Paper No. CB(1)706/07-08(01) — Civil Service Bureau's paper on guidelines and arrangements to safeguard against conflict of interests of civil servants

LC Paper No. CB(1)706/07-08(02) — Hon LAU Kong-wah's question on "The guideline capping the loan-to-value ratio for residential mortgage lending at 70%" raised at the Council meeting on 16 January 2008

LC Paper No. CB(1)559/07-08 — Background Brief on the 70% mortgage cap on residential property prepared by the Legislative Council Secretariat

LC Paper No. CB(1)382/07-08(01) — Paper on issues/questions to be addressed in connection with the 70% mortgage cap on residential property prepared by the Legislative Council Secretariat)

Briefing by the Hong Kong Monetary Authority

28. At the invitation of the Chairman, the Executive Director (Banking Supervision), Hong Kong Monetary Authority (ED/HKMA) highlighted salient points in HKMA's responses to issues and questions raised by the Panel in relation to the 70% mortgage cap on residential property, as follows:

(a) The 70% loan-to-value (LTV) ratio for residential mortgage lending was first initiated by certain leading banks in Hong Kong in November 1991. The practice was then adopted by other banks as a voluntary risk management measure and evolved into an industry standard. HKMA supported the practice and continued to do so.

(b) The 70% LTV ratio generally applied to all residential mortgage loan applications, regardless of the occupation or background of the borrowers. Circumstances where authorized institutions (AIs) might exceed the 70% LTV ratio included: (i) proper risk assessment for the concerned loan had been conducted and the risk of the excess portion of the mortgage loan was properly managed, e.g. covered by additional collateral or mortgage insurance; (ii) residential mortgages granted to staff of AIs as housing benefit; and (iii) to facilitate borrowers in negative equity to refinance their residential mortgages with a lower mortgage rate so as to reduce their mortgage repayments, HKMA had allowed AIs to refinance such residential mortgages by granting up to 100% of the market value of the mortgaged property since October 2001.

(c) HKMA monitored whether AIs had adequate risk-management systems to ensure the effective implementation of HKMA's supervisory requirements and industry standards through on-site examinations and off-site reviews. In respect of residential mortgage lending, HKMA conducted on-site examinations to assess, among other things, AIs' implementation of the 70% LTV ratio. These on-site examinations mainly covered AIs more active in the mortgage market or those in respect of which HKMA had supervisory concerns. HKMA's supervision work focused on the adequacy of AIs' risk-management measures rather than the commercial relationship between AIs and their customers. Since the introduction of the 70% LTV requirement in 1991, the supervisory efforts of the HKMA had been stepped up over time in response to changes in the condition and product features of the residential mortgage loan market.

29. ED/HKMA advised that the implementation of the 70% LTV ratio had contributed to the maintenance of banking stability in Hong Kong during economic downturn and fluctuations of property prices in the past decade or so. HKMA was satisfied that in general, AIs had complied with the 70% LTV ratio in managing their risk in mortgage lending. He further said that HKMA staff were bound by the secrecy provision in section 120 of the Banking Ordinance (BO) (Cap. 155) from public disclosure of information obtained in the performance of their duties. ED/HKMA therefore drew the Panel's attention that when responding to members' questions, he would not be able to disclose information or comment on any individual case.

Discussion

Implementation of the 70% mortgage cap

30. Miss TAM Heung-man was concerned about the circumstances under which AIs could exceed the 70% cap. She asked whether the LTV ratio was merely an arrangement between AIs and their customers, and whether AIs could offer residential mortgage exceeding the 70% cap where they had conducted proper risk assessment for the loan. Noting from HKMA that the implementation of the 70% LTV ratio could prevent over-lending by AIs in their mortgage business, Miss TAM enquired whether the mortgage cap could effectively curb speculative activities in the property market.

31. In response, ED/HKMA advised that the objective of the 70% LTV ratio was to ensure adequate risk management by AIs in their mortgage business, rather than to curb speculative activities in the property market. This risk-management measure had proved to be effective in achieving the objective as there had not been any significant increase in the mortgage loan delinquency rate during the ups and downs of the property market. As to the circumstances under which AIs would deviate from the 70% LTV guideline, ED/HKMA recapped his earlier briefing on the circumstances that AIs might exceed the 70% LTV ratio. He added that in case of any deviation from the 70% LTV ratio, HKMA would seek to understand from the AI concerned more details about such deviation.

32. Mr LAU Kong-wah said that in 1993, when Mrs Anson CHAN was the Chief Secretary (CS), she had obtained a 100% property mortgage loan. Mr LAU considered that her case did not fall within any of the three circumstances under which AIs might deviate from the 70% LTV ratio as mentioned in HKMA's earlier briefing. Mr LAU was gravely concerned whether the lending bank had reasonable justification to grant a property mortgage loan exceeding the 70% LTV ratio to Mrs Anson CHAN from the risk-management perspective; and if not, the supervisory actions HKMA should take to follow up the deviation.

33. In response, ED/HKMA said that he was bound by the secrecy provision under section 120 of BO from commenting on any individual case. He nevertheless explained that the circumstances set out in his earlier briefing were just examples of past cases in which HKMA had considered the deviation by AIs acceptable. However, the circumstances depicted were by no means exhaustive. As part of its supervisory work, HKMA would seek to understand from the AI concerned more details about the deviation in question. If the AI failed to provide a reasonable justification for the deviation, HKMA would assess the implications on the effectiveness of the risk-management system adopted by the AI. To the extent that the risk management standard of the AI concerned was called into question, HKMA would consider the need for appropriate supervisory measures to ensure that the AI rectified the weaknesses identified. These measures included requiring the AI to investigate the weaknesses of its risk-management system and rectify them within a prescribed time. Also, the HKMA might require the AI to appoint an external

auditor to review matters of supervisory concern; or escalate the matter to the AI's senior management or Board of Directors. He stressed that the supervisory focus of HKMA was on whether AIs had adequate risk management measures to ensure the effective implementation of the 70% LTV ratio standard in general.

34. Mr Ronny TONG enquired whether AIs were required to seek approval from HKMA for granting mortgage loans exceeding the 70% LTV ratio. Mr TONG also asked whether the property value referred to the purchase price or the prevailing market price of the property. He remarked that if the purchase price of the property was lower than the prevailing market price, it might be possible that a mortgage loan equivalent to 100% of the purchase price might still not exceed 70% of the market price of the property.

35. In reply, ED/HKMA advised that the onus of putting in place necessary risk-management measures was on AIs, and that the granting of mortgage loans by AIs was not subject to the approval of HKMA. HKMA would monitor the effectiveness of AIs' risk-management systems through on-site examinations and off-site reviews. He reiterated that if the risk-management standard of an AI was called into question, HKMA would consider the need for appropriate supervisory measures to help ensure that the AI rectified the weakness identified. ED/HKMA further explained that for the purpose of processing mortgage loan applications, individual AIs would normally obtain independent property valuation. HKMA could, in its on-site examinations and off-site review, make reference to the market price derived from the valuation to assess whether the AI concerned had adhered to the 70% LTV requirement. Where the market price derived from such valuation was significantly higher than the purchase price of the property, the AI concerned would need to look into the case to ascertain whether the valuation was reasonable and the relevant risks were properly managed. He nevertheless recalled that from the supervisory experience of HKMA, there were only very few cases showing a marked difference between the purchase price and the prevailing market price of a property.

36. Mr James TIEN noted that if a bank extended a mortgage loan in excess of 70% of the value of the property, it should offload the excess risk to a third party, such as by taking out insurance for the excess portion of the mortgage loan under the mortgage insurance scheme operated by the Hong Kong Mortgage Corporation Limited. He enquired whether the above arrangement would have any cost implications on the borrower. Mr TIEN was also concerned whether HKMA had issued any guidelines to banks in respect of the granting of mortgage loans in excess of the 70% LTV ratio for prestigious customers.

37. ED/HKMA stressed that as the 70% LTV requirement was directed at ensuring adequate risk management by AIs, AIs could seek to cap their risk to 70% of the property value by offloading the excess risk through insurance coverage. The insurance coverage would inevitably incur a cost on the borrower and the premium was roughly in the range of 1% to 2% of the loan amount covered. ED/HKMA advised that the 70% cap generally applied to all residential mortgage loan applications, regardless of the occupation or background of the borrowers. To avoid

banks from circumventing the 70% LTV requirement, HKMA had issued a circular in 1997 that banks should not provide any personal top-up loan to a borrower on or before the date of granting of the mortgage loan.

38. Mr Abraham SHEK was concerned about the liquidity of the banking industry back in 1993 when Mrs Anson CHAN obtained a 100% mortgage loan. In response, ED/HKMA said that while he could not recall the liquidity position of the banking industry at that time, HKMA would expect banks to observe the 70% LTV requirement in general. The liquidity position of the industry should not be a factor for consideration in this regard. In response to Mr Abraham SHEK's further enquiry, ED/HKMA said that in deciding the amount of mortgage loan offered, banks would indeed take into account relevant factors, such as the credit worthiness and repayment ability of the borrower in question and other factors relevant to their overall risk management. This said, the 70% LTV requirement should also be observed by AIs. On the number of cases in which residential mortgage loans exceeding the 70% LTV ratio were granted, ED/HKMA pointed out that collection and compilation of such statistics might require considerable resources on the part of AIs. HKMA was satisfied that AIs had in general adopted appropriate risk-management measures for the implementation of the 70% LTV ratio and so far, there was no supervisory concern warranting the collection of such statistics.

Safeguards against conflict of interests of civil servants

39. Mr LAU Kong-wah questioned why the Administration had not taken proactive action to follow up on Mrs Anson CHAN's case, given its public pledge to maintain a high standard of integrity and conduct in the civil service. Mr LAU was of the view that the Administration should demonstrate its strong commitment to upholding a high standard of integrity in the civil service, in particular among senior or top ranking civil servants, by taking necessary actions to follow up cases of suspected breaches or potential conflict of interests and providing an account of its findings to the public. In this connection, Mr LAU enquired whether there was a time limit within which the Administration must take disciplinary action against a civil servant in breach of the guidelines/ requirements on the avoidance of conflict of interests.

40. In response, the Deputy Secretary for the Civil Service, (DSCS) advised that guidelines and arrangements were in place to safeguard against conflict of interests of civil servants. A fundamental rule underlying civil service integrity was the need for civil servants to avoid any actual or potential conflict of interests. In this regard, the acceptance of advantages by civil servants was governed by legislation such as section 3 of the Prevention of Bribery Ordinance (Cap. 201) (POBO) and the Acceptance of Advantages (Chief Executive's Permission) Notice (AAN) issued by the Chief Executive. Under AAN, prescribed officers had been given general permission to solicit or accept loans made available to them in their private capacity by a tradesman or company provided that two specified conditions for the avoidance of conflict of interests were met. If either one of the conditions was not met, the civil servant would be required to apply for special approval from the relevant authority in

the Government. One of the key considerations in assessing applications for special approval was whether the case would give rise to an actual or perceived conflict of interest. Moreover, DSCS informed members that a reporting system was in place for certain civil servants, depending on their posts, to declare private investments in and outside Hong Kong to the Government on an annual or bi-ennual basis. This reporting system, which placed the onus on civil servants, facilitated management actions in identifying and where necessary, taking safeguards against conflict of interests situations. DSCS nevertheless said that in accordance with the Administration's established practice, she would not comment on the individual case of a civil servant or ex-civil servant. She advised that disciplinary actions were not applicable to individuals who had left the civil service. However, where the breach constituted a criminal offence, the individual concerned could still be liable to criminal proceedings.

41. Mr LAU Kong-wah enquired whether prior approval had been given by Mrs CHAN's supervisor at that time, i.e. Mr Chris PATTEN, the former Governor, before she obtained the mortgage loan. Mr WONG Ting-kwong expressed similar concern. Pointing out that Mrs Anson CHAN was the incumbent CS when she obtained a 100% mortgage loan in 1993, Mr WONG doubted whether Mrs CHAN, as head of the civil service, was also subject to an oversight mechanism in respect of conflict of interests equivalent to that applicable to other civil servants. In response, DSCS informed members that the reporting system for declaration of investment was introduced in 1995, while the guidelines/measures to safeguard against conflict of interests had been in place since the 1970s. These guidelines/measures applied to all civil servants irrespective of their rank and post. She nevertheless reiterated that she was not in a position to comment on a specific case.

42. Referring to paragraph 6 of the Administration's paper (LC Paper No. CB(1)706/07-08(01)), Ms Emily LAU noted that while civil servants were required under the reporting system to declare their private investments including the acquisition of a property, there was no requirement for them to declare the mortgage details. Ms LAU expressed concern about the deterrent effect, if any, of the mechanism for safeguarding against conflict of interests of civil servants and enquired about the number of cases in which disciplinary actions had been taken against civil servants who had failed to observe the relevant requirements and/or guidelines.

43. In response, DSCS said that in designing the reporting system for declaration of investment by civil servants, the Administration had to strike a reasonable balance between the need to maintain public confidence in the integrity of the civil service on the one hand, and the rights and privacy of civil servants to private investment on the other. She pointed out that the system of declaring private investment was only part of the measures to safeguard against conflict of interests of civil servants and that there were other built-in safeguards. For example, civil servants were required to declare to their supervisors all relevant interests which conflicted, or were perceived to conflict, with their official duties; civil servants could only obtain loans in their private capacity under conditions where general permission would apply or where

special permission from the relevant authority in the Government had been obtained before they solicited or accepted the loan of money. Given that adequate safeguards had been put in place, the Administration had not sought to impose a further requirement on the declaration of mortgage details relating to the acquisition of a property. As to Ms Emily LAU's concern about the deterrent effect of the mechanism, DSCS said that for the period between 2004-2005 and 2007-2008 (up to November 2007), there were 18 cases involving civil servants' breaches of POBO. Moreover, disciplinary action had been taken in 25 cases involving the acceptance of advantages and entertainment by civil servants from persons with official dealings.

44. Mr James TO referred to a recent incident in which the Equal Opportunities Commission (EOC) had prohibited its staff from accepting the discounted package offered by a fitness centre. He asked whether there were also restrictions applicable to civil servants in securing loans from banks in their private capacity. In response, DSCS advised that under the previous AANs and the latest one issued in 2007, prescribed officers had been given general permission to solicit or accept a loan of money made available to them in their private capacity by a tradesman or company provided that (i) the loan was equally available on equal terms to persons who were not prescribed officers; and (ii) the offeror of the loan had no official dealings with the prescribed officers. If either one of the above two conditions was not met, a civil servant was required to apply for special permission from the relevant authority. As regards the case of EOC as referred to by Mr James TO, DSCS pointed out that EOC was not part of the civil service and its employees were subject to the rules and procedures established by EOC to safeguard against conflict of interests.

45. Noting the condition specified in AAN that civil servants might accept loans under a general permission provided that the offeror of the loan had no official dealings with the civil servants concerned, Mr James TO questioned whether public officers who were involved in the regulation and supervision of banks could obtain a mortgage loan from banks in their private capacity. In reply, DSCS advised that in deciding whether or not there were official dealings between the offeror of the loan and the civil servant to whom the loan was offered, the Administration would take into consideration factors such as whether the civil servant concerned was directly involved in the regulation of the loan offeror's business or whether the civil servant had close contacts with the senior management of the lending institution. Each case had to be considered on its own merits as to whether the acceptance of the loan would give rise to any actual or potential conflict of interests. As such, it would not be practicable to give an exhaustive list of all the possible circumstances.

46. At about 12:34 pm, the Chairman announced that the meeting would be extended from the appointed ending time of 12:30 pm to 12:45 pm to allow further discussion.

47. Mr Abraham SHEK noted that the practice of the 70% LTV ratio for residential mortgage lending had been adopted by the banking industry since November 1991. In this connection, Mr SHEK sought information on the number of cases of civil servants obtaining mortgage loans exceeding the 70% cap into which

investigation had been conducted since then, with a further breakdown on the number of cases in which the civil servants obtaining such loans were found to have conflict of interests and the number of cases in which no irregularity was detected. The Administration noted the request and would endeavour to provide the information after the meeting.

(*Post-meeting note*: The Administration's response to Mr Abraham SHEK's request above was issued to members vide LC Paper No. CB(1)891/07-08 on 22 February 2008.)

48. At around 12:42 pm, the Chairman proposed to further extend the meeting, which would continue till 12:45pm, for 10 more minutes thereafter. There was no dissenting view from members present. The Chairman also informed members at this juncture that he had received a proposal from Mr WONG Ting-kwong in writing which he suggested to deal with later as discussion was still underway. Members present did not raise objection to the Chairman's suggestion.

49. Mr LAU Kong-wah was gravely concerned whether there was any breach of any statutory requirement if Mrs Anson CHAN had obtained a 100% mortgage loan without prior approval from her supervisor. He considered that the matter was of a serious nature and the Administration should account for details of the case to the public. He restated his query on whether Mr Chris PATTEN, the former Governor, and/or the relevant authority in the Government, had given approval to Mrs Anson CHAN or any other civil servant to obtain a residential mortgage loan exceeding the 70% cap.

50. DSCS reiterated that she could not provide details of specific cases of serving or former civil servants in which approval had been given to obtain loans in their private capacity. She also informed members that the record on declaration of investment by individual civil servants (mentioned in paragraph 6 of the Administration's paper) would only be kept for five years after the civil servant concerned had left the civil service. In this regard, she said that Mrs Anson CHAN had left the civil service for over five years. Mr LAU Kong-wah was dissatisfied with the Administration's reply and urged the Administration to look into the case of Mrs Anson CHAN to demonstrate to the public its commitment in upholding the high standard of integrity and conduct in the civil service.

51. Noting that the requirement for civil servants to obtain special permission before obtaining loans if any one of the specified conditions under the AAN was not met had been in place since the 1970s, Ms Emily LAU was concerned about the number of such applications considered and approved since then. In reply, DSCS said that the requirement had been in place for a few decades and there could well be quite a number of such cases. However, the required information was not readily available and considerable efforts would be required to retrieve and consolidate such information.

Motion proposed by Mr WONG Ting-kwong

52. The Chairman referred to the proposed motion in writing received from Mr WONG Ting-kwong and read it out:

"建議政府就前布政司陳方安生取得十成樓宇按揭事件了解詳情，並向公眾作出交待。"

(Translation)
"It is proposed that the Government should look into the incident in which Anson CHAN FANG On-sang, former Chief Secretary, obtained a 100% property mortgage loan; and give the public an account of the incident."

(The proposed motion had been tabled at the meeting at the request of Ms Emily LAU.) The Chairman informed members that he considered the motion directly related to the agenda item under discussion.

53. As it was about 12:49 pm, Ms Emily LAU raised a point of order and said that the motion should be proposed before the appointed ending time of the meeting, i.e. 12:30 pm. As some Panel members had already left the meeting without noting that a motion would be proposed, Ms LAU considered it unfair and inappropriate to proceed with the motion.

54. Mr WONG Ting-kwong explained that he had decided to propose the motion after members had put forward their questions and after the Administration had given its responses. However, he considered that ultimately, the Administration had not addressed members' concerns satisfactorily. Given the widespread public concern about the case in which Mrs Anson CHAN had obtained a 100% property mortgage loan, Mr WONG considered it necessary for the Administration to give the public an account of the incident. Mr Jeffrey LAM shared Mr WONG's view and said that it was in the public interest for the Administration to look into Mrs Anson CHAN's case.

55. On the procedural aspects, the Chairman recapped that he had announced shortly after 12:30 pm that the meeting would continue for 15 minutes as some members would still like to ask questions. He recalled that within the aforesaid period of extension, he had informed the meeting that he had received a proposed motion from Mr WONG Ting-kwong. He also suggested at that juncture to deal with it later. Members present at the meeting did not raise any objection. The Clerk said that according to relevant provisions of the House Rules, a motion which had been proposed and agreed to be dealt with during the appointed meeting time or the extension of 15 minutes as decided by the Chairman could be dealt with during the further extension of the meeting.

56. At around 12:53 pm, the Chairman proposed to further extend the meeting for 10 minutes beyond 12:55 pm. Members present did not raise objection to the further extension.

57. Mr Abraham SHEK said that as far as he could recall, there were cases in which motions had been proposed and dealt with during the extended time of a Panel meeting. He therefore considered it appropriate to proceed with the motion. On the scope of the motion, Mr SHEK was of the view that instead of focusing on an individual case, the Panel might consider requesting the Administration to look into all cases of senior civil servants who had obtained property mortgage loans exceeding the 70% cap so as to secure an overall understanding of the effectiveness of the mechanism to safeguard against conflict of interests of civil servants.

58. Mr WONG Ting-kwong considered that the scope of his motion had been worded in such a way to address public concern about the possible conflict of interests involved in Mrs Anson CHAN's case. Mr LAU Kong-wah was of the view that given the senior position of CS held by Mrs Anson CHAN in 1993, the case had significant implications on the credibility of the entire civil service and should not be viewed merely as an isolated case. Mr LAU also expressed support for Mr WONG's motion.

59. Noting the Administration's established practice of not disclosing details or giving comments on cases involving individual officers, Ms Emily LAU doubted whether the motion, even if passed, could achieve any material effect.

60. In this connection, Mr LAU Kong-wah pointed out that all along, it had been a usual practice for Panel members to choose to state in clear terms their stance or views on a subject of public concern through the moving of a motion. He added that Members were fully aware that such motions, even if passed, were not binding on the Administration, but were a necessary means to reflect the view or position shared by Members on important issues.

61. The Chairman put the motion to vote. Of the members present at the meeting, three voted for and no member voted against the motion. The Chairman declared that the motion was passed.

> (*Post-meeting note*: The Administration's and HKMA's written responses to the motion was issued to members vide LC Paper No. CB(1)890/017-08 on 22 February 2008.)

VI. Any other business

62. There being no other business, the meeting ended at 1:03 pm.

Council Business Division 1
Legislative Council Secretariat
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