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Legislative Council

LC Paper No. CB(1)1658/13-14
(These minutes have been seen by the Administration)

Ref : CB1/PL/FA/1

Panel on Financial Affairs

Minutes of meeting
held on Friday, 7 February 2014 at 10:00 am
in Conference Room 1 of the Legislative Council Complex

Members present :

Hon Starry LEE Wai-king, JP (Chairman)
Hon Christopher CHEUNG Wah-fung, JP (Deputy Chairman)
Hon Albert HO Chun-yan
Hon James TO Kun-sun
Hon CHAN Kam-lam, SBS, JP
Hon Abraham SHEK Lai-him, GBS, JP
Hon WONG Kwok-hing, BBS, MH
Hon Jeffrey LAM Kin-fung, GBS, JP
Hon Andrew LEUNG Kwan-yuen, GBS, JP
Hon WONG Ting-kwong, SBS, JP
Hon Ronny TONG Ka-wah, SC
Hon CHAN Kin-por, BBS, JP
Hon Mrs Regina IP LAU Suk-yee, GBS, JP
Hon James TIEN Pei-chun, GBS, JP
Hon NG Leung-sing, SBS, JP
Hon Kenneth LEUNG
Hon Dennis KWOK
Hon SIN Chung-kai, SBS, JP

Public officers attending : Agenda Item IV

Mr Norman CHAN, GBS, JP
Chief Executive
Hong Kong Monetary Authority

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

Mr Eddie YUE, JP
Deputy Chief Executive (Monetary)
Hong Kong Monetary Authority

Mr Arthur YUEN, JP
Deputy Chief Executive (Banking)
Hong Kong Monetary Authority

Agenda Item V

Miss Salina YAN, JP
Deputy Secretary for Financial Services and the Treasury (Financial Services)1

Agenda Item VI

Mr YEUNG Tak-keung
Deputy Secretary for Financial Services and the Treasury (Treasury)3

Mr Alan SIU, JP
Government Property Administrator

Mr LAM Chik-man
Senior Property Manager (Acquisition, Allocation and Disposal) Projects and Special Duties
Government Property Agency

Mrs Sylvia LAM
Project Director 1
Architectural Services Department

Ms Monica LAM
Chief Project Manager 101
Architectural Services Department

Attendance by invitation	**:**	Agenda item V Mr Carlson TONG, JP Chairman Securities and Futures Commission Mr Ashley ALDER Chief Executive Officer Securities and Futures Commission Mr Andrew WAN Chief Financial Officer and Senior Director, Corporate Affairs Securities and Futures Commission Mr Paul YEUNG Commission Secretary Securities and Futures Commission
Clerk in attendance	**:**	Ms Connie SZETO Chief Council Secretary (1)4
Staff in attendance	**:**	Ms Angel SHEK Senior Council Secretary (1)4 Ms Sharon CHAN Legislative Assistant (1)4

Action

I Confirmation of minutes of meetings and matters arising

(LC Paper No. CB(1)810/13-14 — Minutes of the special meeting on 15 November 2013)

The minutes of the special meeting held on 15 November 2013 were confirmed.

II Information papers issued since the last meeting

(LC Paper No. CB(1)692/13-14(01) — Referral from the Public Complaints Office regarding matters relating to the monitoring of mandatory provident fund trustees (English version only)

LC Paper No. CB(1)791/13-14 — Hong Kong Monetary Authority's press release on Exchange Fund results for 2013)

2. Members noted the information papers issued since the last regular meeting held on 6 January 2014.

III Date of next meeting and items for discussion

(LC Paper No. CB(1)804/13-14(01) — List of outstanding items for discussion

LC Paper No. CB(1)804/13-14(02) — List of follow-up actions)

Regular meeting on 27 February 2014

3. The Chairman suggested and members agreed that the regular meeting originally scheduled for 27 February 2014 (i.e. the regular meeting of March 2014) be cancelled as there was no discussion item proposed by the Administration.

Joint Panel meeting in March 2014

4. The Chairman informed members that the Panel would hold a joint meeting with the Panel on Manpower to discuss issues relating to the arrangement of offsetting severance payment and long service payment against the Mandatory Provident Fund System. The joint meeting was tentatively scheduled for the afternoon of 18 March 2014. Members would be informed of the meeting arrangements in due course.

(*Post-meeting note*: With the concurrence of the Panel Chairman and the Chairman of the Panel on Manpower, the joint meeting of the two panels was scheduled for 18 March 2014 at 3:30 pm. The notice of meeting was issued to members vide LC Paper No. CB(2)926/13-14 on 24 February 2014.)

Regular meeting in April 2014

5. Members agreed that the next regular meeting will be held on 7 April 2014 at 10:45 am to discuss the Administration's latest initiatives to develop the asset management industry which was proposed by the Administration.

(*Post-meeting note*: With the concurrence of the Chairman, two additional items were subsequently added to the agenda of the meeting on 7 April 2014: (a) briefing on the report of the Working Group on Long-Term Fiscal Planning; and (b) briefing on the proposed regulatory regime on stored value facilities and retail payment systems. The Chairman has instructed that the meeting will be held from 9:30 am to 12:30 pm to allow sufficient time for discussion of the items. Members were informed accordingly vide LC Paper CB(1)1084/13-14 issued on 14 March 2014.)

IV Briefing on the work of Hong Kong Monetary Authority

(LC Paper No. CB(1)804/13-14(03) — Paper provided by the Hong Kong Monetary Authority)

Briefing by the Administration

6. At the invitation of the Chairman, the Chief Executive, Hong Kong Monetary Authority ("CE/HKMA"), the Deputy Chief Executive (Development)/HKMA ("DCE(D)/HKMA"), the Deputy Chief Executive (Banking)/HKMA ("DCE(B)/HKMA") and the Deputy Chief Executive (Monetary)/HKMA ("DCE(M)/HKMA") updated members on the work of HKMA through a powerpoint presentation. Topics included assessment of risks to Hong Kong's financial stability, development of financial infrastructure, banking supervision, Hong Kong as an offshore Renminbi ("RMB") centre, and investment performance of the Exchange Fund ("EF").

(*Post-meeting note*: The notes of the powerpoint presentation (LC Paper No. CB(1)895/13-14(01)) were issued to members vide Lotus Notes e-mail on 12 February 2014.)

Discussion

Impact of tapering of bond purchases by the United States

7. Mr Andrew LEUNG expressed concern about the impact of tapering of bond purchases by the Government of the United States ("US") on the Hong Kong economy, in particular the risks of capital withdrawal and interest rate reversal. He observed that recent changes in US' monetary policy had already aroused capital outflows from the emerging markets, whereas the Hong Kong stock market also experienced more volatility. Mr NG Leung-sing and Mr Christopher CHEUNG shared similar concerns.

8. Referring to pages 5 and 12 of the powerpoint presentation, Mr WONG Kwok-hing noted with concern that while personal lending continued to grow in a fast pace in Hong Kong, the potential interest rate hike following US' reduction in quantitative easing would have adverse impact on personal/mortgage lending and asset prices. Mr Christopher CHEUNG sought HKMA's assessment whether the interest rates in Hong Kong could rise earlier than those in US, and the measures HKMA would take to tackle the challenge of US' reduction in quantitative easing.

9. CE/HKMA said that the effects of monetary easing would sustain for some time as the US Federal Reserve would continue to purchase bonds albeit on a progressively reduced scale. Hence, US' reduction in bond purchases might not necessarily result in immediate liquidity shortage in the global market. Yet the effects of US' exit from quantitative easing on the market had to be observed. While no large capital outflows from Hong Kong had been seen given its sound economic fundamentals, risks of capital outflow should not be underestimated with US' continued reduction in quantitative easing. Indeed, capital flow adjustment or reversal would be inevitable during the normalization of interest rate from the current extremely low level.

10. As regards the impact of US' exit from quantitative easing on interest rate movements, CE/HKMA said that while the tapering of bond purchases and potential rise in interest rate in US would affect the wholesale interest rates among banks, the actual impact on personal/business/mortgage lending would essentially hinge on the liquidity of banks, as well as supply/demand of loans. If credit growth in Hong Kong continued with its present fast pace, interbank liquidity could be tightened and this could increase the pressure for interest rate rise. Borrowers and potential home-buyers should therefore be alert of the adverse impact of interest rate reversal on their loan repayment ability, and should not overstretch themselves given that the current lower-than-average interest rates would not last indefinitely. To enhance risk management against rise in interest rates and its effects on the property market, HKMA had

introduced six rounds of countercyclical macroprudential measures since October 2009 when the side-effects of US' quantitative easing on the local property market had surfaced.

11. In reply to Mr Kenneth LEUNG on the latest assessment of the European sovereign debt crisis, CE/HKMA advised that the crisis had been affecting member states of the Eurozone, such as Greece, Spain and Italy, since early 2009. In addition to the implementation of a series of political and economic measures by the governments of the member states, the European Central Bank had pledged support for all Eurozone countries with a view to maintaining the integrity of the Eurozone as a currency union. Although the crisis had somewhat subsided, it remained a huge challenge for individual member countries to tackle their debts and unemployment problems. Moreover, as concerns about banks' capital levels and liquidity problem in the Eurozone remained, it would be difficult for banks to increase credit growth and the Eurozone to restore economic growth.

12. Mr Jeffrey LAM expressed concern that the economies in US and Eurozone might encounter credit crunch, which could result in reduction in demand for Hong Kong exports. CE/HKMA said that the manufacturing and exports sectors were susceptible to changes in demand from the advanced economies which were the major markets of Hong Kong's merchandise exports. He observed that bank credit in the Euro areas would likely remain tight for some time as the private and banking sectors were heavily in debt. Nevertheless, the outlook for Hong Kong's exports sector was not pessimistic given the solid economic growth and renewed liquidity in US, and the economy of the Euro area had stopped contracting. These should provide cushion against setback in Hong Kong's export demand.

Credit growth and regulation of money-lending business

13. Mr Kenneth LEUNG noted with concern the substantial loan growth during the first three quarters of 2013, and as a result HKMA had written in October 2013 to draw the attention of certain banks with faster credit growth of the Stable Funding Requirement to be implemented in 2014. He enquired if HKMA had identified any systemic risks in the banking system and the use of loans by borrowers outside Hong Kong. Mr Jeffrey LAM enquired about HKMA's measures to manage credit and liquidity risks in the banking system and the economy.

14. CE/HKMA said that the loan-to-deposit ratio for all currencies stood at a high level of 70% at end December 2013. In view of the rapid credit growth, HKMA had reminded banks of the need to maintain sufficient and stable funding, as well as to be aware of interest rate risks and their impact on asset

prices and borrowers' repayment capacities. DCE(B)/HKMA said that the growth in loan demand for use outside Hong Kong was the major impetus in the credit growth in the banking sector in the recent period. At present, loans for use outside Hong Kong accounted for about 30% of the total loans approved by banks. DCE(B)/HKMA supplemented that banks were required to follow measures and requirements set by HKMA in their daily operation for managing liquidity and credit risks. The Stable Funding Requirement was meant to provide further guidance in respect of the tenor matching measures, so as to ensure a stable funding source necessary for banks to maintain a sustainable credit flow and avoid liquidity risk in the event of massive capital outflow. The measure was not designed to suppress the rate of credit growth.

15. To enhance risk management of personal loans, Mr NG Leung-sing considered that HKMA should analyze the components of loans to better understand their risks. In view of the substantial increase in personal loans, Mr SIN Chung-kai asked whether the default rate had risen.

16. DCE(B)/HKMA said that personal lending comprised credit card loans which accounted for about one-third of the portfolio, and other personal loans, e.g. loans for tax payment and car mortgage. The default rate of personal lending varied between different types of personal lending, but generally speaking was low, at around 1% to 2%, in the recent quarters. The delinquency rate was expected to rise with normalization of the interest rate.

17. Mr Albert HO and the Chairman expressed concern about the prevalence of money-lending advertisements emphasizing quick and handy means to obtain loans, and the increasing number of complaints from the public about malpractices of financial companies in their operation, such as charging very high interest rates or other additional expenses for early repayment of loans, financial companies and beauty/fitness centres engaging in unfair trade practices to induce customers to obtain loans for purchasing beauty/fitness plans where the customers concerned were forced to repay the loans even when the centres in question subsequently closed down or failed to provide the procured services. He considered it inappropriate for the Police to regulate the business of money lenders as such business involved financial companies. He opined that the current regulatory regime on money lenders should be enhanced to better protect the interests of the public.

18. CE/HKMA said that licensing of money lenders and regulation of money-lending transactions were governed by the Money Lenders Ordinance (Cap. 163), whereas the Banking Ordinance (Cap. 155) conferred the Monetary Authority with the powers, amongst others, to regulate banking business and the business of taking deposits in order to provide a measure of

protection to depositors. While financial companies could be associated with banks in loan arrangements, most of the financial companies in Hong Kong were not subject to HKMA's supervision as they did not engage in deposit-taking business, i.e. they were not authorized institutions under the purview of HKMA. As regards the suggestion raised by Mr Albert HO and the Chairman to review the regulation of money-lending business, CE/HKMA said that the suggestion would be relayed to the appropriate authority for consideration.

The Mainland economy and daily conversion limit of RMB

19. Mr CHAN Kam-lam sought HKMA's assessment of the longer-term outlook on the Mainland economy in face of US' gradual withdrawal from quantitative easing, potential appreciation of the US dollar and strengthening of the Hong Kong dollar.

20. CE/HKMA said that some economists and financial analysts had taken the view that there were increasing downside risks in the economic growth in the Mainland, in particular, due to risks arising from shadow banking activities and other non-traditional sources of credit and borrowing. While tackling these problems might have short-term negative effects on the Mainland economy, CE/HKMA considered that the issues should be addressed in tandem with progress of structural reform of the Mainland economy in the medium to long term.

21. Mr CHAN Kam-lam considered that HKMA should step up its efforts to seek early abolition of the daily conversion limit of RMB 20,000 per person as it had impeded RMB flow across the border. Mr CHAN said that Members belonging to the Democratic Alliance for the Betterment and Progress of Hong Kong ("DAB") would raise the issue at the upcoming meetings of the National People's Congress and the Chinese People's Political Consultative Conference in March 2014.

22. CE/HKMA said that HKMA and The Hong Kong Association of Banks recognized the need to abolish the daily conversion limit to enhance RMB circulation in Hong Kong. HKMA had put forth the proposal to the Central People's Government and discussed the matter with People's Bank of China ("PBoC") on a number of occasions. The detailed proposal was under active consideration by PBoC. CE/HKMA said that he welcomed DAB's initiative to raise the matter with the Mainland authorities through other channels as appropriate.

Implementation of Basel III

23. In relation to the implementation of Basel III, Mr NG Leung-sing enquired about the timeframe for conducting consultation with the banking industry on HKMA's assessment methodology for identifying domestic systematically important banks, and whether the requirements in this regard would be more stringent than those developed by the Basel Committee on Banking Supervision. DCE(B)/HKMA said that HKMA would make reference to the framework and standards already established by the Financial Stability Board for identifying global systematically important banks, and would take into account the unique circumstances of Hong Kong in drawing up the relevant requirements. As regards the consultation timetable, DCE(B)/HKMA said that HKMA was seeking the views of the Banking Advisory Committee, and expected to commence industry consultation in a few weeks' time.

Performance of the Exchange Fund

24. Mr Jeffrey LAM observed that the full-year investment income of EF had dropped from $111.6 billion in 2012 to $75.9 billion in 2013. Referring to page 31 of the powerpoint presentation, Mrs Regina IP noted with concern that the high investment return of 12.1% in 1998 had turned into -5.6% in 2008, and sought reasons for the large fluctuations. The Chairman observed that the investment income of EF in 2013 was lower than the average of the past four years (i.e. 2009 to 2012). She asked whether the less satisfactory performance of EF in 2013 was due to a more challenging investment environment. She also enquired about the ratio of investment income in terms of realized gains vis-à-vis valuation change in each portfolio of EF.

25. CE/HKMA advised that, in accordance with generally accepted accounting principles, investment income of EF were calculated based on valuation changes. He stressed that EF was not an investment fund. Unlike sovereign wealth funds targeted at gaining medium to long-term high investment return, due regard must be given to EF's statutory functions of maintaining monetary and financial stability in Hong Kong when considering its investment strategies. CE/HKMA stressed that all along there had been fluctuations in the investment income of EF since 1994. The exceptionally high return of 12.1% in 1998 was mainly attributable to the substantial gains from Hong Kong equities held by EF as a result of the Government's market operation in the same year. Since he had taken up the office of CE/HKMA in 2009, the assets placed in the Backing Portfolio had increased from around $800 billion to the present level of around $1,300 billion. Assets placed in the Backing Portfolio were mostly invested in short-term, highly liquid US Treasury securities. Since the US began quantitative easing in 2009,

short-term interest rates had been kept close to zero and the returns of US Treasury securities had remained very low. Consequently, as observed, the low investment return from these bonds had reduced the rate of EF's overall investment return. Nevertheless, with US' gradual exit from quantitative easing, and the possible results of capital withdrawal, the assets held in the Backing Portfolio for backing the Monetary Base would be reduced, and the low investment return of the Backing Portfolio would have less impact on EF's overall investment performance.

26. Mrs Regina IP enquired about the currency portfolio of EF's assets, and whether HKMA had established a sovereign wealth fund with part of EF's assets for the purpose of diversifying investment. DCE(M)/HKMA said that about 79% of EF's assets (including those in the Backing Portfolio) were held in US dollar assets. As regards EF's investment in RMB assets, the investment limit in respect of the interbank bond market on the Mainland was up to RMB 30 billion, and the investment quota under the Qualified Foreign Institutional Investor Scheme to invest in exchange-traded securities on the Mainland was US$1.5 billion. Given that both limits had been reached, HKMA would discuss with the relevant Mainland authority on raising the limits. As regards diversification of EF's investment, DCE(M)/HKMA said that the aggregate market value of EF's investment in private equities and real estate (which some sovereign wealth funds invested in) under the Long-Term Growth Portfolio ("LTGP") had reached about $80 billion.

27. Mr CHAN Kin-por noted that the full-year investment income from bonds recorded a loss of $19.1 billion. Given the substantial investment of EF in bonds and that their value would likely drop when interest rate rose, he enquired about HKMA's measures to mitigate the loss or to secure more gains from bond investment. The Chairman considered that bond was comparatively a lower risk investment tool and it might be inappropriate to change the investment strategy merely based on the performance of bond investment in a particular year.

28. CE/HKMA said that an upward cycle of interest rate would be unfavourable to bondholders due to re-valuation of the fair price of the bonds. As the Chairman of the US Federal Reserve had said last year, US' tapering of bond purchases would depend on the strength of the country's economic data. With the downside risks of US' economic recovery remained and the pace of its exit from quantitative easing still uncertain, it would be difficult to predict the interest rate movements precisely for adjusting investment strategies. While switching investment from bonds to holding cash could shield investment from interest rate hike, it could nonetheless result in substantial loss of potential gains. To illustrate, the difference between the yield of about 2.5% from 10-year US Treasury bonds and near 0% from cash would be

around 250 basis points. Likewise, it was also difficult to predict whether increasing EF's investment in equities could guarantee better return given the changing economic circumstances and market volatilities.

29. Mr SIN Chung-kai noted that the annualized return of EF's investment in respect of the new asset classes of private equity and real estate since inception till 2013 was of 15.9%. In view of the relatively higher risks associated with such high-yield investment, he enquired about HKMA's internal guidelines for risk management. DCE(M)/HKMA advised that HKMA exercised caution in the diversification of EF's investment and attached importance to risk management. The investment of LTGP, which held the asset classes of private equity and real estate, was capped at a level equivalent to one-third of the Accumulated Surplus of EF, which was $210 billion at present. Stringent guidelines were put in place for investment management and conduct of due diligence for individual investment items. The Investment Sub-Committee of the Exchange Fund Advisory Committee of HKMA, which was chaired by CE/HKMA, would continue to monitor closely the investment management work of HKMA.

30. The Chairman observed that the full-year investment income from "Other equities" in 2013 was rather high, i.e. $71.6 billion, compared to only $10.1 billion (excluding valuation changes in EF's Strategic Portfolio) in respect of Hong Kong equities. She enquired whether the comparatively higher investment income in "Other equities" was due to exclusion of valuation changes in Strategic Portfolio for Hong Kong equities.

31. CE/HKMA said that it was likely that investment in equities would experience larger fluctuations. EF's investment in "Other equities" generally performed well in 2013, i.e. about a return of 20%-30% from European stocks and 30% from US equities, compared to only 3% on Hong Kong equities.

Measures to address the recent appearance of $1,000 counterfeit notes

32. Mr SIN Chung-kai observed that some retailers still refused to accept $1,000 banknotes from customers due to appearance of 2003 series $1,000 counterfeit notes in late December 2013 notwithstanding that the number of counterfeits discovered or seized had declined in the recent period. Mr WONG Ting-kwong expressed concern about the impact of counterfeit banknotes on the market, and the measures adopted by banks following the incident.

33. CE/HKMA pointed out that counterfeit banknotes appeared from time to time and it was impossible to eradicate counterfeiting completely. Although the newly spotted 2003 series $1,000 counterfeits bore a fair degree of

resemblance to the real notes, it was not difficult to identify the counterfeits based on the tips provided by HKMA and the Police. Since the surfacing of the new types of counterfeit banknotes, HKMA had organized 33 banknote security feature seminars for over 7,000 participants (including frontline employees from banks, retail businesses and public services, etc). A recording of banknote security feature seminar had been uploaded onto the website of HKMA and Youtube. Banks had also taken measures to ensure adequate supply of $500 banknotes and 2010 series $1,000 banknotes at bank counters or via automatic teller machines to cater for the needs of members of the public who would like to exchange their 2003 or 2010 series $1,000 banknotes. As it would take time for bank tellers to check the $1,000 banknotes collected from customers, this would inevitably cause disruption to general banking services. CE/HKMA further said that the 2010 series $1,000 banknotes had incorporated more advanced and easy-to-recognize security features, which should be sufficient to deter counterfeiting in the near future. HKMA would continue to upgrade the security features of banknotes on regular basis. As regards Mr WONG Ting-kwong's enquiry about whether retailers' refusal to accept banknotes of certain series would breach the law, DCE(D)/HKMA said that banknotes issued by note-issuing banks were legal tender in Hong Kong. However, in all commercial transactions, parties to a transaction might determine the terms of the transaction, including the mode of payment.

34. Mr WONG Ting-kwong and Mr SIN Chung-kai enquired about the timeframe for HKMA to complete withdrawal of the 2003 series of banknotes. CE/HKMA said that there were currently about 110 million pieces of 2003 series $1,000 banknotes in circulation, and withdrawal of the series from circulation was in progress. However, the withdrawal arrangement was not meant to replace all 2003 series $1,000 banknotes at one time but to speed up the gradual withdrawal of older banknotes of the series.

Other issues

35. Noting that the current term of office of CE/HKMA would end in about September 2014, Mr Christopher CHEUNG enquired whether CE/HKMA would stay in his post to continue serving the public as he was concerned that changes in HKMA's top management could adversely affect the stability of Hong Kong's monetary and financial systems. CE/HKMA said that the Financial Secretary ("FS") would consider the appointment of CE/HKMA carefully and announce his decision when appropriate.

V Budget of the Securities and Futures Commission for the financial year 2014-2015

(LC Paper No. CB(1)804/13-14(04) — Administration's paper on "Securities and Futures Commission Budget for the Financial Year 2014-15"

LC Paper No. CB(1)804/13-14(05) — Background brief on the annual budgets of the Securities and Futures Commission prepared by the Legislative Council Secretariat)

Briefing by the Administration

36. At the invitation of the Chairman, the Deputy Secretary for Financial Services and the Treasury (Financial Services)1 ("DS(FS)1") said that the Administration was studying in detail the Securities and Futures Commission ("SFC")'s proposed budget for the financial year 2014-15. DS(FS)1 stressed that while it was essential for SFC to maintain a healthy financial position to perform its role as an independent regulator, it was a public commitment of SFC, as a publicly funded organization, to deploy its resources and control its expenditure in a prudent manner. The Administration noted that SFC had proposed to increase its headcount to cope with new and increasing regulated activities over the years. The Administration also noted SFC's proposals to reduce the rate of levy on securities transactions and futures/options contracts ("the levy") by 10% (i.e. from 0.0030% to 0.0027% for securities transactions and from $0.6 or $0.12 per contract to $0.54 or $0.108 per contract for futures/options contracts with effect from 1 October 2014 tentatively), and to extend the annual licensing fee holiday for another period of two years (with effect from 1 April 2014). Moreover, SFC would set aside $20 million for funding training initiatives for intermediaries, particularly small and medium-sized firms, to meet the challenges arising from a changing market landscape. The Administration would like to listen to Panel members' views when considering SFC's proposed budget.

37. At the invitation of the Chairman, the Chairman, SFC ("C/SFC") briefed members on SFC's proposed budget as set out in his speaking note tabled at the meeting.

(*Post-meeting note*: The speaking note was issued to members vide LC Paper No. CB(1)871/13-14 on 10 February 2014.)

Discussion

Manpower plan

38. Mr Christopher CHEUNG, Mr CHAN Kin-por and Mr NG Leung-sing noted with concern the substantial increase of 51 headcounts in SFC's proposed budget for 2014-2015. The Chairman observed that SFC continued to increase its manpower resources in the recent years. She expressed concern about the need for the proposed headcounts and queried whether the purpose was to cut down SFC's huge reserves. Mr CHEUNG was worried that the additional manpower for the Intermediaries Division ("INT") would imply tightening of the supervision of intermediaries. In his view, SFC should increase resources to strengthen regulation of listed companies in promoting a quality listed market in Hong Kong.

39. C/SFC stressed that SFC exercised prudence in the deployment of its reserves, and its budget was subject to monitoring by the public and the Legislative Council ("LegCo"). The Chief Executive Officer, SFC ("CEO/SFC") explained that, as set out in the Annex to the Administration's paper (LC Paper No. CB(1)804/13-14(04)), the proposed manpower increase was to deal with specific projects or challenges ahead, such as the need to enhance efficiency of SFC's enforcement process, to be more active in the regulation of listed companies and to enhance SFC's approach to the supervision of the Hong Kong Stock Exchange. Of the proposed 51 new headcounts, only 13 posts were related to INT. The remaining 38 posts covered various other divisions, i.e. Corporate Finance Division ("CFD") (eight posts), Enforcement Division ("ENF") (six posts), Legal Services Division ("LSD") (eight posts), Investment Product Division ("IPD") (five posts), Supervision of Markets Division (nine posts) and Corporate Affairs Division (two posts). The headcount request for INT was mainly to deal with the steady increase in licensing applications, whereas the proposed manpower increase in CFD would support work resulting from, amongst others, the creation of a new corporate regulation team to enhance oversight of listed companies.

40. Mr James TIEN observed that SFC's estimated expenditure for 2014-2015 amounted to $1,670.47 million (including a provision of $66 million for the 51 new headcounts). In view of the substantial financial and manpower inputs to strengthen the regulatory and supervisory framework of the securities markets, Mr TIEN expressed concern about the increase in compliance burden on the securities industry, in particular the increasingly

difficult operating environment faced by small and medium-sized enterprises ("SMEs"). The Chairman opined that, while a robust regulatory regime was vital in reinforcing Hong Kong's status as an international financial centre, the financial services sector was worried about SFC's substantial headcount increase which might imply more regulatory initiatives from SFC. She considered that SFC should clarify the proposal and take note of the industry's concerns, in particular those from SMEs.

41. Mr CHAN Kin-por cautioned that SFC should strike a proper balance between enhancing regulation and development of the financial services industry as new regulatory requirements would inevitably increase compliance costs on the industry. He suggested that in catering for market needs and product demand, SFC should implement measures to shorten the lead time in processing authorization of products, and increase flexibility in considering the authorization.

42. C/SFC said that international financial regulators and standard setters such as the International Organizations of Securities Commissions had been pursuing structural reforms of the financial markets and systems to address the problems exposed by the global financial crisis in 2008. As an international financial centre, Hong Kong was obliged to follow the relevant international standards and requirements as appropriate. CEO/SFC added that SFC adopted the same regulatory approach for all licensed corporations, irrespective of their sizes and having regard to their potential risks to the markets. In this connection, SFC had conducted a series of risk-focused industry meetings, with a view to improving risk management and mitigation in the securities market. The first report of the outcomes of these meetings was published in December 2013. SFC understood that introducing new rules or requirements would inevitably increase compliance costs on the industry. It was aware of calls for an appropriate balance, however in practice there should be no conflict between investor protection measures and market development. SFC would also consult the industry before introducing new regulatory requirements. CEO/SFC supplemented that SFC understood the pressure of the financial regulatory reform on the industry, SMEs in particular. To assist SMEs, SFC had proposed to extend the two-year annual fee waiver for licensees, as well as set aside $20 million in the 2014-2015 budget for funding training initiatives for intermediaries, particularly those in SMEs.

43. Mr NG Leung-sing sought information on the six new posts to be created in ENF in 2014-2015 for supporting "resource intensive work" of the division. He was concerned that there would be overlaps in the work between LSD and ENF.

44. CEO/SFC advised that ENF was responsible for undertaking

investigations and enforcement whereas LSD provided legal advice on such related matters, and prepared proceedings before the Market Misconduct Tribunal ("MMT"). There was clear delineation on the work of the two divisions. CEO/SFC added that the proposed new posts in ENF would be created at the junior level to mainly handle intensive document work in the course of investigations. The additional manpower sought for LSD was related to the establishment of a new litigation team to enhance the efficiency in handling litigations.

45. Mr CHAN Kin-por noted that the headcount request for IPD would support the work relating to mutual recognition of funds in Mainland and Hong Kong, implementation of product design measures, etc. He enquired whether the new posts would cover increased regulatory work/issues arising from the rising number of Mainland investors purchasing financial products in Hong Kong in recent years, including investment-linked assurance schemes. CEO/SFC said that SFC would continue to monitor market developments closely and seek additional manpower resources as appropriate and necessary to deal with extra workload.

46. Referring to paragraph 5.1 on "Income and expenditure statement" in the Annex to the Administration's paper (LC Paper No. CB(1)804/13-14(04)), Mr Kenneth LEUNG noted that the recurrent expenditure in respect of staff cost was forecast to increase by 17.8%. Given the substantial increase in SFC's manpower, he queried the justifications for the forecast increase of 14.8% in respect of recurrent expenditure on "Professional & Others". CEO/SFC advised that the proposed expenditure increase for "Professional & Others" was to address the demand for external legal and expert services to cope with the increasing number of complex litigation cases undertaken by SFC, and preparation of proceedings before MMT. At the request of the Chairman, CEO/SFC agreed to provide a written response to Mr LEUNG's enquiry above.

(*Post-meeting note*: SFC's written response was issued to members vide LC Paper No. CB(1)1039/13-14(02) on 5 March 2014.)

Reserves and levy rate

47. Mr James TIEN opined that, despite a forecast deficit of about $500 million in SFC's proposed budget for 2014-2015, the estimated reserves of $6.6 billion by end of the year would be sufficient to cover budget deficits of similar size in the next 10 years. As such, he queried why C/SFC had remarked in his opening speech that SFC's reserves were projected to shrink to only around two times the annual operating expenditure in three years' time.

48. C/SFC explained that, in accordance with section 396 of the Securities and Futures Ordinance (Cap. 571) ("SFO"), SFC should consult FS with a view to recommending to the Chief Executive-in-Council that the rate or amount of the levy be reduced when its reserves were more than twice its estimated operating expenses for the financial year. This requirement implied that the reserves level at twice of its estimated operating expenditure was basically healthy. However, SFC would need to revisit its options to ensure adequate funding, should the reserves drop beyond this level, including the possibility of raising the levy rate. C/SFC stressed that while SFC's income and level of reserves were bound to fluctuate during successive business cycles, it remained SFC's obligation to deliver consistently efficient and effective regulatory work.

49. Mr Christopher CHEUNG said that the securities industry welcomed SFC's proposals to reduce the levy rate by 10% and extend the annual fee waiver for licensees for further two years, in particular the latter would help reduce the financial burden of market intermediaries. He also commended SFC's efforts in enhancing communication with the industry to gauge their views. Mr James TO considered that there was room for SFC to further reduce the levy rate to over 10%, and SFC's projection of the average daily securities market turnover at $65 billion for 2014-2015 was too conservative. He urged SFC to continue to review the levy rate in light of its financial position each year. In his view, SFC should not continue to collect levy for maintaining its reserves at three times or above the annual operating expenditure, given that SFC could seek LegCo's approval to increase the levy rate to meet its operating expenditure when necessary. Mr NG Leung-sing also considered SFC's projection of the daily turnover of securities market in 2014-2015 conservative. With Hong Kong's sound market regulatory regime and the ongoing efforts of the Administration/industry to promote the Hong Kong stock market, he believed that transactions in the securities market would continue to increase.

50. CEO/SFC stressed that it was appropriate and necessary, for proper budgetary planning, for SFC to adopt a conservative projection of the market turnover and its income. C/SFC said that the proposed budget was essentially dynamic given the need to accommodate changing market circumstances. He assured members that SFC would keep in view the actual market turnover in each year and decide on any adjustments of the levy rate as appropriate.

Training initiatives

51. The Chairman suggested that SFC's training initiatives to be funded by the $20 million set aside in the 2014-2015 proposed budget should target at assisting SMEs to enhance their competitiveness in facing challenges arising from global regulatory reforms and financial product innovations, and enable them to seize business opportunities amidst rapid expansion in the financial services sector. C/SFC said that SFC currently entrusted the Hong Kong Securities and Investment Institute to provide licensing-related training and examinations for market intermediaries. The funding in question would be used for providing other types of training initiatives for intermediaries, which mainly aimed at enhancing their understanding of new financial products and the latest regulatory requirements. As large financial institutions normally had the resources for organizing in-house training for their market practitioners, it was envisaged that the proposed training would mainly benefit SMEs.

Funding to external parties

52. Noting that SFC would continue to fund the operation of the Financial Reporting Council ("FRC"), Mr Kenneth LEUNG enquired whether this arrangement would be reviewed and consideration be given to requiring listed companies to bear the cost in the long run given that FRC's major functions were to enquire/investigate into non-compliances with accounting requirements or auditing/reporting regularities in relation to listed entities.

53. C/SFC said that currently, the operation of FRC was funded by four parties, i.e. SFC, the Companies Registry Trading Fund, the Hong Kong Exchanges and Clearing Limited ("HKEx") and the Hong Kong Institute of Certified Public Accountants ("HKICPA") in accordance with the relevant Memorandum of Understanding signed among the parties. C/SFC said that the funding arrangement might be reviewed in light of the auditor regulatory reform which might involve changes in the functions of FRC and HKICPA towards the regulation of the accountancy profession.

Division of work between SFC and HKEx

54. Mr Kenneth LEUNG observed that the division of work between SFC and HKEx in the regulation of listed companies at various stages from the initial public offering to on-going monitoring was apparently unclear. In particular, he was concerned whether there were regulatory overlaps or gaps between SFC and HKEx. CEO/SFC explained that the regulatory functions of HKEx over listed companies were related to enforcement of the Listing Rules, whereas SFC regulated the securities and futures markets at large, including listed companies, in accordance with SFO. The different perspectives in

exercising regulatory oversight as well as the ongoing coordination between SFC and HKEx would help ensure no regulatory overlaps/gaps between the two parties. At the request of Mr LEUNG, CEO/SFC agreed to provide a written response to his enquiry above.

(*Post-meeting note*: SFC's written response was issued to members vide LC Paper No. CB(1)1039/13-14(02) on 5 March 2014.)

VI Construction of West Kowloon Government Offices

(LC Paper No. CB(1)804/13-14(06) — Administration's paper on "Construction of West Kowloon Government Offices"

LC Paper No. CB(1)804/13-14(07) — Background brief on the construction of West Kowloon Government Offices prepared by the Legislative Council Secretariat)

Briefing by the Administration

55. At the invitation of the Chairman, the Deputy Secretary for Financial Services and the Treasury (Treasury)3 ("DS(Tsy)3") briefed members on the proposal to construct the West Kowloon Government Offices ("WKGO") at 11 Hoi Ting Road, Yau Ma Tei to reprovision some of the government offices currently accommodated at the three government office buildings at the Wan Chai waterfront, the Yau Ma Tei Multi-storey Carpark Building and leased premises in four urban districts. DS(Tsy)3 said that the project would be implemented through the Design-and-Build ("D&B") approach. The construction unit cost of the project, as at September 2013 price level, was estimated to be about $30,000/square metre ("$m^2$") to $33,000/$m^2$ (the figure would be adjusted in accordance with the money-of-the-day prices). The Administration would invite tender for the project in March 2014 and submit funding proposal to the Public Works Subcommittee ("PWSC") and seek funding approval from the Finance Committee ("FC") of LegCo in the first half of 2015. Subject to funding approval, construction works for WKGO would commence in the second half of 2015.

Discussion

Project cost and implementation approach

56. Mr James TIEN said that Members belonging to the Liberal Party supported the proposal as it would reprovision some of the government offices currently accommodated in leased office premises in the urban areas, thereby releasing the premises for commercial use. Referring to the drastic increase in the project cost of the New Broadcasting House of Radio Television Hong Kong which also adopted the D&B approach, Mr TIEN asked whether the estimated construction unit cost of the WKGO project was reasonable. He was worried that if the tender for the project was conducted after seeking funding approval from FC, this would enable contractors to make reference to the approved project estimates in submitting their bids. As such, it would be unlikely that contractors would set the tender prices below the approved project estimates. Mr TIEN suggested that the Administration should seek funding approval based on the tender outturn prices.

57. The Chairman said that Members belonging to DAB supported the proposal. However, she noted the comments from the construction industry that the high costs of public works projects were partly due to the above-standard requirements for the projects. Indeed, she observed that the costs of some public works projects in recent years had far exceeded the respective approved estimates. She said that it would be difficult for Members to support the Administration's request for additional funding in every case. The Chairman requested the Administration to review the measures for controlling expenditure of public works projects, including exploring the feasibility of adopting fixed-price contract, before seeking funding approval for the WKGO project.

58. The Project Director 1, Architectural Services Department ("PD1/ASD") said that the construction unit cost of \$30,000/m^2 to \$33,000/m^2 was only a preliminary estimation for the WKGO project. She said that as the project procurement would involve tendering open to all contractors meeting the prequalification requirements and followed by invitation of the selected prequalified contractors to submit bids, the tender prices were expected to be competitive. DS(Tsy)3 supplemented that the estimated construction unit cost had been worked out with reference to the costs of comparable public works projects in the past. He clarified that the Administration would invite tenders and consider the bids received before submitting the funding proposal to PWSC and seeking funding approval from FC. Given that the process of seeking funding approval on public works projects was essentially transparent, contractors could make reference to the costs of past approved projects when making bids for contracts of similar projects.

59. DS(Tsy)3 stressed that the Administration had always attached importance in exercising stringent control of public expenditure. Of some 600 capital works projects with funding approved by FC in the past ten years, only 10% of the projects required increase in approved project estimates and the amount of increase accounted for 3.4% of the total project cost. He informed members that the Development Bureau was conducting a review on measures to enhance control of public works expenditure and would provide the review report to the Panel on Development in due course. The Chairman suggested that the document should be circulated to all LegCo Members for their reference. The Administration took note of the suggestion.

60. Mr James TIEN noted that the proposed WKGO project comprised two blocks of 16 and 18 storeys respectively and would provide an estimated total net operation floor area of some 50 500 m^2. In view of the relatively simple and small project scope, he asked why the Administration had decided to implement the project through the D&B approach instead of taking up the design work in-house and inviting public tender for the construction works only.

61. DS(Tsy)3 said that, based on past experiences, tender prices of project contracts procured under the D&B approach were comparable to those of the conventional approach. PD1/ASD said that each implementation approach had its advantages and limitations. Adoption of the D&B approach for the WKGO project would enable the design and construction works to be undertaken in parallel by the contractor and his team of designers, thereby shortening the project delivery time. This would help accelerate relocation of the government offices in question to WKGO and achieve savings in rentals of the offices concerned.

Timeframe for relocation of government offices accommodated in the three government office buildings at the Wan Chai waterfront

62. Pointing out that the initiative of reprovisioning the government offices accommodated in the government office buildings at the Wan Chai waterfront had been announced for some years, the Chairman expressed concern about the slow progress in taking forward the initiative. She urged the Administration to accelerate the reprovisioning exercise, with a view to releasing the relevant land/premises for commercial development as early as possible.

63. DS(Tsy)3 said that the Administration was actively pursuing the relocation project. The Government Property Administrator ("GPA") explained that the relocation exercise, which involved three government office buildings with a total gross floor area of 175 000 m^2 currently accommodating

the offices of 29 government bureaux/departments with over 11 000 staff, would be taken forward in phases. It was anticipated that the relocation exercise would commence in 2018-2019 at the earliest after completion of the WKGO project. The Administration would continue to build other new government office buildings in future for relocation of the remaining government offices accommodated at the Wan Chai waterfront. GPA supplemented that, in order to expedite the supply of office spaces to the market, the Administration would release the relevant premises for leasing as soon as after they were vacated instead of waiting until the completion of the entire relocation plan.

Conclusion

64. Concluding the discussion, the Chairman said that Panel members had no objection to the Administration submitting the funding proposal to PWSC and FC respectively in the first half of 2015.

VII Any other business

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

Council Business Division 1
Legislative Council Secretariat
23 June 2014