

立法會
Legislative Council

LC Paper No. CB(1)526/09-10
(These minutes have been seen
by the Administration)

Ref : CB1/PL/FA/1

Panel on Financial Affairs

Minutes of meeting
held on Monday, 2 November 2009 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 Albert HO Chun-yan
Ir Dr Hon Raymond HO Chung-tai, SBS, S.B.St.J., JP
Dr Hon David LI Kwok-po, GBM, GBS, JP
Hon James TO Kun-sun
Hon Emily LAU Wai-hing, JP
Hon Abraham SHEK Lai-him, SBS, JP
Hon Vincent FANG kang, SBS, JP
Hon Jeffrey LAM Kin-fung, SBS, JP
Hon Andrew LEUNG Kwan-yuen, SBS, JP
Hon CHIM Pui-chung
Hon KAM Nai-wai, MH
Hon Starry LEE Wai-king
Hon CHAN Kin-por, JP
Hon CHAN Tanya
Hon Mrs Regina IP LAU Suk-ye, GBS, JP

Members absent : Dr Hon Philip WONG Yu-hong, GBS
Hon WONG Ting-kwong, BBS, JP
Hon Paul CHAN Mo-po, MH, JP

Public officers attending : Agenda Item IV
Prof K C CHAN, SBS, JP
Secretary for Financial Services and the Treasury

Miss AU King-chi, JP
Permanent Secretary for Financial Services and the
Treasury (Financial Services)

Mr CHOI Yiu-kwan, JP
Deputy Chief Executive (Banking)
Hong Kong Monetary Authority

Mr Nelson MAN
Executive Director
Banking Supervision Department
Hong Kong Monetary Authority

Agenda item VI

Mr Peter PANG, JP
Deputy Chief Executive (Development)
Hong Kong Monetary Authority

Mr Arthur YUEN, JP
Executive Director (External)
Hong Kong Monetary Authority

Ms Carmen CHU
Division Head (External)
Hong Kong Monetary Authority

Attendance by invitation : Agenda item IV

Mr Paul KENNEDY
Executive Director and Chief Operating Officer
Securities and Futures Commission

Mr Stephen PO
Senior Director
Intermediaries Supervision Department
Securities and Futures Commission

Agenda item V

Mr Peter PANG, JP
Executive Director
Hong Kong Mortgage Corporation Limited

Mr James LAU, Jr., JP
Chief Executive Officer
Hong Kong Mortgage Corporation Limited

Clerk in attendance: Ms Rosalind MA
Chief Council Secretary (1)5

Staff in attendance : Mr Noel SUNG
Senior Council Secretary (1)4

Miss Constance MAN
Senior Council Secretary (1)8

Ms Haley CHEUNG
Legislative Assistant (1)8

Action

I Confirmation of minutes of meeting and matters arising

(LC Paper No. CB(1)141/09-10 — Minutes of meeting on 15 October 2009)

The minutes of the meeting held on 15 October 2009 were confirmed.

II Information papers issued since the last regular meeting on 6 July 2009

(LC Paper No. CB(1)2247/08-09 — Administration's consultation paper on the conceptual framework of the legislative proposal to enhance the anti-money laundering regulatory regime in respect of the financial sectors

LC Paper No. CB(1)2290/08-09 (01) — Administration's response to Hon Mrs Regina IP's letter on recent developments of Lehman Brothers-related Issues

- LC Paper No. CB(1)2350/08-09(01) — Administration's paper on second quarterly report of 2009 on Employees Compensation Insurance — Reinsurance Coverage for Terrorism
- LC Paper No. CB(1)2475/08-09(01) — Half-yearly Economic Report 2009 and the press release
- LC Paper No. CB(1)2491/08-09(01) — Chief Executive Officer of Hong Kong Deposit Protection Board's letter dated 18 August 2009 on Review of the Deposit Protection Scheme (English version only)
- LC Paper No. CB(1)2491/08-09(02) — Report on the public consultation on enhancing deposit protection under the Deposit Protection Scheme
- LC Paper No. CB(1)2491/08-09(03) — Consultation paper on strengthening the operation of the Deposit Protection Scheme
- LC Paper No. CB(1)2591/08-09(01) — Referral from the Bills Committee on Dutiable Commodities (Amendment) Bill 2009
- LC Paper No. CB(1)2767/08-09 — Process Review Panel for the Securities and Futures Commission Annual Report to the Financial Secretary for 2008-2009
- LC Paper No. CB(1)38/09-10(01) — Administration's information note on proposed implementation of an Integrated Annual Survey of Economic Activities
- LC Paper No. CB(1)109/09-10(01) — Administration's information note on revision of fees and charges under the purview of the Financial Services and the Treasury Bureau (Treasury Branch)

LC Paper No. CB(1)191/09-10(01) — Information note on public consultation on the review of corporate rescue procedure legislative proposals)

2. Members noted the information papers issued since the last regular meeting on 6 July 2009.

III Date of next meeting and items for discussion

(LC Paper No. CB(1)145/09-10(01) — List of outstanding items for discussion

LC Paper No. CB(1)145/09-10(02) — List of follow-up actions)

Meetings in December 2009

3. Members noted that the Administration had proposed the following items for the next regular meeting scheduled for 7 December 2009:

- (a) Briefing by the Financial Secretary (FS) on Hong Kong's latest overall economic situation;
- (b) 2010-2011 Budget consultation;
- (c) Review of corporate rescue procedure legislative proposals; and
- (d) Legislative proposal to enhance the anti-money laundering regulatory regime in respect of the financial sectors.

4. In addition to the above items, the Chairman referred members to item 6 of the Panel's list of outstanding items for discussion on "Depreciation allowances for profits tax in respect of machinery or plant under the Inland Revenue Ordinance (IRO) (Cap. 112)". He recapped that members had agreed to consider scheduling the subject for discussion at the Panel meeting in December 2009 at the request of Mr Paul CHAN and Dr LAM Tai-fai. Given the number and complexity of the proposed items for discussion, the Chairman proposed and members agreed that the starting time of the meeting on 7 December 2009 be advanced to deal with items (a) to (c) above.

5. The Chairman then sought members' views on scheduling a special meeting on 14 December 2009 at 8:30 am to deal with the other two outstanding items (item (d) above and the item proposed by Mr Paul CHAN and Dr LAM Tai-fai). Noting the concern of Mr Albert HO about members' availability for the proposed meeting slot, the Chairman advised that he would ask the Secretariat to consult Panel members and

finalize the meeting arrangements having regard to members' returns. Members also agreed that the Panel should invite relevant business and professional organizations to attend the special meeting to give views on the subject of "Depreciation allowances for profits tax in respect of machinery or plant under the IRO".

(Post-meeting note: Notice of meeting on 7 December and that of the special meeting on 14 December were issued to members vide LC Paper Nos. CB(1)239/09-10 and 328/09-10 on 3 and 11 November 2009 respectively.)

Provision of discussion papers by the Administration

6. As the Administration had failed to observe the agreed deadline for provision of discussion papers for items IV and V on the agenda, the Chairman sought members' views on the way to deal with the items. While not objecting to the discussion of the two items at the meeting, Ms Emily LAU expressed concern about the timely provision of discussion papers and opined that the Administration should provide explanations on why the deadline could not be observed.

7. In response, the Permanent Secretary for Financial Services and the Treasury (Financial Services) (PS(FS)) advised that more time had been taken to coordinate input from parties concerned for the discussion paper on the progress of the Administration's action plan on recommendations in the reports prepared by the Hong Kong Monetary Authority (HKMA) and the Securities and Futures Commission (SFC) on the Lehman Brothers Minibonds Incident (the Action Plan). The Secretary for Financial Services and the Treasury (SFST) and PS(FS) took note of members' concern and assured the meeting that the Administration would endeavour to observe the deadline for provision of discussion papers for committee meetings.

IV Progress of the Administration's action plan on recommendations in the reports prepared by the Hong Kong Monetary Authority and the Securities and Futures Commission on the Lehman Brothers Minibonds Incident

(LC Paper No. CB(1)145/09-10(03) — Administration's paper on progress of the Administration's action plan on recommendations in the reports prepared by the HKMA and SFC on the Lehman Brothers Minibonds Incident

- LC Paper No. CB(1)145/09-10(04) — Hong Kong Association of Banks' submission dated 23 October 2009 on improvement measures implemented by the retail banking sector (English version only)
- LC Paper No. CB(1)142/09-10 — Background brief on progress of the Administration's action plan on recommendations in the reports prepared by HKMA and SFC on the Lehman Brothers Minibonds Incident prepared by the Legislative Council Secretariat)

Briefing by the Administration

8. SFST briefed members on the progress of the implementation of the Action Plan as at end October 2009, highlighting the salient points in the Administration's paper. A number of improvement measures had been implemented by Registered Institutions (RIs) under the initial phase of the Action Plan to enhance the sales process of investment products and the business conduct of intermediaries. SFC had also launched a three-month public consultation on 25 September 2009 on proposals to enhance the regulation of intermediaries selling investment products to the public. The SFC had also just launched a two-month public consultation on proposal to transfer the public offering regime for structured products in the form of debentures from the Companies Ordinance (Cap. 32) to the Securities and Futures Ordinance (SFO) (Cap. 571), the consultation period of which would end on 31 December 2009. The Administration planned to conduct public consultations, before end 2009, on other longer-term proposals, including the establishment of an Investor Education Council and a financial dispute resolution scheme.

Discussion

Disclosure of product features and risks

9. Mr Albert HO opined that the Action Plan had not addressed some of the fundamental issues revealed in the Lehman Brothers-related Minibonds Incident. In this connection, Mr HO was particularly concerned about the protection of ordinary retail investors under the current disclosure-based regulatory regime, as they might be exposed to high risk and complicated investment products under the regime. Mr HO was of the view that reference should be made to the practices of advanced economies which prohibited the offering of investment products with returns disproportionate to the high risks involved to ordinary retail investors and limited the offering to institutional and professional investors.

10. SFST said that the disclosure-based regulatory approach was commonly adopted by advanced economies in Europe and the United States (US). He advised that there were a number of requirements under the disclosure-based regime to protect the interest of the investing public. For example, requirement on disclosure of product features and risks, and regulation of intermediaries' business conduct in the sale of the investment products. Intermediaries were also required to put in place investor characterization procedures to minimize risk mismatch between the risk rating applied to the investment products and the customer's risk profile.

11. Mrs Regina IP remarked that one of the major causes of the global financial tsunami was the opaque derivatives market, which had recorded substantial turnover in the year ending 2007. The price volatility of derivatives had affected the interests of many investors and they had complained about the lack of transparency of these products, such as the market turnover, counter-party risks and the underlying collaterals, etc. Pointing out that the US and European economies were examining measures to enhance the transparency of the derivatives market, such as through the establishment of a central counter-party clearing platform, Mrs IP asked whether the Administration had plans to follow the latest international practice in this regard.

12. SFST responded that Hong Kong had actively participated in international forums for enhancement of the regulation and risk management of the financial markets. The Administration would consider putting in place suitable measures to improve market transparency, such as the shifting of over-the-counter derivatives transactions to a central counter-party clearing platform. With respect to derivative products sold to the public, the SFST appreciated Mrs IP's concern about protection of investors' interests and advised that proposals had been formulated in this regard. For example, SFC had proposed in its consultation on enhancing protection of the investing public a new category of investors which required the intermediaries to seek client information about knowledge of derivatives.

13. To assess the impact of derivative products on investors, Mrs Regina IP requested the Administration to provide latest information on the size of issuance and market turnover of these products, including products such as warrants, bull/bear contracts and accumulators. SFST noted Mrs IP's request and agreed to provide the relevant information as far as practicable.

Sale of investment products and business conduct of intermediaries

14. Noting that one of the measures to improve the sale of investment products in the Action Plan was to make the SFC website the repository of information about unlisted investment products authorized by SFC, Mrs Regina IP enquired about the meaning of SFC's authorization of such products as SFC would not authorize the issuance of investment products under the existing regime. In response, SFST advised that the offering documentation and marketing materials of the products referred to in the improvement measures were subject to SFC's review and authorization before issuance and distribution to the investors.

15. Mr Albert HO noted that a number of improvement measures in the initial phase of the Action Plan had been implemented by RIs, but still required consultation for implementation by brokers. He was concerned about the consistency in the sales process and business conduct between RIs and brokers, and the possible confusion that might be caused to investors. Ms Emily LAU shared Mr HO's concern and enquired about the reasons for the discrepancy in the implementation of improvement measures by institutions supervised by HKMA and SFC.

16. The Deputy Chief Executive (Banking) , HKMA (DCE(B)/HKMA) advised that HKMA issued a circular to RIs in January 2009, requiring the implementation of some measures to enhance the sales process of retail investment products as soon as practicable. Given the particular mode of business operation of RIs, implementation of some of the enhancement measures were of more imminent need, for example, a clearer differentiation between traditional deposit-taking activities and retail securities business. SFST supplemented that HKMA had requested RIs to take immediate actions for implementation of some of the recommendations in its report on the Lehman Brothers Minibonds Incident as far as possible under the existing regulatory framework. In parallel, SFC had reviewed the regulatory framework for investment products and launched public consultations on proposals to enhance the regulation of the sale of these products. Nevertheless, SFST pointed out that in view of the differences in the mode of operation of financial institutions, there might be variations in the actual implementation of the improvement measures. Upon completion of SFC's consultation on proposals to enhance protection of the investing public, consultation conclusions would be issued and intermediaries would be required to comply with a final package of measures to improve the sales of investment products and business conduct, including enhanced disclosure requirements.

17. Mr KAM Nai-wai expressed concern about the practices of banks in assessment of their customers' risk profile. He enquired whether the banks would adopt standard criteria for the assessment so that they would not arrive at different risk profiles for the same customer.

18. In response, SFST said that it would not be practicable to require standardized assessment of customers' risk profiles by different banks, and it was a common practice for regulators to issue guidelines to regulated institutions in this regard instead of requiring compliance as regulatory requirements. DCE(B)/HKMA supplemented that while different banks would consider similar factors in the assessment of customers' risk profiles, e.g. the customer's wealth, his investment knowledge and history, the assessment might vary among banks due to differences in customer-bank relationship and the customer information held by the bank. It would not therefore be feasible to have similar risk profiling result for the same customer by different banks.

19. Mr CHAN Kin-por opined that a proper balance should be struck between protection of the investing public and development of the financial market, so that measures to improve the regulation and sales process of investment products would not be excessive as to hinder product diversification and innovation in the financial market.

20. SFST appreciated Mr CHAN's concern and advised that the Administration and the regulators would take heed of the balance between investor protection and market development in the implementation of improvement measures. Responding to Mr CHAN's concern about the procedures and time required in the recent offering of renminbi bonds in Hong Kong, DCE(B)/HKMA advised that as banks needed time to familiarize with the new measures for the sale of investment products, such as audio-recording of the process and documentation requirement on customers' risk profile, more time might have been taken to complete the sales process for the bonds. As the risk profile assessment would be valid for one year, the process would not have to be repeated for the same customer for every transaction. Moreover, the time required for completing the sales process was expected to reduce as bank staff became conversant with the new procedures over time.

SFC's consultation on proposals to enhance protection for the investing public

21. Referring to SFC's consultation on proposals to improve the marketing of investment products, such as the accuracy of marketing materials and restrictions on the use of gifts as marketing tools, Mr Albert HO opined that these were basic requirements which should be implemented right away. He therefore questioned the need for SFC's consultation on the proposals.

22. Noting that a number of the improvement measures in the Action Plan implemented by banks were also included as proposals in SFC's consultation on enhancing protection for the investing public, the Chairman enquired about the feedback of the banking sector in the implementation of the measures. In this connection, he highlighted the concern of the banking sector about the complexity and time required in the enhanced sales process. He asked whether it would be more appropriate to implement the improvement measures after the outcome of the consultation exercise was known, so that the banks did not have to modify the measures if these turned out to be inconsistent with the consultation outcome.

23. SFST advised that SFC's public consultation launched on 25 September 2009 was part of the measures under the initial phase of the Action Plan. The proposals contained therein were consistent with the broad direction of the improvement measures in the Action Plan, i.e. to enhance regulation of the sale of investment products and conduct of intermediaries for the interests of the retail investors. Throughout the implementation of the measures, refinements might be required to cater for operational needs and such refinements should not affect the implementation of the measures in general. As such, slight adjustments to the improvement measures to accommodate the finalized proposals after the consultation

should not be a problem for the intermediaries. DCE(B)/HKMA added that HKMA had maintained close liaison with the banking sector in the implementation of measures in the Action Plan. The proposals in SFC's consultation paper and the improvement measures implemented by the banking sector were broadly similar and therefore the outcome of the consultation was not expected to give rise to any major changes to the measures already implemented by the banking sector. DCE(B)/HKMA advised that the banking sector, taking the opportunity of SFC's consultation, would put forward the suggestion of providing for a simplified sales process for transactions on execution only basis and for those initiated by the clients and did not involve the giving of investment advice or solicitation by the RI.

24. Mr Jeffrey LAM was concerned whether SFC had consulted the financial services industry in formulating the proposals in its consultation paper. Pointing out that the banking sector had expressed concern about possible abuse of the proposed cooling-off period by investors to engage in speculative activities, Mr LAM called on SFC to take heed of the views of the relevant stakeholders and the industry before putting forward proposals to enhance regulation. He opined that excessive regulatory requirements might have adverse impact on the development of Hong Kong as an international financial centre.

25. SFST advised that SFC had arranged discussions with the banking sector in the formulation of the consultation proposals. The banking sector, like all other interested parties in the community, might forward their views on the proposals during the consultation period. Mr Paul KENNEDY, Executive Director and Chief Operating Officer, SFC (ED(COO)/SFC), supplemented that in formulating the consultation proposals, SFC had consulted a large number of organizations, including the Hong Kong Association of Banks, and had taken into account their views in working out the proposals. On the proposal of a cooling-off period, SFC had adopted a pragmatic approach and proposed a cooling-off period only for products where the investment was long-term and where there was no ready secondary market. ED(COO)/SFC said that the purpose of a public consultation was to invite views of all interested parties before deciding on the appropriate arrangements for introduction into the market. SFC had held or organized 35 consultation sessions so far to gauge the views of interested parties on the consultation proposals. It had also invited the banking sector to attend a workshop in early December 2009 to specifically discuss the proposals on cooling-off period and commission disclosure.

Regulatory regime for the financial services industry

26. Ms Starry LEE said that the Lehman Brothers Minibonds incident had revealed the inadequacy of the current regulatory regime in protection of retail investors' interests. Ms LEE was concerned that regulation of the financial services industry by two regulators, namely HKMA and SFC, had given rise to problems in the supervision of intermediaries. She enquired whether the Administration would make reference to oversea practices and consider setting up a single regulatory body for the financial services industry. Mr Abraham SHEK expressed similar concern

and asked whether the Administration would consider changes to the regulatory regime so that SFC would become the single regulator for securities and futures industry.

27. In response, SFST said that the Administration had formulated the Action Plan in consultation with the two regulators to take forward the various recommendations set out in their reports on the Lehman Brothers Minibonds Incident. The improvement measures in the Action Plan were targeted at different stages of the offering and distribution of investment products, to address the regulatory issues arising from the Lehman Brothers Minibonds Incident in an effective and pragmatic manner. The Administration would closely monitor the implementation of the improvement measures and would be happy to consider views on proposals for enhancement of the regulatory framework, including those on fundamental changes of the regulatory regime.

Investigation of complaints about Lehman-related investment products

28. Pointing out that the majority of the complaints relating to the Lehman Brothers Minibonds had been resolved through the settlement arrangement offered by distributing banks, Ms Starry LEE opined that more resources could now be deployed to deal with the complaints relating to the sale of Lehman-related investment products other than Minibonds (non-Minibond Lehman-related products), in particular, equity-linked notes (ELNs). She enquired about the progress of investigation of complaints relating to these products.

29. Mr KAM Nai-wai, Ms Emily LAU and Mr Abraham SHEK expressed similar concern. Mr KAM was concerned that HKMA had not completed the investigation nor taken disciplinary actions for even one case after more than a year's investigation. Mr KAM enquired about HKMA's pledge for investigation of these complaints and whether SFC would continue to adopt the top down approach for investigation of complaints relating to non-Minibond Lehman-related products. Ms LAU and Mr SHEK were concerned that investigation of complaints relating to non-Minibond Lehman-related products should be expedited following the resolution of the majority of the Minibonds complaints. Mr SHEK enquired about the timeframe for processing the complaints relating to non-Minibond Lehman-related products and for the regulators to take disciplinary actions against the intermediaries' mis-selling of these products.

30. DCE(B)/HKMA said that in the past few months, HKMA had deployed more resources to handle the complaints relating to non-Minibond Lehman-related products, such as ELNs, as the majority of the complaints on Minibonds had been resolved through the settlement arrangement. Given the complexity of the cases and the need to go through due process for the investigation, DCE(B)/HKMA said that it was hard to give a definite timeframe for completion of investigation of all the complaints, or the timing for disciplinary actions, if mis-selling was involved. He advised that based on the latest position of the investigation, about 610 of complaints

on non-Minibond Lehman-related products were under disciplinary consideration. DCE(B)/HKMA said that HKMA would take necessary disciplinary actions if mis-selling was involved, but could only announce the outcome of the investigation of a complaint after completion of the whole investigation process, including the process for persons concerned to make representations and appeals.

31. ED(COO)/SFC said that for complaint cases relating to Lehman Brothers Minibonds which resolution had been reached between the complainants and banks, the top down approach investigation was discontinued. The distributing banks had, as part of the repurchase agreement, undertaken to review the sales process and enhance their complaint handling procedures. These agreed improvement measures would be subject to an independent review to be completed in the first quarter of 2010. SFC together with the HKMA would monitor the banks' compliance with the terms of the settlement agreement and they would be subject to regulatory actions if they did not comply with the agreed steps.

32. The Deputy Chairman also expressed concern about the process of investigation of complaints relating to Lehman-related investment products, in particular, the transparency of the process. The Deputy Chairman queried why the regulators had not taken enforcement actions against any banks or their staff for mis-selling of investment products, but had devoted their efforts in seeking resolution of the complaints through the settlement arrangement instead. As the investigation of these complaints had been conducted for over one year, he questioned why the regulators had not announced any cases of disciplinary actions, or disclosed to the public the progress of the investigation. The Deputy Chairman was also concerned whether the regulators would only take enforcement action against distributing banks which had not made settlement arrangement with the complainants.

33. ED(COO)/SFC responded that as pointed out in SFC's report on the Lehman Brothers-related Minibonds Incident, SFC did not have the authority to order compensation. SFC had worked out the settlement arrangement in accordance with section 201 of SFO in the best interest of the public. This enabled a very large amount of compensation to be paid to investors. ED(COO)/SFC said that the outcome of investigation of a case would be announced on completion of the whole investigation process where disciplinary action was taken or the matter was put before the courts. DCE(B)/HKMA supplemented that based on its legal advice, disclosure of details of its investigation should not be made until completion of investigation and all representation procedures. HKMA had provided updated information on the progress of investigation of Lehman-related complaints on a weekly basis on its website, and the latest figure of non-Minibond Lehman-related cases put under disciplinary consideration was 610. DCE(B)/HKMA assured members that investigation of the minibond related complaints which had not been resolved through settlement arrangement and alleged mis-selling of cases of non-Minibond Lehman-related products would continue.

34. PS(FS) explained the due process of the SFC disciplinary proceedings. Following its investigation, SFC would consider if there was sufficient evidence to start disciplinary proceedings against a regulated person. If so, SFC would issue to the party concerned a notice which set out the findings of the investigation and the proposed sanctions. The party concerned could make representations to SFC within a certain period of time to explain the matter and the reasons for opposing the proposed sanctions. After reviewing all information submitted by the party concerned, SFC would then issue another notice in writing detailing the reason for its decision and the sanctions to be imposed. The party concerned would be given another period of time to appeal to the Securities and Futures Appeals Tribunal if they so wished. In the interest of justice, SFC could only disclose the outcome of the disciplinary decision when the appeal procedures had been completed. This due process was laid down in the statute, with a view to giving a fair hearing to the party to be disciplined by SFC.

35. At the request of the Deputy Chairman, HKMA agreed to provide information on the legal basis which had given rise to its view that information on the investigation progress of the complaints could not be disclosed to the public before completion of the investigation and all representation procedures, and to seek legal advice on the feasibility of disclosing relevant information of the complaints at an earlier stage of the investigation.

36. Ms Emily LAU remarked that apart from making the settlement arrangement between banks and the complainants, SFC and HKMA should also take enforcement actions against intermediaries which had involved in mis-selling of investment products. Ms LAU urged the regulators to expedite the investigation process by deploying additional manpower for the purpose, so as to alleviate the hardship of investors who suffered heavy losses in their investments of Lehman-related investment products as soon as possible.

37. Mr Abraham SHEK opined that the complainants should be kept informed of the progress of the investigations. Responding to Ms Emily LAU's remark about the settlement arrangement for the sister-in-law of the Chief Executive, Mr SHEK clarified that there was no preferential or priority treatment in the settlement arrangement, as more than 4 000 investors had already reached settlement with the banks concerned during the same period.

38. The Chairman opined that HKMA and SFC should enhance the efficiency and transparency in investigating the complaints relating to Lehman-related investment products, in order to address concerns of the investors and the public. Mr CHAN Kin-por echoed the Chairman's view and requested HKMA to provide the following information:

- (a) whether all of the complainants concerned were informed when their cases proceeded to the stage of disciplinary consideration, and the number of the complainants informed if only some but not all of them were informed; and

- (b) if the complainants were not informed, whether there was any legal restriction which prohibited the regulators from informing the complainants concerned of the investigation progress at certain stages.

(Post-meeting note: SFC and HKMA's responses to members' concerns at paragraphs 13, 35 and 38 above were circulated to members vide LC Paper Nos. CB(1)524/09-10(01) and (02) on 1 December 2009.)

V The roles and operation of the Hong Kong Mortgage Corporation Limited

- (LC Paper No. CB(1)145/09-10(05) — Hong Kong Mortgage Corporation Limited (HKMC)'s paper on the roles and operation of HKMC
- LC Paper No. CB(1)143/09-10 — Background Brief on the roles and operation of HKMC prepared by the Legislative Council Secretariat
- LC Paper No. CB(1)2055/08-09(01) — Hon Mrs Regina IP's letter dated 1 June 2009 on the operation of the HKMC (English version only)
- LC Paper No. CB(1)2055/08-09(02) — Administration's response to Hon Mrs Regina IP's letter dated 1 June 2009
- LC Paper No. CB(1)122/09-10(01) — Hon Mrs Regina IP's letter dated 2 September 2009 on operation of HKMC (English version only)
- LC Paper No. CB(1)122/09-10(02) — HKMC's response to Hon Mrs Regina IP's letter dated 2 September 2009
- LC Paper No. CB(1)173/09-10(01) — HKMC's press release dated 21 October 2009 on Fixed Adjustment Rate Mortgage Programme
- LC Paper No. CB(1)173/09-10(02) — HKMC's press release dated 23 October 2009 on Mortgage Insurance Programme)

LC Paper No. CB(1)257/09-10(01) — Powerpoint presentation material provided by HKMC (tabled at the meeting and soft copy issued on 3 November 2009))

Declaration of interests

39. Mr Abraham SHEK, Miss Tanya CHAN, Ms Starry LEE, Mr CHAN Kin-por Dr David LI and Mr Andrew LEUNG declared that they were directors of HKMC.

Discussion

40. Mr Jeffrey LAM expressed concern about the achievement of the core objectives of HKMC through its current business activities. Noting that HKMC was initially set up with reference to the business model of Fannie Mae and Freddie Mac (Fannie/Freddie), Mr LAM was concerned whether the business operation of HKMC would be at risk like that of Fannie/Freddie during the global financial tsunami. In the event that HKMC ceased operation, Mr LAM asked whether corporations in the private sector could take up its role to provide mortgage insurance and purchase mortgage loans from banks.

41. Mr Peter PANG, Executive Director, HKMC (ED/HKMC) advised that the core objectives of HKMC were to enhance banking stability through providing liquidity to banks, promote home ownership in Hong Kong and facilitate the development of the debt markets. While reference had been made to the business model of Fannie/Freddie back in 1997 when the Corporation was established, HKMC had adopted a much more prudent risk management framework. HKMC had adopted a passive approach in making purchases from banks whereas Fannie/Freddie purchased mortgages actively through an "originate-and-sell" model for profit maximization while promoting home ownership. The leverage rate for Fannie/Freddie was 60 to 80 times at end-2007 but was only 8 to 10 times for HKMC. The capital risk weight for mortgage-backed securities (MBS) was 2% for HKMC, versus 0.45% for Fannie/Freddie. The delinquency ratio for HKMC's retained loan portfolio at end July 2009 was 0.08%, in contrast with Fannie Mae's 4.2% and Freddie Mac's 3%.

42. ED/HKMC said that private sector corporations might be willing to purchase mortgage loans and provide mortgage insurance when the financial market was stable. However, during volatile market conditions like the recent global financial crisis, it would be difficult for private companies to cope with the surge in demand for liquidity, having regard to commercial and risk management considerations. ED/HKMC pointed out that HKMC purchased about \$11.4 billion mortgage loans during the Asian Financial Crisis in 1998, and that in late 2008 banks offered around \$30 billion of mortgage loans for sale, and in the end HKMC purchased \$11.5 billion of mortgage loans. This scale of purchase was nearly four times higher than HKMC's average annual purchase of \$2.4 billion of assets from banks during non-crisis times.

43. Mrs Regina IP questioned why HKMC had engaged in investments in mortgage loan business outside Hong Kong, such as Malaysia, Korea and Shenzhen, if its core missions were to enhance banking stability and promote home ownership in Hong Kong. Mrs IP was concerned about the higher risks involved in these overseas investments. She also queried the propriety of HKMC's decision on such an important change in business strategy without consulting the Legislative Council (LegCo), but merely based on the recommendations of its consultant and consideration of its Board of Directors. Mrs IP was concerned that HKMC's business expansion overseas was investing public money in high risks activities, as the property markets in Korea, the Mainland and Malaysia were rather volatile. Ms Starry LEE was also interested in whether the HKMC should consult or report to the LegCo on major changes to its business strategies.

44. ED/HKMC said that HKMC's overseas activities were intended to strengthen HKMC's financial position and hence its ability in achieving its core missions in Hong Kong. HKMC's business diversification beyond Hong Kong had been pursued following a strategic business development review conducted in 2006 by a management consultant, the recommendations of which had been endorsed by HKMC's Board of Directors. In 2006, FS had authorized under section 3(2) of the Exchange Fund Ordinance (Cap. 66) (EFO) that capital injection to HKMC could be used for investment purposes. He added that HKMC's overseas activities were often undertaken in collaboration with the relevant central banks. For example, the mortgage guarantee businesses in Malaysia and Shenzhen were in the form of a joint venture with a company wholly or partly owned or sponsored by Bank Negara Malaysia and the Shenzhen Branch of the People's Bank of China respectively. These central banks considered HKMC's business model to be an effective way to address risks related to mortgages and its general adoption to be a way to improve regional financial stability. ED/HKMC pointed out that overseas mortgage purchase also provided a supplementary source to achieve a more steady flow in mortgage acquisition. He added that the Korean mortgages represented a very good investment with robust credit risk mitigation arrangements, including a low loan-to-value ratio of around 50%, prudent seasoning requirement and sizable equity piece retained by the seller to absorb first losses.

45. Responding to Ms Starry LEE's comment on regular briefings on HKMC's work, ED/HKMC said that HKMC would be prepared to provide information and brief Members on its work on request. In addition to briefings, members of the Panel might also make enquiries during the regular briefings by the Chief Executive of HKMA. The Chairman opined that the Panel could arrange to invite HKMC for further briefings on its work, as and when necessary, if members so wished.

46. Ms Emily LAU questioned whether HKMC's overseas activities had gone beyond its core missions. Noting that HKMC's capital from the Exchange Fund (EF) was also for investment purposes since 2006, Ms LAU enquired about the background of such change in HKMC's business strategy. Ms LAU opined that

providing HKMC with capital from the Exchange Fund had in a way circumvented LegCo's approval of the use of public funds. She asked whether and what measures would be put in place to ensure that HKMC would operate in accordance with its core missions.

47. ED/HKMC said that the capital injection to HKMC by the EF was in line with section 3(1A) (i.e. to maintain stability and integrity of the monetary and financial systems of Hong Kong) and section 3(2) (i.e. to enter into financial arrangement for the prudent management of the Exchange Fund) of the EFO. ED/HKMC recapped that HKMC's business diversification had been pursued in accordance with the recommendations of a consultancy review in 2006. HKMC's business diversification only involved a small portion of its balance sheet for purchase of mortgage assets overseas, which would diversify its risks and support its credit ratings. The amount of investment in overseas business was subject to a cap set by the Board of Directors. He assured members that HKMC was firmly committed to its core missions.

HKMC

48. Ms Emily LAU remained concerned about the decision on HKMC's business diversification. She requested HKMC to provide information on the strategic business development review conducted by its management consultant in 2006, such as the consultancy report and considerations of its Board of Directors leading to acceptance of the consultant's recommendation for business diversification. ED/HKMC agreed to consult the Board of Directors in this regard.

49. Mr Abraham SHEK recalled that HKMC's Board of Directors, including several LegCo members and other stakeholders, had studied in detail the consultancy study report and the recommendations of the consultant in 2006. The business diversification beyond Hong Kong was important for HKMC to maintain its capability to discharge its core policy role in Hong Kong while gaining more experience in overseas markets, which would be to the benefit of Hong Kong as an international financial centre. The Board's deliberation was both legitimate and appropriate for serving the interest of Hong Kong. The overseas ventures set up by HKMC were well publicized and not kept as a secret as such. Dr David LI echoed Mr SHEK's comments.

50. Mrs Regina IP was of the view that LegCo Members were appointed to public bodies in their personal capacities, and could not represent LegCo in such public service. Pointing out that HKMC's Board of Directors only met quarterly, Mrs IP considered that the directors might not have a full picture of the implications of the business diversification. Moreover, Mrs IP questioned whether joint ventures with central banks overseas could bring benefit for the community of Hong Kong. For example, whether the joint venture in Malaysia could help HKMC develop Islamic finance in Hong Kong, apart from helping Malaysia to provide mortgage guarantee.

51. ED/HKMC explained that HKMC's joint venture in Malaysia involved provision of retail mortgage guarantee, instead of the wholesale Islamic financial services which the Hong Kong Government planned to develop. The joint venture

had provided HKMC with the opportunity to develop expertise in Islamic mortgage finance.

52. Mrs Regina IP asked whether HKMC's Mortgage Insurance Programme (MIP) was in line with the principle of "Small Government, Big Market", i.e. whether the programme had any crowding out effect in the mortgage insurance market. In response, ED/HKMC said that HKMC's business activities would not lead to market monopoly. In fact, HKMC had been reinsuring a substantial part of its MIP business with private insurance companies in Hong Kong and overseas, and a new private company was also positioning itself to provide mortgage insurance service in Hong Kong. Interested enterprises which could meet the relevant regulatory requirements were free to enter the mortgage insurance market. HKMC's role was to act as a provider of mortgage insurance in order to promote wider home ownership in Hong Kong, and at the same time its stringent underwriting practice served as a model for prudent risk management in mortgage insurance business.

53. Miss Tanya CHAN enquired whether HKMC had any performance pledge for vetting applications for mortgage insurance, as she had received complaints regarding the long processing time for such applications. Miss CHAN further asked whether the heated property market had any impact on the business of HKMC.

54. Mr James LAU, Chief Executive Officer, HKMC said that owing to the heated property market and the surge in the number of duplicate applications for mortgage loans, longer processing time had been necessary earlier in 2009. With the Corporation's injection of additional resources and also the collaboration of banks, the processing time had reverted to the normal level in July 2009, i.e. about one to two days' turnaround after receipt of applications. To better manage the increased risks in a heated property market, HKMC had introduced on 21 October 2009 a special scheme under its Fixed Adjustable Rate Mortgage Programme (the FARM Programme) to promote mortgage loans with fixed-rate periods from one to ten years, and introduced certain refinements to the Insurance Eligibility Criteria of MIP on 23 October 2009.

55. Mr CHAN Kin-por opined that the HKMC had been successful in its overseas business and risk diversification, and that the financial performance had also been impressive. The average bonus payout for the Corporation staff suggested that staff were not pursuing risky business for their own gains. In the face of such criticism, he opined that HKMC could do better by providing advice and sharing its experience with central banks overseas as a consultant, instead of the current mode of engaging in joint ventures with central banks. Ms Emily LAU expressed a similar view. Mr CHAN said that this could minimize the investment risks involved in overseas investments and alleviate public concern about the use of HKMC's capital. Mr CHAN was also of the view that only insurance companies with sufficient expertise and capital could cope with the provision of mortgage insurance services, and the near collapse of several leading international mortgage insurers during the recent financial crisis suggested that there should be strict requirements for new entrants.

56. Noting that HKMC's retained loan portfolio had a combined delinquency plus rescheduled loan ratio of 0.15% at July 2009, Ms Starry LEE was concerned about the financial position of HKMC. She asked whether the provision of fixed-rate mortgage loans under the FARM Programme would have any impact on the ratio, and the risk in re-insurance through securitization of mortgage portfolios. Ms LEE also enquired about HKMC's debt issuance strategy as it had \$34.3 billion in outstanding debt that accounted for about 4% of the total Hong Kong dollar outstanding debt of \$862 billion.

57. ED/HKMC responded that fixed rate mortgage enabled the borrowers to lock in the current low mortgage rate so that their repayment ability would not be undermined by future increase in interest rate. This should help to maintain rather than undermine the low delinquency rate of the HKMC's mortgage portfolio. ED/HKMC added that the FARM programme would not increase the funding risk of the HKMC's debt issuance programme as the fixed rate funding to support the programme had been pre-arranged.

58. Ms Emily LAU reiterated her dissatisfaction that capital injection to HKMC through the Exchange Fund had in effect bypassed the mechanism for approval of funding proposals by LegCo. Ms LAU was concerned whether HKMC's participation in mortgage insurance and debt issuance programmes had any crowding out effect and had any impact on fair competition in the insurance and debt markets.

59. Mrs Regina IP commented that the responses given by HKMC was misleading, as the amount of mortgage loans purchased by HKMC during the financial crisis was insignificant compared with the amount of capital injection by central banks overseas during the same period, and therefore could hardly help to maintain banking stability. Mrs IP opined that HKMC's purchase of mortgage loans and its MIP had in effect competed with the banking sector for low risk mortgage business. Mrs IP was concerned that with the anticipated increase in interest rates in 2010 following exit from quantitative easing by governments overseas, whether it was appropriate for HKMC to provide fixed-rate mortgages under the FARM Programme. Referring to the current abundance of liquidity in the banking sector, Mrs IP doubted whether the FARM Programme would result in competition with the banking sector for mortgage business.

60. ED/HKMC assured members that HKMC adopted a market-oriented approach in fulfilling its core objectives. It was working in collaboration and partnership, rather than entering into direct competition, with other market players. In the purchase of mortgage loans, HKMC acted as a passive buyer of assets from banks, and would respond to banks' offers to sell mortgage loans in exchange for liquidity. As the transactions were made at arms-length commercial basis, there was no stigma attached to this source of liquidity. Through MIP, HKMC had enlarged banks' mortgage lending capacity (with an additional \$132 billion mortgage loans granted since 1999) and created a new market for the local insurance industry.

ED/HKMC advised that as the funding for the FARM Programme had been secured in advance, the operation of the scheme would not be affected by future changes in interest rates. Moreover, ED/HKMC pointed out that the mortgage rate under the FARM Programme was in fact higher than the prevailing market interest rate and hence competition with other market players should not be an issue.

VI Hong Kong's participation in Chiang Mai Initiative Multilateralization

(LC Paper No. CB(1)145/09-10(06) — HKMA's paper on Hong Kong's participation in Chiang Mai Initiative Multilateralization (CMIM)

LC Paper No. CB(1)144/09-10 — Background Brief on Hong Kong's participation in CMIM prepared by the Legislative Council Secretariat)

Briefing by the Hong Kong Monetary Authority

61. At the invitation of the Chairman, Deputy Chief Executive (Development), HKMA (DCE(D)/HKMA) briefed members on the framework of CMIM, the strategic importance for Hong Kong to participate in CMIM and the modality of Hong Kong's participation. DCE(D)/HKMA highlighted the following points in his briefing:

- (a) CMIM was a regional emergency liquidity facility agreed by the 10 members of the Association of Southeast Asian Nations together with China, Japan and Korea (the ASEAN+3). The objective of CMIM was to provide a more advanced framework of regional liquidity support mechanism which would supplement the existing international financial arrangements.
- (b) It was of strategic importance for Hong Kong to participate in CMIM as Hong Kong, being a major international financial centre and one of the largest reserves holders in the region, should show solidarity and join this newest and most important regional joint-defence mechanism. The participation had substantial practical and symbolic importance to Hong Kong's financial stability. Moreover, Hong Kong's separate participation in CMIM was another practical demonstration of its autonomy in international financial affairs under the concept of the "One Country, Two Systems".
- (c) As agreed by the ASEAN+3 Finance Ministers in February 2009, the size of CMIM was US\$120 billion. Hong Kong undertook to commit, on a callable basis, up to US\$4.2 billion (i.e. 3.5% of US\$120 billion). The level of Hong Kong's commitment was largely in line with its

regional peers of similar economic size such as Singapore and Malaysia. In early October 2009, FS endorsed the commitment of US\$4.2 billion via EF. The lending would be structured as a currency swap under which the lender would provide US dollars in exchange for the domestic currency of the borrower. Lending decisions would be made by CMIM participants by majority voting and Hong Kong could vote on the decisions.

Discussion

Modality of Hong Kong's participation

62. Mrs Regina IP expressed concern about details of Hong Kong's participation in CMIM, such as how Hong Kong's financial contribution of 3.5% of the total size of CMIM was determined and the interest rates for lending.

63. DCE(D)/HKMA advised that all the main components of CMIM, including individual country's contribution, borrowing accessibility and the surveillance mechanism, were agreed at meetings of the ASEAN+3 Finance Ministers. The level of commitment of Hong Kong was largely in line with those ASEAN member countries of similar economic size. Interest for lending would be charged at the prevailing market rate, which would be based on the London Interbank Offered Rate plus certain spread. In response to Mrs IP's further question, DCE(D)/HKMA said that Hong Kong's commitment on a callable basis referred to the operation of the bilateral swap arrangements under CMIM where liquidity support would be provided on a need basis instead of setting aside a pool of reserve for the purpose.

64. The Deputy Chairman was concerned about the representation and involvement of Hong Kong in the discussions on the main components of CMIM, as Hong Kong was not a member of the ASEAN+3. He questioned whether the representation of Hong Kong in the process was in line with the role that the Hong Kong Special Administrative Region (HKSAR) might play, i.e. using the name "Hong Kong, China" when participating in international organizations and conferences, as stipulated in Articles 151 and 152 of the Basic Law. Ms Emily LAU shared his concern.

65. DCE(D)/HKMA advised that Hong Kong participated in the discussions on CMIM as a member of the Chinese delegation, despite that it was not a member of ASEAN+3. Representatives of HKSAR had participated in meetings at different levels, including working groups, under the ASEAN+3. The Central People's Government consulted Hong Kong on the modality of participation before reaching agreement with other ASEAN+3 members on the main components of CMIM. At the request of Ms LAU and the Deputy Chairman, the Administration undertook to provide information on the participation of Hong Kong representatives in meetings of ASEAN+3 and/or its working groups.

(Post-meeting note: The Administration's written response was circulated to members vide LC Paper No. CB(1)525/09-10(01) on 1 December 2009.)

66. The Deputy Chairman expressed dissatisfaction that the Administration had not consulted or briefed the LegCo on the modality of Hong Kong's participation in CMIM before agreement was reached by the ASEAN+3 Finance Ministers in May 2009. Ms Emily LAU and Mrs Regina IP echoed the Deputy Chairman's view.

67. In response, DCE(D)/HKMA advised that a brief report on Hong Kong's participation in CMIM had been provided in the paper for the briefing on the work of HKMA at the Panel meeting on 21 May 2009. While the framework for the regional liquidity support mechanism under CMIM was agreed at the ASEAN+3 Finance Ministers meeting on 3 May 2009, the operational details and formal documents for CMIM were being finalized and would also be signed by Hong Kong as one of the participating economies. HKMA had planned to brief the Panel on the proposal and had therefore made arrangement for a briefing at this meeting shortly after the summer recess.

68. Noting that FS had endorsed the commitment of US\$4.2 billion via EF for Hong Kong's financial contribution to CMIM, Ms Emily LAU queried the propriety of the funding arrangement. Ms LAU was concerned that the use of EF for the purpose would in a way bypass the LegCo in the funding approval, which in her view was not a prudent management of public resources. The Deputy Chairman also expressed concern about the mode of providing for the financial commitment and the impact of such commitment on EF.

69. DCE(D)/HKMA advised that FS' endorsement of the commitment via EF was in accordance with section 3(1A) of EFO, which empowered FS to use the fund as he thought fit to maintain the stability and integrity of the monetary and financial systems of Hong Kong. As CMIM aimed to provide temporary liquidity to participants in need, and in doing so helped mitigate the risk of financial contagion, Hong Kong's participation in CMIM had substantial practical and symbolic importance to its financial stability, through guarding against speculative attacks in future. While funding approval by LegCo would not be required for the use of EF, DCE(D)/HKMA explained that the financial contribution of Hong Kong for CMIM was not a donation but a commitment for lending to provide liquidity support through a network of bilateral swap arrangements. The lending would be structured as a currency swap under which the lender would provide US dollar in exchange for the domestic currency of the borrower and interest would be charged at the prevailing market rate.

70. Ms Emily LAU maintained her view that the use of EF which had bypassed the LegCo in the funding approval process was inappropriate.

71. Ir Dr Raymond HO expressed support for Hong Kong's participation in CMIM. While appreciating the power of FS to use EF for maintenance of the

stability of the financial and monetary systems of Hong Kong, Ir Dr HO considered that the Administration should improve the transparency in the use of EF, which was public money. Ir Dr HO suggested that the subject could be further discussed at a Panel meeting and all LegCo Members be invited to participate in the discussion.

72. Mr Abraham SHEK expressed full support for Hong Kong's participation in CMIM, as participation in this regional cooperation initiative would bring long-term benefit to Hong Kong. Mr SHEK agreed that the Administration should enhance the transparency in discussions on the international agreement but pointed out that this should be done having regard to the need of maintaining the status and competitiveness of Hong Kong in the region through suitable participation in international and regional cooperation initiatives.

73. The Chairman called on the Administration to take heed of members' concern about the transparency of the discussion process of international cooperation initiatives. The Chairman said that another briefing for the Panel might be arranged at a later stage when the operational details and formal documents of CMIM were finalized.

Benefits for Hong Kong's participation in CMIM

74. Mrs Regina IP questioned whether Hong Kong could reap real benefits from the participation in CMIM, as Hong Kong would unlikely require short-term balance-of-payments support in view of its substantial level of foreign reserves. Mrs IP was concerned whether the participation in CMIM could guard against speculative attacks on the peg to the US dollar under the Linked Exchange Rate system.

75. DCE(D)/HKMA advised that Hong Kong as one of the participating economies could seek short-term liquidity support under CMIM in the event of speculative attacks on its financial and monetary systems. While it was unlikely that Hong Kong would need to borrow through the liquidity arrangement of CMIM, DCE(D)/HKMA stressed the strategic importance for Hong Kong to participate in CMIM because the establishment of CMIM was a powerful demonstration to international markets of the determination of the regional economies to work together to overcome short-term liquidity issues so as to promote overall financial stability in the region.

76. The Chairman said that Members belonging to the Democratic Alliance for the Betterment and Progress of Hong Kong supported Hong Kong's participation in CMIM, which was a regional joint-defence mechanism. Lending support to other regional economies facing liquidity shortage would be important to the financial development of Hong Kong, as this represented Hong Kong's commitment to the joint-defence mechanism and its willingness to work with other regional economies to promote overall financial stability in the region. He highlighted that in the past, Hong Kong had participated actively in some regional and international liquidity

support arrangements, such as the New Arrangements to Borrow of the International Monetary Fund and the financing package offered to Thailand during the Asian financial crisis in 1997.

VII Any other business

77. There being no other business, the meeting ended at 12:53 pm.

Council Business Division 1
Legislative Council Secretariat
4 December 2009