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Report of the Panel on Financial Affairs for submission to the Legislative Council

Purpose

This report gives an account of the work of the Panel on Financial Affairs for the 2010-2011 legislative session. It will be tabled at the meeting of the Legislative Council (LegCo) on 13 July 2011 in accordance with Rule 77(14) of the Rules of Procedure of LegCo.

The Panel

2. The Panel was formed by a resolution passed by the Council on 8 July 1998 and as amended on 20 December 2000, 9 October 2002, 11 July 2007 and 2 July 2008 for the purposes of monitoring and examining government policies and issues of public concern relating to financial and finance matters. The terms of reference of the Panel are set out in **Appendix I**.

3. For the 2010-2011 session, the Panel comprised 21 members, with Hon CHAN Kam-lam and Hon CHAN Kin-por elected as Chairman and Deputy Chairman respectively. The membership list of the Panel is in **Appendix II**.

Major work

Macro economy

4. During the 2010-2011 session, the Panel continued to provide a forum for LegCo Members to exchange views with the Financial Secretary (FS) on matters relating to Hong Kong's macro-economic situation. The Panel noted at

the meeting on 9 June 2011 that the economy was poised for a real growth of 5-6% for 2011 as a whole. Benefiting from the thriving Asian and emerging economies, the global economy had continued to expand. However, the pace of the economic recovery in the United States (US) was still dragged by the weak fundamentals and hence had remained slow, and the sovereign debt problems in some of the eurozone countries had caused volatilities in the financial markets and cast a shadow over Europe's economic prospects. Besides, some new uncertainties had successively emerged, including further macroeconomic policy tightening in Asia, heightened geopolitical risks in the Middle East and North Africa, and Japan's earthquake and nuclear incident. These uncertainties would pose some downside risks to Hong Kong's external trade, possibly causing export growth to slow down for the rest of 2011.

Property market

5. Members noted with grave concern that notwithstanding the introduction of the Special Stamp Duty in November 2010 and the measures taken by the Hong Kong Monetary Authority (HKMA) to tighten mortgage lending, flat prices had continued to increase. The overall flat prices in March 2011 were already 3% higher than the 1997 peak, and the home purchase affordability (i.e. the ratio of mortgage payment for a 45-square metre flat to median income of households, excluding those living in public housing) soared further from 45% in the fourth quarter of 2010 to around 49% in the first quarter of 2011. Members therefore urged FS to carefully monitor the risk of a property bubble and formulate appropriate measures to ensure stable and healthy development of the property market. Members made various suggestions such as increasing land supply for residential uses, resuming the construction of Home Ownership Scheme flats, and imposing restrictions on the purchase of residential properties by non-Hong Kong residents etc.

6. FS advised that the Government had put in a lot of efforts to increase the supply of residential units. In the next three to four years, about 61 000 residential units would be completed and put on the market. The Chief Executive had also indicated that in the next 10 years, the Government would ensure that land supply was sufficient for a supply of about 20 000 residential units each year on average, in addition to the public housing units provided by the Housing Authority. As regards the suggestion of resuming the construction of Home Ownership Scheme flats, FS said that the Chief Executive would provide a response on the issue in due course.

Inflation

7. Another major concern of Members was the inflation pressure faced by local households. With domestic and external factors both adding to local inflation in the near term, the forecast rates of headline and underlying consumer price inflation for 2011 as a whole were revised upwards to 5.4% and 5.5% respectively, from the 4.5% first announced in the 2011-2012 Budget. Members were particularly concerned about the surge in food prices and the rentals of private housing and shops, which had direct impacts on people's livelihood. Members urged FS to formulate targeted measures to alleviate the pressure of inflation on businesses and the general public. Some Members queried whether the Linked Exchange Rate System was a main factor contributing to sustained inflation in Hong Kong.

8. FS advised that most economies in Asia had to deal with rising inflation risks, and Hong Kong was no exception. To relief the inflation pressure on local households, the 2011-2012 Budget had included some one-off relief measures. The Government would strive to ensure continued development in the economy in the long run, so as to generate employment for both the lesser and high skilled, so that the whole community would benefit. Furthermore, to forestall the risk of upward price spiral and high inflation over the medium to long term, the Government would strive to promote continued productivity upgrading as an effective cushion against local price pressures. The Government's investment in large infrastructure projects and in manpower training and retraining should help in this regard. FS also maintained that the Linked Exchange Rate System was suitable for Hong Kong's economic setting. There was no need nor any intention to change the system.

Monetary affairs

9. The Panel continued to receive regular briefings by the Chief Executive of HKMA and his colleagues on the work of HKMA. At these briefings, HKMA provided information on global/regional/local financial and economic conditions, currency stability, banking stability, development of financial infrastructure, regional and international co-operation on financial affairs and the performance of the Exchange Fund.

Banking supervision

10. Noting that the total loans extended by the banking sector in Hong Kong grew by 29% or HK\$940 billion in 2010, which was the largest increase in more than 10 years, Panel members enquired about the reasons for the significant growth and the measures taken by HKMA to ensure prudent risk

management by banks. HKMA advised that one major reason was the strong demand for US dollar credit loans from Mainland enterprises. The total US dollar loans had growth by 68.2% in 2010 and the growth was expected to continue in 2011, as the interest rates for US dollar loans in Hong Kong were lower than those in the Mainland. HKMA assured the Panel that it had stepped up on-site examination of banks to ensure that the banks had not compromised their credit underwriting standards. Banks would also be requested to review and, where necessary, increase their regulatory reserve as a countercyclical measure to provide themselves with a buffer for the potential increases in the credit costs in future.

11. The Panel noted that since October 2009, HKMA had introduced several rounds of prudential measures on banks' mortgage business, aiming at dampening the cyclical effects of the property market and upholding the stability of the banking sector. As the local property market remained exuberant, some members expressed concern about the influx of capital from the Mainland into the local market, and asked whether HKMA had collected relevant information and would consider introducing measures to tighten mortgage lending for property buyers from the Mainland and overseas jurisdictions. HKMA stressed that its work in relation to banks' mortgage business was premised on the need to maintain the stability of the banking sector. Given that Hong Kong maintained a free and open economy allowing free flow of capital, HKMA did not maintain data on the amount of capital from the Mainland invested in the local property market. In granting mortgage loans, banks had to comply with the relevant maximum loan-to-value ratios and debt-servicing ratios set by HKMA.

12. Some Panel members had been advocating the establishment of a positive credit database on mortgage loans to enhance the risk management of banks. In this regard, the Panel noted that following a public consultation exercise on the banking industry's proposal for positive mortgage data sharing, the Office of the Privacy Commissioner for Personal Data determined in March 2011 that positive mortgage data sharing among banks would lead to responsible borrowing and lending. The Office therefore had revised the Code of Practice on Consumer Credit Data on 1 April 2011 so as to allow for the implementation of positive mortgage data sharing. At the Panel meeting on 23 May 2011, HKMA advised that authorized institutions (AIs) had been sending out letters to their existing mortgage customers to seek their prescribed consent for the uploading of their pre-existing mortgage data to the credit reference agency. All new applicants for mortgage loans were required to make declarations in relation to their pre-existing mortgages and the relevant database would be built up over time.

13. On members' concern about the progress of the investigations into the complaints against banks for mis-selling of Lehman Brothers-related structured products, HKMA advised at the meeting on 23 May 2011 that HKMA had completed the investigation into the great majority of the complaint cases by March 2010, and had proceeded to pursue disciplinary actions in the substantiated cases. The parties involved would be given time to respond to HKMA's proposed disciplinary actions according to the established rules and statutory procedures. Announcement of the outcome of the investigations would be made when all the necessary procedures had been completed. If there was any suspected criminal offence involved in the sale of the structured products, the relevant cases would be referred to the Police for investigation notwithstanding settlement agreements reached between the banks and the investors.

The Exchange Fund

14. The Panel continued to monitor the investment and management of the Exchange Fund, and noted that the investment income of the Exchange Fund for 2010 (excluding valuation charges in Strategic Portfolio) amounted to \$79 billion. Most of the asset classes, except for foreign exchange, recorded investment gains in the year. The Accumulated Surplus increased by \$37.9 billion in 2010, and the investment income of the Exchange Fund for the first quarter of 2011 was \$24.2 billion. The fixed rate for calculating the payment to the fiscal reserve for 2010 was 6.3%, based on which the Exchange Fund paid \$33.8 billion to the fiscal reserves in 2010.

15. Some members expressed concern that the investment returns of the Exchange Fund had continued to decline over the years, from an average of 5.9% since 1994, to 4.9% in the past five years, and to 3.6% in 2010. HKMA responded that the primary purpose of the Exchange Fund was to maintain the stability of the exchange value of the Hong Kong currency, and given the specific statutory objectives of the Exchange Fund, its investments should concentrate on financial products with a high level of liquidity, such as quality US Treasury securities of relatively short maturity. A direct comparison between the investment returns of the Exchange Fund and other trust funds would not be appropriate.

Securities and futures market

Development of a scripless securities market

16. On 1 November 2010, the Administration together with the Securities and Futures Commission (SFC) and the Hong Kong Exchange and Clearing

Limited (HKEx) briefed the Panel on the consultation conclusions on the proposed operational model for implementing a scripless securities market in Hong Kong. Under the proposal, the scripless initiative would be implemented progressively and listed companies would be allowed to take up the scripless option on a voluntary basis. After the dual system had operated for some time, and when market participants considered that the scripless operational model was convenient and cost-effective, consideration would be given to implementing the scripless regime on all listed companies. During the Initial Public Offers of shares, the companies concerned would be required to provide the option of scripless securities to the subscribers.

17. The Panel discussed various issues including how the proposed operational model compared with the relevant arrangements in other major financial markets, measures to encourage market participants to use the scripless operational model, safeguards to protect the security of the data on scripless securities held in the Central Clearing and Settlement System, and measures to ensure the stability and reliability of the securities clearing and data storage systems.

Regulation of the over-the-counter derivatives market

18. On 3 January 2011, the Administration, HKMA and SFC briefed the Panel on the latest international developments in the regulation of the over-the-counter (OTC) derivatives market and the way forward for Hong Kong. The Panel noted that to address the risks embedded in the OTC derivatives market and to implement the recommendations of G-20, the Government, HKMA and SFC would work with relevant stakeholders to build a regulatory regime for the OTC derivatives markets in Hong Kong, which would cover the reporting of OTC derivatives transactions to a local trade depository to be created by HKMA, and the clearing of standardized OTC derivatives transactions through an authorized central counterparty. At the initial stage, the reporting and clearing requirement would be applied to interest rate swaps and non-deliverable forwards. HKMA would build upon its existing Central Moneymarkets Unit infrastructure to develop a local trade depository in Hong Kong, whereas HKEx planned to establish a local authorized central counterparty to provide central clearing services for the specified products. Members noted that amendments to the Securities and Futures Ordinance (Cap. 571) (SFO) were required for implementation of the proposed regulatory regime.

19. Some members noted with concern that the proposed regulatory regime would not cover equity derivatives and foreign exchange derivatives. SFC and HKMA explained that it was difficult to achieve standardization, which was a

prerequisite for centralized clearing, for equity derivatives. While foreign exchange derivatives constituted the greatest share of the OTC derivatives market, the majority of the foreign exchange derivatives involved short-term foreign exchange swaps whose risk was relatively low. Depending on the development in the international arena, Hong Kong might consider regulating OTC equity derivatives and some of the long term foreign exchange derivatives at a later stage.

20. The Panel also discussed the financial arrangements for the establishment and operation of the authorized central counterparty and trade depository, the level of fees to be charged by the facility operators, the impact of the proposed regulatory arrangements on the competitiveness of the derivatives market in Hong Kong, and the risk management requirements on financial institutions dealing with non-centrally cleared OTC derivative trades.

Consultation conclusions on the proposed statutory codification of certain requirements to disclose price sensitive information by listed corporations

21. On 21 February 2011, the Administration briefed the Panel on the consultation conclusions on the proposed statutory codification of certain requirements to disclose price sensitive information (PSI) by listed corporations. The Administration reported that the respondents to the public consultation generally supported the objective of the proposal. Respondents generally believed that a statutory regime could cultivate a continuous disclosure culture among listed corporations and enhance market transparency, which would help enhance the competitiveness of the Hong Kong stock market. There was also a consensus on introducing civil sanctions to the statutory disclosure regime. Based on the views collected during the public consultation, the Administration would refine the legislative proposals and planned to introduce the relevant Bill into LegCo in the current legislative session.

22. Some members expressed concern about the obligations and liabilities of individual directors and high level staff responsible for managing a listed corporation in disclosing PSI, particularly the use of the expression "ought reasonably to have come into possession of the PSI" in the indicative draft legislative provisions. They opined that if a company director or management officer had acted in good faith, he should not be held liable for breaching the disclosure requirement. The Administration advised that there was general support from respondents to the public consultation for the indicative draft legislative provisions relating to the obligations of company directors and high-level staff in disclosure of PSI. A company director or high-level officer would only be held responsible if SFC could provide evidence to prove that the breach in relation to a listed corporation was a result of the intentional, reckless

or negligent act of that director or officer, or that director/officer had not taken reasonable measures to prevent the breach in relation to the listed corporation.

23. Some members queried why the proposed legislation did not cover relevant professionals such as accountants and lawyers hired by a listed corporation for provision of services. The Administration explained that professionals hired by a listed corporation for provision of services should be bound by the third party confidentiality clauses in the agreements with the corporation. Professionals who had breached the confidentiality agreement with a listed corporation might be subject to disciplinary proceedings under the licensing and/or registration requirements applicable to these professionals. Besides, SFC would take enforcement actions if such professionals were involved in insider dealing activities.

24. The Panel also discussed other relevant issues including the proposed safe harbours, applicable sanctions, timing for disclosure of PSI, transparency of the operation of listed companies incorporated outside Hong Kong, and enforcement against persons outside Hong Kong.

Lehman Brothers Minibonds collateral recovery agreement and related issues

25. On 27 March 2011, the Receivers of the collateral securing Lehman Brothers Minibond series 10 to 12, 15 to 23 and 25 to 36 announced that they had reached a conditional agreement with Lehman Brothers Special Financing Inc. in respect of the collateral of those Minibond series. According to the information provided by the Receivers, the estimated recovery to Minibond investors from the collateral ranged from approximately 70% to 93% of the principal amount invested. The Distributing Banks also announced on 28 March 2011 that, in addition to the collateral recovery amount, the Banks would offer an ex gratia payment scheme to eligible customers of those Minibonds series. The total level of recovery to eligible customers, after taking into account the offer of the ex gratia payments by the Distributing Banks, would be in the range of 85% to 96.5% of the principal amount of their investment. The Distributing Banks had also increased the funding amount available to the Trustee from approximately \$291 million to approximately \$662 million to pay all fees, expenses and other amounts which might be incurred in connection with the recovery of the collateral of the outstanding Minibonds and the Trustee's role in respect of the Minibonds.

26. The Panel held a special meeting on 21 April 2011 to discuss the Lehman Brothers Minibonds collateral recovery agreement and related issues with the Administration, HKMA, SFC, the Distributing Banks, the Trustee and the Receivers. During the discussion, members raised questions regarding the

latest market value of the collateral, whether there was sufficient disclosure of relevant information to Minibond holders for them to determine if they should accept the collateral recovery agreement, the total expenses incurred by the Trustee and the Receivers and whether any deduction had been made from the collateral value to finance those expenses, and the amounts claimed and received by the Lehman Brothers Special Financing Inc. under the agreement etc.

27. In response to members' requests, the Receivers provided, after the special meeting, supplementary information to explain the difference between the current market value of the underlying collateral and the amount that would be distributed to the Minibond holders.

Policy issues relating to suspension of trading and subsequent buyback of four derivative warrants linked to the Nikkei 225 Index issued by Goldman Sachs Structured Products (Asia) Limited

28. On 31 March 2011, the trading of four derivative warrants (DWs) linked to the Nikkei 225 Index issued by Goldman Sachs Structured Products (Asia) Limited (GS) was suspended. GS issued on the same date two amendment notices stating that the formula for the "Cash Settlement Amount per Board Lot" and the definition of "Cash Settlement Amount" for the warrants concerned were erroneously stated in the relevant supplemental listing documents. The amendment notices also set out how the formula/definition should have been stated. GS subsequently issued a notice on 21 April 2011 setting out the legal basis for the amendments to the terms and conditions of the warrants and GS's Buyback Offer to repurchase the warrants from existing warrant holders.

29. The Panel discussed on 23 May 2011 the policy issues relating to the incident with the Administration, SFC and HKEx. During the discussion, members raised questions on the respective roles and responsibilities of SFC and HKEx in regulating the listing and trading of DWs, whether an issuer should be allowed to unilaterally modify the terms and conditions in the listing documents, and what follow-up actions, such as disciplinary actions, had been or would be taken by HKEx in respect of the issuer. At the Panel meeting on 9 June 2011, the Panel passed a motion expressing dissatisfaction with the way in which the Government, SFC and HKEx had handled the matter so far, and requested the these authorities to continue the discussion with the issuer for a reasonable and fair resolution for the investors concerned.

30. In response to members' requests, SFC and HKEx provided, after the meetings, supplementary information on the practices of overseas jurisdictions

on the regulation of listed structured products, and their response on the issue of whether the present arrangement that the Stock Exchange of Hong Kong was responsible for approving the listing and regulating the trading of listed structured products would give rise to conflict of interest.

Investor Education Council and Financial Dispute Resolution Centre

31. Following a three-month public consultation on the proposed establishment of an Investor Education Council (IEC) and a Financial Dispute Resolution Centre (FDRC), the Administration briefed the Panel on 3 January 2011 on the consultation conclusions and the way forward. According to the Administration, the respondents in general welcomed the establishment of an IEC to holistically oversee the delivery of investor education. There were however very diverse comments on the proposed establishment of an FDRC. While consumers generally supported the proposal, reactions from industry organizations ranged from qualified support to opposition. Having regard to the comments received, the Administration upheld the proposals in the consultation document at large with certain modifications to the FDRC proposal, including revisions to the fee structure, and the collaborative arrangements with relevant regulatory bodies for handling cases with wider implications and/or involving alleged misconduct of financial institutions.

32. While members generally supported the proposal to establish an IEC, some members envisaged that the IEC would face difficulty in educating different groups of investors whose investment needs and level of financial literacy were very varied. As regards the proposed FDRC, some members expressed reservation about the effectiveness of the FDRC, and opined that in order to provide adequate protection for investors, a one-stop service system such as a financial services ombudsman should be established to deal with complaints from investors, investigate the complaints, impose sanctions and order compensations from financial institutions. Some members were concerned that the maximum claimable amount of \$500,000 might be too low, and urged the Administration to review this aspect as soon as possible. The Panel also discussed the mediation/arbitration procedures of the FDRC, the institutional set-up of the FDRC and the division of responsibilities between the FDRC and the financial regulators.

33. The Administration consulted the Panel on 9 May 2011 on the funding arrangement for setting up the FDRC. According to the Administration, it had agreed with HKMA and SFC to share the set-up costs as well as the operating costs of the FDRC for the first three years on a 50:25:25 basis. The set-up costs were estimated to be \$15 million and the annual budget of FDRC was estimated to be \$55 million, based on an estimated caseload of 2 000 per

year. FDRC was expected to formally come into service by mid-2012. Panel members were generally supportive of the funding proposal. While some members expressed concern whether the FDRC would have adequate resources to handle the estimated caseload, a member considered that the FDRC should exercise vigilance in controlling costs, as financial institutions were expected to shoulder the operation costs of FDRC from 1 January 2015 onwards.

Insurance

Proposed establishment of a Policyholders' Protection Fund

34. Following the launch of a three-month public consultation exercise on the proposals for the establishment of a Policyholders' Protection Fund (PPF), the Administration briefed the Panel on the proposals on 4 April 2011. The Panel discussed the proposed coverage, level of compensation, funding mechanism and governance arrangements of the Fund.

35. Noting that the maximum compensation limit per policy would be set at \$1 million, some members expressed concern that the proposal of imposing a uniform levy rate of 0.07% of the applicable premium for all insurance policies might not be fair to those policyholders whose claims exceeded \$1 million. The Administration advised that the 0.07% levy would be collected from insurance companies based on their premium income as shown in their annual financial reports. Given the low levy rate, insurance companies probably would not transfer the levy payment to insurance policyholders. Some members requested the Administration to consider providing for a mechanism for adjustment of the levy rate in legislation.

36. Members expressed concern about the arrangements for the transfer of insurance policies in the event of the insolvency of an insurance company, and the protection available to affected policyholders. The Administration advised that for a life policy or an accident & health policy with a guaranteed renewability clause, arrangement would be made to transfer the insurance policy to another insurance company. If the insurance policy could not be transferred and had to be terminated, the affected policyholder would be paid the cash/account value of the insurance policy plus declared dividends/bonuses, and might also be paid an "ex-gratia payment" out of the PPF to enable him/her to procure a similar policy with similar benefits in the market, up to a cap of \$1 million in total.

Issues relating to the difficulties encountered by the transport sector in obtaining insurance coverage

37. The Panel held a joint meeting with the Panel on Transport 28 February 2011 to discuss with deputations and the Administration issues relating to the difficulties encountered by the transport sector in obtaining insurance coverage. During the discussion, members and deputations pointed out that the difficulties encountered by the transport sector in obtaining insurance coverage were attributable to a number of factors and might involve policy, legal, operational as well as enforcement issues. In order to follow up the relevant issues in a comprehensive and focused manner, the two Panels agreed at the joint meeting on 18 March 2011 to appoint a joint subcommittee under the two Panels to study the relevant issues. Having regard to the then position of Bills Committee and subcommittees on policy issues and the staffing resources of the LegCo Secretariat, the House Committee agreed on 8 April 2011 to place the joint subcommittee on the waiting list for activation upon completion of work of an existing subcommittee on policy issues.

Proposed establishment of an independent Insurance Authority

38. The Administration launched a three-month public consultation exercise in July 2010 on the proposed establishment of an independent Insurance Authority (IIA). On 4 July 2011, the Administration briefed the Panel on the consultation conclusions and the Administration's detailed proposals, including the functions, powers, funding mechanism, governance and organization of the proposed IIA.

39. Regarding the regulation of insurance intermediary activities of banks, the Panel noted that the Administration had revised the proposed arrangement having regard to the views of the insurance and banking industries and the public. Under the revised proposal, the IIA would be the primary and lead regulator for all insurance intermediary activities. The legislation would stipulate that all powers to regulate the insurance intermediary activities, whether in banks or otherwise, were to be vested with the IIA. Given the specific client profile and sales environment in banks, the IIA would work closely with HKMA on the regulation of insurance intermediary activities of banks, mainly in respect of inspection, investigation and the disciplinary process. IIA would delegate specified powers to HKMA, and such delegable powers would be stipulated in the statute. Some members expressed in-principle support for the revised proposal, and urged the Administration to further consult the insurance and banking sectors to work out the detailed arrangements that would ensure a level playing field for insurance intermediaries and consistency in regulatory standards.

40. A member relayed the concern of the insurance sector as to whether the disciplinary powers of the IIA would be exercised in a fair and impartial manner, and how the expertise and experience of the insurance sector would be utilized in the disciplinary process. The Administration advised that the insurance intermediary involved in a disciplinary case would be given adequate opportunities to respond to the accusations and the proposed disciplinary actions to be imposed. The Governing Board of the IIA would appoint an Expert Panel with members having industry knowledge to provide expert advice to the Disciplinary Committee as and when necessary. An independent Insurance Appeals Tribunal would be established to handle appeals from insurers and insurance intermediaries against relevant decisions of the IIA.

41. During the discussion, the Panel also discussed the proposed 0.1% levy on the policy premiums to support the operation of the IIA, the mechanism to deal with claims for compensation from policyholders, and ways to enhance protection for policyholders.

Mandatory Provident Fund System

Review of the minimum and maximum relevant income levels for Mandatory Provident Fund contributions

42. The Panel discussed on 21 February 2011 the findings of the review on the minimum and maximum relevant income levels for Mandatory Provident Fund (MPF) contributions prepared by the Mandatory Provident Fund Schemes Authority (MPFA). The Panel noted the following findings of the review -

- (a) Based on the statutory adjustment factors, the minimum and maximum levels of relevant income might be adjusted from \$5,000 to \$5,500 per month and from \$20,000 to \$30,000 per month respectively; and
- (b) Upon taking other relevant factors and views gathered in consultation into account, there would appear to be general support for increases in the two levels as set out in (a) above. Regarding the minimum level of relevant income, some stakeholders suggested an increase beyond \$5,500. As for the maximum level of relevant income, some stakeholders suggested a phased approach.

43. A number of Panel members and non-Panel Members joining the discussion expressed the view that the review should not just focus on the

statutory adjustment factors. Rather, the minimum level of relevant income for MPF contributions should take into account the effects of the statutory minimum wage and make reference to the income criteria of other relevant schemes such as the Work Incentive Transport Subsidy Scheme. Members opined that an increase beyond \$5,500 should be considered.

44. While some Members expressed support for increasing the maximum level of relevant income to \$30,000, there was a concern that the increase might add to the burden of small and medium sized enterprises which were already affected by the implementation of statutory minimum wage.

45. To gauge public views on the issue, the Panel held a special meeting on 20 April 2011 to receive views from concerned parties and members of the public. The Panel noted that based on the views expressed by deputations and given in the written submissions received, there was a general consensus that the minimum relevant income level for MPF contributions should be revised to about \$6,500 to align with the monthly income of workers receiving a minimum wage of \$28 per hour and the income criterion of the Work Incentive Transport Subsidy Scheme. As for the maximum relevant income level, the views were rather diverse regarding the extent of increase.

46. Noting that some low-income workers would become obliged to make MPF contributions after the implementation of the statutory minimum wage on 1 May 2011, Members urged the Administration to expedite the legislative work to revise the minimum and maximum relevant income levels for MPF contributions, and where necessary to take forward the upward revision of the minimum relevant income level in the first place.

Regulation of Mandatory Provident Fund intermediaries

47. On 4 April 2011, the Administration and MPFA briefed the Panel on the legislative proposals to strengthen the regulation of MPF intermediaries. The Panel noted that under the proposed statutory regulatory regime, both pre-existing MPF corporate intermediaries and MPF individual intermediaries sponsored by corporate intermediaries would be covered by the proposed statutory regulatory regime. Corporate intermediaries (which would be known as Principal Intermediaries (PIs) under the legislative proposal) would be required to establish policies and measures for compliance with the legislation and designate a responsible officer to ensure that such policies and measures were properly followed, while individual intermediaries (which would be known as Sponsored Intermediaries (SIs) under the legislative proposal) would be required to comply with the conduct requirements set out in the legislation. These requirements would be further elaborated in the Code of Conduct for

MPF Intermediaries issued by MPFA. Both PIs and SIs would be liable to disciplinary actions for misconduct in carrying out MPF sales and marketing activities.

48. Some members considered that apart from regulating frontline staff, the senior staff and owners of MPF corporations should also be held liable for malpractices in MPF sales and marketing activities. The Administration advised that a PI would be required to appoint a responsible officer for maintaining proper internal controls and procedures for compliance with the conduct requirements, and the PI would be held liable for breaches of conduct requirements if the breaches were attributable to inadequacies of the internal controls and procedures and/or supervision of their SIs.

49. The Panel noted that the proposed regulatory regime would adopt the pre-existing institution-based approach and hence would involve three frontline regulators, namely SFC, HKMA and the Insurance Authority (IA). Members asked how the Government would ensure that these regulators together with MPFA would perform their regulatory role effectively and that there would be consistency in their regulatory standard and approach.

50. The Administration and MPFA explained that as MPF activities were incidental to the main lines of business of most MPF intermediaries, the institution-based approach would allow each financial institution to deal with a single frontline regulator for their financial activities, including MPF intermediary service. Under the proposal, MPFA would be the sole authority to issue the Code of Conduct for MPF intermediaries. It would also provide a number of "one-stop" arrangements including maintaining a MPF Intermediaries Register and receiving complaints from MPF scheme members. Frontline regulators would be empowered to inspect, investigate and discipline the MPF intermediaries under their regulatory purview. A single appeals channel would be established to handle appeals against disciplinary decisions. A forum for regular communication among MPFA and the three other regulators would be established, and this would help maintain consistency in supervision and enforcement.

51. On members' concern about the timeframe for the legislative exercise and the implementation of Employee Choice Arrangement, the Administration advised that it aimed at introducing the relevant Bill within 2011 and hoped that the legislative process would be completed within the 2011-2012 legislative session. On that basis, it was anticipated that the Employee Choice Arrangement would be launched in the second half of 2012.

Budget of the Securities and Futures Commission for the financial year of 2011-2012

52. As an established arrangement over the past years, the Panel discussed SFC's budget for the 2011-2012 financial year at the meetings on 7 and 28 March 2011. Some members considered that given that SFC had accumulated a reserve of about \$6,750 million, SFC should take the initiative to seek FS's view regarding the waiving or reduction of the transaction levies in view of its large reserve. SFC responded that since the levies on securities transactions and futures and options contracts had been reduced by 25% in October 2010, SFC did not recommend to FS a reduction of the levies in 2011-12. On the basis of the transaction volume in 2011-12, SFC would make a recommendation to FS regarding the appropriate level of the levies in the next budget.

53. Noting that SFC proposed an increase of 61 posts in 2011-2012, members sought details and justifications for the proposed staff increase. SFC responded that the additional staff were required to meet the increased volume, scope and complexity of work handled by SFC. The total capitalisation of the Hong Kong stock market had nearly doubled in the previous two years and the number of enforcement cases had been increasing in the past years. Seven and 15 additional posts were proposed in the 2011-2012 budget for the Corporate Affairs Division and the Enforcement Division respectively to deal with, among other things, complaints and enforcement cases.

54. Some members questioned the appropriateness of adopting a top-down approach by the SFC in handling the complaints relating to Lehman Brothers-related structured products. They enquired whether SFC would co-operate with the Police to investigate into cases which had not been resolved through the settlement arrangement, and where appropriate, take prosecution actions. SFC responded that it would not have been fair to the majority of investors who chose to accept the re-purchase payments if the top-down approach was not adopted and the settlement agreements with the banks had not been reached. When a settlement had been reached between the investors and the banks concerned, SFC would not continue investigating into the relevant complaint cases relating to the banks. SFC considered that adopting the top-down approach and entering into a settlement between the investors and the banks was a better solution than SFC continuing the investigation of individual cases for a period of time and the investors not knowing whether they would be able to receive any payment. So far SFC had not received any evidence relating to the Lehman Brothers Minibonds Incident which met the threshold for criminal prosecutions under the SFO.

55. The Panel also discussed other issues relating to SFC's budget, including the staff turnover and recruitment situation, the resource provision for authorization of structured products, office premises and staff secondment/attachment arrangements between SFC and the Government.

Work of the Financial Reporting Council

56. As in the past years, the Panel received a briefing on the work of Financial Reporting Council (FRC) on 4 April 2011. The Panel noted that FRC received nine complaints about auditing or reporting irregularities in 2010, and had initiated two enquiries and handled eight investigations in the year. The Panel also noted that the FRC had widened its scope of review by implementing a new risk-based financial statement review programme since January 2011. As a result, in addition to reviewing issues identified in modified auditors' reports, FRC also performed comprehensive reviews of entire sets of financial statements selected from various categories.

57. Some members were concerned that the reported profit of some listed companies was at great variance with the profit forecast made by the companies before listing, and suggested that FRC should compare the profit forecasts and the reported profits of companies after listing for more than one year to identify financial statements of listed companies which required further review. There was also a suggestion that the criteria for selection of financial statements for review under the new risk-based review programme should be made public. FRC responded positively to the suggestions.

58. A member expressed concern that some listed companies frequently changed their asset assessors resulting in significant changes to the value of their assets. FRC advised that under the risk-based review programme, FRC would review cases where the change in valuation of the assets of a listed company was not in line with the change in valuation on similar assets of other listed companies. FRC's review would include a review of the assumptions for the valuations.

59. The Panel also discussed the staffing provision of FRC, the collaboration between FRC and other local regulators and the regulators of other jurisdictions, and ways to enhance the public awareness of FRC's work.

Measures to curb speculation in residential properties

60. The Panel held a joint meeting with the Panel on Housing on 22 November 2010 to discuss the two proposed measures to curb speculation in residential properties, namely the introduction of a three-tier Special Stamp

Duty (SSD) on residential properties acquired on or after 20 November 2010 and resold within 24 months after acquisition, and disallowing deferred payment of the current ad valorem property transaction stamp duty for all residential property transactions. The Panels noted that the measures would require amendments to the Stamp Duty Ordinance (Cap. 117).

61. While members of the two Panels generally welcomed the proposed measures, they raised a number of concerns. The notable ones included: the effectiveness of the SDD measure in curbing speculative property dealings effected through the transfer of shares in shell companies; the appropriateness for the SDD to take effect prior to the enactment of the relevant legislation; the effect of the proposed measures on genuine home buyers; the impact of the proposed measures on the speculative activities in non-residential property markets and other economic sectors; the scope of exemptions from the SDD; and the appropriateness of holding both the seller and the buyer jointly and severally liable for the SSD.

Financial and legislative proposals

62. During the 2010-2011 session, the Panel has also discussed the following subjects relating to legislative or funding proposals -

- (a) conclusions of the two phases of consultation on the draft Companies Bill;
- (b) proposed extension of a supernumerary directorate post in the Financial Services Branch to coordinate anti-money laundering matters;
- (c) proposed creation of a supernumerary Administrative Officer Staff Grade C Post for the establishment of an independent Insurance Authority and a Policyholders' Protection Fund;
- (d) treatment of accrued benefits derived from mandatory contributions for Mandatory Provident Fund in the case of bankruptcy of a scheme member;
- (e) proposals for implementation of Basel II enhancements and plan to implement Basel III;
- (f) proposed provision of an electricity subsidy of \$1,800 to each residential electricity account;

- (g) proposals to provide profits tax deduction for capital expenditure on intellectual properties;
- (h) proposal to give a sum of \$6,000 to eligible persons;
- (i) the Hong Kong Institute of Certified Public Accountants' proposals to amend the Professional Accountants Ordinance (Cap. 50); and
- (j) SFC's proposal for a short position reporting regime.

63. From October 2010 to July 2011, the Panel has held a total of 20 meetings, including two meetings jointly held with the Panel on Housing and the Panel on Transport respectively.

Council Business Division 1
Legislative Council Secretariat
7 July 2011

Legislative Council

Panel on Financial Affairs

Terms of Reference

1. To monitor and examine Government policies and issues of public concern relating to financial and finance matters.
2. To provide a forum for the exchange and dissemination of views on the above policy matters.
3. To receive briefings and to formulate views on any major legislative or financial proposals in respect of the above policy areas prior to their formal introduction to the Council or Finance Committee.
4. To monitor and examine, to the extent it considers necessary, the above policy matters referred to it by a member of the Panel or by the House Committee.
5. To make reports to the Council or to the House Committee as required by the Rules of Procedure.

**Legislative Council
Panel on Financial Affairs**

Membership list for 2010 - 2011 session

Chairman Hon CHAN Kam-lam, SBS, JP

Deputy Chairman Hon CHAN Kin-por, JP

Members 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
Dr Hon Philip WONG Yu-hong, GBS
Hon Emily LAU Wai-hing, JP
Hon Abraham SHEK Lai-him, SBS, JP
Hon Vincent FANG kang, SBS, JP
Hon LEE Wing-tat
Hon Jeffrey LAM Kin-fung, SBS, JP
Hon Andrew LEUNG Kwan-yuen, GBS, JP
Hon WONG Ting-kwong, BBS, JP
Hon Ronny TONG Ka-wah, SC
Hon CHIM Pui-chung
Hon KAM Nai-wai, MH
Hon Starry LEE Wai-king, JP
Dr Hon LAM Tai-fai, BBS, JP
Hon Paul CHAN Mo-po, MH, JP
Hon Mrs Regina IP LAU Suk-yee, GBS, JP

(Total : 21 members)

Clerk Ms Anita SIT

Legal Adviser Mr Timothy TSO