立法會
Legislative Council

LC Paper No. CB(1)1996/13-14
(These minutes have been seen by the Administration)

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Panel on Financial Affairs

Minutes of meeting
held on Monday, 7 April 2014 at 9:30 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 WONG Ting-kwong, SBS, JP
Hon Ronny TONG Ka-wah, SC
Hon CHAN Kin-por, BBS, JP
Hon NG Leung-sing, SBS, JP
Hon Kenneth LEUNG
Hon SIN Chung-kai, SBS, JP

Members attending :
Hon Michael TIEN Puk-sun, BBS, JP
Hon WU Chi-wai, MH

Members absent :
Hon Andrew LEUNG Kwan-yuen, GBS, JP
Hon Mrs Regina IP LAU Suk-yee, GBS, JP
Hon James TIEN Pei-chun, GBS, JP
Hon Dennis KWOK

Public officers attending	**:**	Agenda Item IV Prof K C CHAN, GBS, JP Secretary for Financial Services and the Treasury Ms Elizabeth TSE, JP Permanent Secretary for Financial Services and the Treasury (Treasury) Mr Martin SIU Director of Accounting Services Mrs Helen CHAN, JP Government Economist Ms Esther LEUNG Deputy Secretary for Financial Services and the Treasury (Treasury)1 Mr Charlix WONG Principal Assistant Secretary for Financial Services and the Treasury (Treasury)(H) Agenda Item V Miss Salina YAN, JP Deputy Secretary for Financial Services and the Treasury (Financial Services)1 Ms Joyce HO Principal Assistant Secretary for Financial Services and the Treasury (Financial Services)1 Ms Christina CHOI Senior Director, Investment Products Securities and Futures Commission Ms Grace CHAN Director, Investment Products Securities and Futures Commission

Agenda Item VI

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

Mr Jackie LIU
Principal Assistant Secretary for Financial Services and the Treasury (Financial Services)5

Mr Esmond LEE, JP
Executive Director (Financial Infrastructure)
Hong Kong Monetary Authority

Mr LI Shu-pui
Head (Financial Infrastructure Development)
Hong Kong Monetary Authority

Attendance by invitation : Agenda item IV

Prof Francis LUI
Member of the Working Group on Long-Term Fiscal Planning

Mr Mark SAUNDERS
Member of the Working Group on Long-Term Fiscal Planning

Mrs Jennifer WONG
Member of the Working Group on Long-Term Fiscal Planning

Mr Marcellus WONG
Member of the Working Group on Long-Term Fiscal Planning

Clerk in attendance: Ms Connie SZETO
Chief Council Secretary (1)4

Staff in attendance : Miss Winnie LO
Assistant Legal Adviser 7

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)981/13-14 — Minutes of the meeting on 2 December 2013)

The minutes of the meeting held on 2 December 2013 were confirmed.

II Information papers issued since the last meeting

(LC Paper No. CB(1)864/13-14(01) — Fourth quarterly report of 2013 on "Employees Compensation Insurance — Reinsurance Coverage for Terrorism"

LC Paper No. CB(1)1013/13-14 — Quarterly Report of the Securities and Futures Commission (October to December 2013)

LC Paper No. CB(1)1135/13-14(01) — Press release on re-appointment of the Chief Executive of the Hong Kong Monetary Authority)

2. Members noted the information papers issued since the last regular meeting held on 7 February 2014.

III Date of next meeting and items for discussion

(LC Paper No. CB(1)1180/13-14(01) — List of outstanding items for discussion

LC Paper No. CB(1)1180/13-14(02) — List of follow-up actions)

3. Members agreed to discuss the following items proposed by the Administration at the next regular meeting scheduled for 5 May 2014:

(a) Briefing on the work of Hong Kong Monetary Authority ("HKMA");

(b) Mandatory Provident Fund Schemes (Amendment) Bill 2014;

(c) Review of abscondee regime under the Bankruptcy Ordinance (Cap. 6); and

(d) Annual briefing on the work of the Financial Reporting Council.

4. Members further agreed that the regular meeting on 5 May 2014 should start at 9:00 am so as to allow sufficient time for discussion of the above four items.

IV Briefing on the report of the Working Group on Long-Term Fiscal Planning

(LC Paper No. CB(1)1180/13-14(03) — Paper provided by the Working Group on Long-Term Fiscal Planning

LC Paper No. FC47/13-14 — Executive summary of the Report of the Working Group on Long-term Fiscal Planning

LC Paper No. CB(1)1180/13-14(04) — Background brief on long-term fiscal planning of Hong Kong prepared by the Legislative Council Secretariat)

Briefing by the Administration and the Working Group on Long-Term Fiscal Planning

5. The Secretary for Financial Services and the Treasury ("SFST") said that the Working Group on Long-Term Fiscal Planning ("the Working Group") had conducted a fiscal sustainability appraisal on the current state of public finances in Hong Kong to cope with the longer term financial commitments of the Government arising from an ageing population. The appraisal was made on the basis of prevailing government policies, projections on population, government revenue and expenditure, as well as economic growth up to 2041-2042. According to the Working Group's analysis, while Hong Kong's public finances was healthy and stable in the short to medium term, if government expenditure continued to grow faster than its revenue, a structural deficit would surface sooner or later. As such, the Working Group considered that the Government should tighten its fiscal discipline to re-align government expenditure growth with that of government revenue and the economy, and strive to achieve the principles enshrined in Article 107 of the Basic Law ("BL").

6. With the aid of a powerpoint presentation, the Permanent Secretary for Financial Services and the Treasury (Treasury) ("PS(Tsy)") briefed members on the report of the Working Group ("the Report"), including the fiscal health check on Hong Kong since 1997, implications of an ageing population on government expenditure, macroeconomic assumptions adopted in the analysis, projections of government revenue and expenditure, fiscal sustainability of Hong Kong, and the Working Group's recommendations.

Discussion

Projections on population, government revenue and expenditure

7. Mr Ronny TONG said that in conducting the fiscal sustainability appraisal, the Working Group had not set out clearly in the Report the relevant assumptions adopted on population policy and population projections, and whether the inflation factor had been taken into account in making the projections on the government revenue and expenditure. He pointed out that the Working Group's projections on government expenditure and revenue were conservative. For instance, since Hong Kong's population growth had already stabilized and reached a plateau after 1997, there would not be continuous growth in government expenditure in all service areas. Moreover, while an ageing population would result in increased expenditure on age-sensitive items, there would not be substantial growth in the recurrent

expenditure on housing and education when the basic infrastructures, like public housing flats and schools, had been provided.

8. Prof Francis LUI, Member of the Working Group, said that the fiscal sustainability appraisal had taken into account the impact of an ageing population on the economy, and relevant data from the official population projections and price changes up to 2041-2042 had been included in the analysis. Projections on the recurrent expenditure on education had been made with due regard to changes in student population and the relevant expenditure on education at different levels. For example, recurrent expenditure on education was projected to decrease under the no service enhancement scenario owing to expected decline in student population. Nevertheless, as recurrent expenditure on education was only some 3% of Hong Kong's nominal GDP in 2014-2015, which was lower than the world's median of 5%, there was pressure for this expenditure item to rise. It was observed that the unit cost of education expenditure in Hong Kong had been on the rise over the past years, which was in line with the global trend.

9. PS(Tsy) stressed that the Working Group had been conscious not to overstate expenditure requirements in making the projections. With the relevant expenditure and student data provided by the Education Bureau, projection of recurrent education expenditure was presented in four scenarios (i.e. no service enhancement, service enhancement at historical trend, at 1% or 2% per annum). Under the no service enhancement scenario, recurrent education expenditure as a percentage of nominal GDP was projected to decrease from 3% in 2014-2015 to 2.8% in 2041-2042, which reflected the trend of a declining student population. She added that the four projection scenarios were developed for reference only. It was not the task of the Working Group to assess which scenario was more reasonable or more likely to happen. In reply to Mr Ronny TONG, PS(Tsy) said that non-recurrent expenditure for implementing one-off relief measures proposed in the budgets were not included in the Working Group's projections of government expenditure.

10. Mr SIN Chung-kai commended the work of the Working Group. He said that as the Working Group had forecast that a structural deficit problem might surface in seven to 15 years' time, the public was worried that the Government might suppress public demand for enhancement of public services under the pretext of containing expenditure growth to tackle the problem. In particular, he noted that the Working Group had not made any quantifiable projection of the future demand for public services (e.g. additional healthcare facilities/services to cope with the ageing population).

11. SFST responded that the Working Group had conducted the fiscal sustainability appraisal on the assumption that there would be no change to the prevailing government policies during the projection period as the base case scenario to assess the impact of population ageing and price adjustment to existing services. As individual bureau was expected to enhance public services under its respective purview which would increase government expenditure during the projection period, the Working Group had put forward three service enhancement scenarios to analyze the possible impact on long-term projection of government recurrent expenditure. He stressed that, while it was necessary to keep the budget commensurate with GDP growth consistent with the requirement of Article 107 of BL, the Government reckoned the need to meet community aspirations for public services, and would continue to enhance the quality and cost-effectiveness of services by streamlining work processes.

12. Mr CHAN Kam-lam enquired whether the Working Group had taken into account the possible side effect arising from constitutional development and universal suffrage in Hong Kong, such as the rise of populism or welfarism, which might cause public expenditure to surge while impeding economic growth. PS(Tsy) stressed that the expenditure projection scenarios presented in the Report were essentially based on the prevailing government policies. The Working Group was politically neutral in conducting the appraisal and drawing up its recommendations. It was not tasked to analyze and comment on government expenditure in specific policy areas.

13. Mr CHAN Kin-por enquired about projection on land premium, including forecast revenue from sale of land created by reclamation or through releasing country park areas for housing development. PS(Tsy) said that during the period of 1997-2007, the percentage share of average land premium per year in nominal GDP was 2.01% (or $27.2 billion). The percentage share went up to 3-4% (about $60 billion) in recent years with the buoyant property market and Government's efforts to put out more land for disposal in the market. The percentage share was projected to be 3.2% by 2041-2042 under the econometric model adopted by the Working Group.

Projected economic growth and structural fiscal deficit

14. Mr Michael TIEN noted that according to the Working Group's analysis, a real GDP trend growth of 3.1% per annum was required under the no service enhancement scenario to tackle the projected structural deficit problem in Hong Kong. He commented that this scenario was unrealistic

given the prevailing social and political sentiments urging for implementation of new initiatives and continuous improvement in public services which would exert pressure on government recurrent expenditure.

15. Mr Kenneth LEUNG considered that the assumption of a long-term real GDP trend growth at 2.8% per annum from 2014 to 2041 under the Base Case was conservative. He enquired whether the Working Group had made reference to the 10-year trend GDP growth of other economies in making its analysis.

16. Prof Francis LUI explained that the long-term real GDP trend growth rate of 2.8% per annum was not an assumption but a projected figure. In fact, the projection might be over-optimistic rather than conservative taking into account the difficulty to achieve significant enhancement in total factor productivity, from the current 1.8% to the projected 2.2% (compared to Singapore's rate of 1%). As regards Mr Kenneth LEUNG's enquiry about whether more automation and improved production mode could help sustain economic growth and offset the negative effects of a declining labour force on the economy, Prof LUI said that it would depend on whether the new mode of production would be compatible with economic development in Hong Kong.

17. SFST shared the view that attaining a real GDP growth rate of 2.8% would be a challenge for Hong Kong. Given the constraints in land and human resources, it would require concerted efforts on the part of both the Government and the society to continue with existing initiatives as well as to innovate in achieving the goal.

18. Mr Jeffrey LAM considered that the Government should make better use of the fiscal reserves and the accumulated surplus of the Exchange Fund ("EF") to cope with rising government expenditure and allow expenditure to exceed GDP growth by a reasonable level. In this connection, Mr LAM enquired about the amount of EF's assets other than those required for backing the Monetary Base, which could be used to meet government expenditure.

19. SFST advised that the current assets of EF stood at around $3,000 billion, including some $1,300 billion for backing the Monetary Base. EF's accumulated surplus (about $640 billion) and placements of Government's fiscal reserves in EF (about $745.9 billion) together amounted to about $1,400 billion. Prof Francis LUI pointed out that, while the Government could use the fiscal reserves and the net assets of EF to fund government needs when necessary, this would not be a sustainable solution to the structural deficit problem. Compared with the extent of the deficit

problem, the fiscal reserves which were equivalent to only some 35% of GDP could not meet the need. He agreed that the Government should consider how investment returns from the net assets of EF and the fiscal reserves placed with EF could be better utilized.

20. Mr CHAN Kam-lam remarked that the findings and recommendations of the Working Group had highlighted the need for the Government to review its fiscal measures and economic development policies in the light of an ageing population, including whether the Administration had adhered to the budgetary principle in Article 107 of BL in keeping the budget commensurate with economic growth, future expenditure needs, and ways to enhance Hong Kong's competitiveness.

21. Mr Jeffrey LAM enquired about the measures recommended by the Working Group for Hong Kong to promote economic development to address the structural deficit problem, such as raising capital investment, and improving the business environment to attract more investment to Hong Kong and create more jobs.

22. Mr CHAN Kin-por stressed the importance to identify new revenue sources for meeting continuous growth in government expenditure. He reiterated the benefits for Hong Kong in developing headquarters economy and suggested reducing profits tax for multi-national companies setting up headquarters in Hong Kong. He believed that the potential economic benefits brought by these measures in the longer term would far more than compensate the short-term tax revenue forgone.

23. Mr Michael TIEN observed that the average real GDP growth of Hong Kong was 2.7% in the past five years, which lagged far behind that of 4.8% for Singapore. Mr TIEN considered it a priority for the Government to promote economic development to broaden its revenue base in addressing a structural deficit in future. He suggested that the Government should make reference to Singapore to import more labour to Hong Kong so as to enhance its productivity. He noted that, in contrast to the pool of 880 000 low-skilled imported labour in Singapore accounting for about 28% of its workforce as at end 2012, only some 2 400 imported workers could be approved each year under the present Supplementary Labour Scheme in Hong Kong. Mr TIEN also agreed to pursue reclamation to increase and ensure a stable land supply to support economic development of Hong Kong.

24. The Chairman, Mr Kenneth LEUNG and Mr CHAN Kin-por were of the view that, while Hong Kong could make reference to the experience of Singapore, it should devise strategies and measures to promote economic development with regard to its own needs and circumstances. Mr CHAN considered that, riding on its competitive advantages and opportunities from economic development in the Mainland, with appropriate measures and strategies, Hong Kong was well-placed to achieve steady economic growth which could exceed that of Singapore. Given that Government's financial resources were not unlimited, Mr LEUNG sought the views of the Administration and the Working Group on how resources allocation decisions between capital investment and recurrent items should be made.

25. Prof Francis LUI shared that Members' suggestion of broadening the revenue base could help address a possible structural deficit to some extent. Nonetheless, the Working Group took the view that the Government should adopt a multiple-pronged approach in tackling the problem. Prof LUI added that, to prevent a structural deficit problem, it was necessary for Hong Kong to maintain a real GDP trend growth of 5.4% per annum under the historical trend service enhancement scenario. Such a growth rate would be a huge challenge for Hong Kong as the economy had become more mature with lower growth.

26. As regards economic growth in Singapore, Prof Francis LUI said that the 5.9% per annum real GDP trend growth achieved by Singapore was mainly due to its far more vigorous savings mechanism. In Singapore, at least 50% of the net investment return (compared to Hong Kong's 24%), on a real basis, on past reserves was saved every year for investment, and the average per-capita consumption was much lower. Notwithstanding the substantial growth in capital investment, the benefit in terms of efficiency enhancement was disproportionately low in Singapore, and indeed there had been concern about the appropriateness and cost-effectiveness of Singapore's mode of economic development. Singapore had pursued economic development with its unique considerations. Such experience might not be entirely relevant to the Hong Kong context.

27. SFST pointed out that economic development in Hong Kong was, to some extent, constrained by insufficient supply in land and human resources. On the other hand, between 2007 and 2012, massive importation of labour (about 80 000 workers each year) in Singapore had resulted in a relatively higher growth of 4.4% per annum in its labour force which was nearly five times that of Hong Kong. Rapid development in new land resources in Singapore had also supported its economic growth. It would be infeasible for

Hong Kong, with different political and economic circumstances, to achieve economic growth in the same manner.

28. Mr SIN Chung-kai opined that the Government should have set up the Working Group earlier to conduct a health check on Hong Kong's public finances more timely. He said that there was room in past years for the Government to make more savings for the future. Mr SIN suggested that the Administration should continue to review Hong Kong's fiscal sustainability on a regular basis. The Chairman considered that the Report would facilitate a more focused discussion by the community on issues relating to Hong Kong's fiscal sustainability and measures to promote the economy. She suggested that the Government and the Working Group should conduct studies on economic development and growth of other mature economies such as South Korea and Israel.

29. Mr Mark SAUNDERS, Member of the Working Group agreed that Hong Kong had its own competitive advantages. In addressing the structural deficit problem, the Working Group saw the need for the Government to examine options for partnerships with the private sector and enlist the support of the whole community in implementing the fiscal measures.

30. SFST said that the Government would take note of members' views and suggestions in relation to economic development of Hong Kong and the work of the Working Group. As regards the Chairman's enquiry about coordination of efforts from bureaux in devising strategies and measures to promote economic development, SFST said that there were ongoing communications and meetings among various bureaux and the Government's relevant advisory groups (e.g. Economic Development Commission). The Government would also listen to the views of the community on the recommendations of the Working Group and measures to promote Hong Kong's economic development.

Proposal of establishing a Future Fund

31. On the Working Group's proposal to save for Hong Kong's future by creating a Future Fund ("FF") comprising $220 billion of the Land Fund balance in 2014-2015 and a portion of the Government's future budget surpluses, Mr WONG Kwok-hing and Mr Christopher CHEUNG enquired about the details of the FF, including its usage, management, and investment. Mr WONG asked whether the Government would consider using part of the FF to set up a universal retirement protection scheme for Hong Kong. Mr CHEUNG and the Chairman questioned the need to set up the FF with

assets segregated from the fiscal reserves as the purpose and role of the FF could be served by the fiscal reserves. Mr Albert HO enquired whether the Administration was contemplating to set up an investment company owned by the Government to make strategic investment in infrastructure projects, similar to the operation of the Temasek Holdings of Singapore.

32. Mr NG Leung-sing said that he was a trustee of the Land Fund when it was established. He expressed support for the direction to establish a savings scheme in view of the limited financial resources of the Government and the anticipated spending pressure exerted by an ageing population. Given the historical background of setting up the Land Fund and the special nature of the Fund, he remarked that the Government should be cautious of the political implications of "freezing" the Land Fund. Mr NG enquired about the Working Group's views on the portion of future budget surpluses to be credited to the FF, and FF's investment strategy. He also expressed concern about feasibility for the FF to achieve a 5% annual return from its investment in reaching a balance of $510 billion in ten years' time by 2023-2024 as assumed by the Working Group. He pointed out that the balance of the Land Fund was about $199.6 billion when it was established in 1997. Over the past 16 years, assets in the Land Fund had only increased by some 10% to the current balance of $219.7 billion.

33. Mr Marcellus WONG and Mrs Jennifer WONG, Members of the Working Group, explained that in making the recommendation on the FF, the Working Group had made reference to the experiences of some economies such as Australia which had created funds for stabilization or savings purposes. Despite that Hong Kong's current fiscal position was still healthy and the structural deficit problem would not emerge until some seven to 15 years later, the Working Group considered that the Government should start saving for the future. Since the Land Fund currently had no designated uses and were in effect "idled" assets, it could be better utilized as a ready endowment for setting up the FF. The Working Group's initial views were that the FF would not be accounted for as part of the fiscal reserves, and its investment could be segregated from the fiscal reserves placed with EF and a more aggressive and longer-term investment strategy could be adopted to yield higher returns. They supplemented that the FF was still at a conceptual stage. While the Working Group had deliberated on whether the FF should be established with designated uses, say, for social welfare, health or retirement protection, etc., it had not come to any conclusion in this respect. The Working Group considered that the community should first discuss whether the FF should be established and its composition. Details on the operation and management of the FF would be examined at a later stage. The FF was not

meant to be an all-cure solution to the structural deficit problem. It was an option for further consultation and discussion. Mr Mark SAUNDERS added that the FF could consider adopting a bolder investment strategy (e.g. investment in technology-based companies). The investment could potentially bring to Hong Kong external expertise (e.g. people, skills and technology) which could further help improve Hong Kong's productivity and competitiveness. He echoed that the FF was just a possible fiscal tool, and it alone could not resolve the structural deficit problem.

34. SFST stressed that setting up of the FF, which would not be accounted for as part of the fiscal reserves, would enable the Government to make longer-term investments on the assets for gaining higher returns. Regarding the small increase in the balance of the Land Fund in the post-handover period, SFST explained that the Land Fund had the same rate of investment return as the portion of the fiscal reserves placed with the EF. A total of $160 billion had been transferred from the Land Fund in 2003-2004 and 2004-2005 to the General Revenue Account for meeting anticipated cash flow shortfall resulted from the budget deficits since 2000-2001.

35. Mr WU Chi-wai noted from the Financial Secretary's 2014-2015 Budget Speech that the FF would serve as a contingency fund in the event of sustained budget deficit to finance strategic infrastructure projects conducive to Hong Kong's future economic development. However, the Working Group seemed to suggest that the major purpose of the FF was to deal with the fiscal challenge arising from an ageing population. Mr WU sought clarification on the usage of the FF, in particular whether the Fund was meant to finance capital works projects operated by public enterprises (e.g. Airport Authority Hong Kong) with a view to generating recurrent revenue to cope with longer-term challenges of public finances.

36. SFST responded that the Government's initial thinking was that it would be more appropriate to use the FF to finance non-recurrent initiatives which were time-limited in nature, in particular capital works projects, so that these initiatives would not be hindered or deferred at times of economic downturn or budget deficits. Nonetheless, the usage of the FF would be open to public discussion. PS(Tsy) pointed out that capital works projects such as hospitals and elderly homes were closely related to improvement of people's livelihood and meeting the needs of an ageing population. The projections on capital works expenditure had taken into account, amongst others, assessment by the Hospital Authority of the relevant demand and investment for healthcare facilities up to 2041.

37. The Chairman enquired whether there were other economies apart from Australia which had set up funds similar to the proposed FF for savings purpose. Mrs Jennifer WONG advised that the savings fund set up in Australia was similar to the FF although the former was established with designated uses. In Norway, a similar savings fund had been set up with usage and investment strategies catering for its special circumstances as a resource-rich economy.

38. Mr CHAN Kam-lam expressed concern that the amount of fiscal reserves for meeting the day-to-day cash flow requirements of the Government was low. He opined that the Government should maintain the fiscal reserves at an optimum level sufficient to meet the equivalent of at least 12 or 18 months of government expenditure, after setting aside the necessary resources for setting up the FF.

39. PS(Tsy) advised that, of the $745.9 billion estimated fiscal reserves as at end March 2014, only the portion held in the General Revenue Account, i.e. about $394 billion, could be flexibly deployed for meeting the day-to-day cash flow requirements. The balances of about $132 billion were held in various Funds set up by Resolutions of the Legislative Council ("LegCo") for designated purposes. For instance, the balance of $78.679 billion in the Capital Works Reserve Fund was designated for capital works, major systems and equipment. She added that the total financial commitment for all Category A capital works projects from 2014-2015 onwards which had yet to be paid from the fiscal reserves had already reached $340 billion. The current balance of $78.679 billion in the Capital Works Reserve Fund was sufficient to meet only around one year of its expenditure.

V Proposal for open-ended fund companies: initiatives to develop the asset management industry

(LC Paper No. CB(1)1180/13-14(05)	—	Administration's paper on "Proposal for open-ended fund companies: initiatives to develop the asset management industry"

LC Paper No. CB(1)1180/13-14(06) — Background brief on the Government's latest initiatives to develop the asset management industry prepared by the Legislative Council Secretariat)

Briefing by the Administration

40. At the invitation of the Chairman, the Deputy Secretary for Financial Services and the Treasury (Financial Services)1 ("DS(FS)1") briefed members on the background and details of the proposed open-ended fund companies ("OFCs") to develop Hong Kong's asset management industry, including the relevant policy objectives, key benefits of OFCs, OFC structure, investment scope and fund operation, the legislative framework, registration and authorization for OFCs, investor protection measures, as well as the tax regime for OFCs. DS(FS)1 said that a three-month public consultation on introducing a new OFC structure was launched from 20 March to 19 June 2014. The Administration would work on the details of the proposal taking into consideration views and comments received during the consultation.

(*Post-meeting note*: The notes of the powerpoint presentation (LC Paper No. CB(1)1215/13-14(01)) were issued to members vide Lotus Notes e-mail on 9 April 2014.)

Disclosures

41. Mr NG Leung-sing said that he was a director of a trust company. Mr Kenneth LEUNG said that he was an ex-member of Alternative Investment Management Association.

Discussion

Tax regime for OFCs

42. Mr WONG Kwok-hing expressed reservation about extending the current tax exemption for public funds to publicly offered OFCs as there was a long standing concern about Hong Kong's narrow tax base and that operation of the OFC regime would require public resources.

43. DS(FS)1 advised that it was a common practice in other fund jurisdictions to provide profits tax exemption for public funds. She said that the new OFC structure would help attract more funds to domicile in Hong Kong, deepen and broaden the asset management industry, increase tax revenue for the Government, and bring about other economic benefits such as driving demand for professional services in fund management, investment advice, as well as legal and accounting services.

44. Mr Ronny TONG said that he welcomed the Administration's proposal which was conducive to reinforcing Hong Kong's status as an international financial centre. While he noted that the Administration was still considering whether profits tax exemption should be provided for privately offered OFCs with its central management and control ("CMC") located onshore, he was concerned about Hong Kong's competitiveness in attracting domicile of overseas mutual funds and private funds if OFCs were required to pay profits tax. As such, he suggested that the Administration should consider extending the current profits tax exemption to privately offered OFCs. Mr NG Leung-sing also considered that taxation on privately offered OFCs with CMC located onshore might fail in attracting private funds to set up in Hong Kong. The Chairman enquired about Hong Kong's competitiveness in attracting the domicile of OFCs.

45. Mr Kenneth LEUNG pointed out that Hong Kong had lagged behind other major fund centres, for example, the United Kingdom ("UK"), Ireland and Luxembourg, in introducing the OFC structure. Apart from extending the existing profits tax exemption for public funds to publicly offered OFCs and offshore funds, he said that the Administration should consider providing profits tax exemption to privately offered OFCs with CMC located onshore. He also queried why the Administration had not considered exempting the transfer of shares in OFCs from payment of stamp duty as the tax could be avoided if such transfers were effected by simultaneously issuing and redeeming shares.

46. Mr Christopher CHEUNG said that he welcomed the proposal to develop the asset management industry in further consolidating Hong Kong's position as an international financial centre. However, he pointed out that exempting OFCs from profits tax or stamp duty in respect of transfer of shares would enhance attractiveness of such funds to investors. He was concerned that this could put the trading of stocks which was subject to stamp duty in an unlevel playing field. He also observed that, as fund products offered by banks usually had a high marked-up price, providing tax incentives to OFCs might widen the price differential at the expense of retail investors.

Mr CHEUNG further enquired about the tax incentives offered to OFCs by other fund jurisdictions.

47. DS(FS)1 said that the number of funds registered in Hong Kong had increased rapidly in recent years with 343 Hong Kong-domiciled SFC-authorized funds as at end 2013. She explained that currently, an open-ended investment fund could be established under the laws of Hong Kong in the form of a unit trust but not in corporate form due to various restrictions on capital reduction under the Companies Ordinance (Cap. 622) ("CO"). The current proposal had taken into account industry calls for introducing a new OFC structure as an additional option or to complement the existing unit trust structure. In the international arena, especially in Europe and the United States, the corporate fund structure had become more popular with increased familiarity and experience of market participants with such company model. DS(FS)1 agreed that taxation would be among the factors considered by market participants in making decisions on fund domicile. Currently, privately offered OFCs with CMC located offshore had already been exempted from profits tax, which was in line with the existing profits tax exemption available to all offshore funds. As regards privately offered OFCs with CMC located onshore, it was observed that some fund jurisdictions offered profits tax exemption to such funds. The Administration would consider the exemption proposal carefully taking into account overseas practices, suggestions from Members and the public during consultation, as well as possible implications of the proposal.

48. As regards the choice of investment (e.g. funds or equities) made by individual investors, DS(FS)1 said that it would be up to the investors to decide having regard to their circumstances. She stressed that appropriate measures to protect investors interests would be put in place for OFCs. For instance, OFC investment manager and custodian would have to meet the basic eligibility requirements, and assets of OFCs must be segregated from that of the investment manager and entrusted to a separate, independent custodian for safekeeping. Investor protection would in fact be enhanced. While currently privately offered funds were not subject to regulation by the Securities and Futures Commission ("SFC") under the Securities and Futures Ordinance (Cap. 571) ("SFO"), OFCs including privately offered OFCs would be regulated by the new OFC regime under the oversight of SFC.

49. In reply to Mr Albert HO, the Administration agreed to provide information on the justifications for extending the existing profits tax exemption for public funds to publicly offered OFCs, with reference to the operation, investment/trading activities and treatment of profits/income in respect of public funds and publicly offered OFCs.

(*Post-meeting note*: The Administration's written response was circulated to members vide LC Paper No. CB(1)1316/13-14(02) on 25 April 2014.)

50. Mr Christopher CHEUNG enquired whether securities firms could handle the trading of OFC funds, and whether the Administration would encourage the listing of OFCs in Hong Kong with a view to enhancing the governance of these fund structures and facilitating regulatory oversight. The Senior Director (Investment Products), SFC ("SD(IP)/SFC") said that as long as the securities traders were licensed by or registered with SFC to carry out Type 9 (i.e. asset management) regulated activity, they could set up and undertake investment management of OFCs. On listing of OFCs, SD(IP)/SFC said that the relevant requirements under the Listing Rules for listing of funds would apply.

OFC structure and regulation

51. Mr Kenneth LEUNG noted that the proposed OFC might be created as an umbrella fund consisting of a number of separately pooled sub-funds, and the assets and liabilities of each sub-fund would be segregated such that it could be wounded up separately in the event of insolvency, without giving rise to contagion risk to other sub-funds. Mr LEUNG enquired whether such protected cell regime of OFCs was more advanced and competitive than the OFC structures available in other fund jurisdictions. SD(IP)/SFC said that the proposed protected cell regime had taken into consideration similar OFC structures and the latest developments in other major fund centres (e.g. UK and Ireland). She added that the protected cell regime was introduced in UK only in recent years although OFC had been implemented in the UK market since 1997.

52. Pointing out that the proposed OFC structure was similar to those adopted in other fund jurisdictions, Mr Kenneth LEUNG was concerned how Hong Kong could enhance its competitiveness in attracting overseas funds to domicile. As such, to complement the OFC structure, he reiterated the need for the Administration to provide tax incentives for OFCs. DS(FS)1 said that public consultation on the OFC proposal was still underway and the Administration was open to all suggestions. As observed, market participants had expressed interest in using the OFC structure to set up funds in Hong Kong. She believed that the OFC proposal would bring benefits to Hong Kong economy at large.

53. Mr NG Leung-sing considered that the industry generally welcomed introduction of more competitive financial products and services in Hong Kong. He stressed that the Administration should strike a balance in exercising financial regulation and investor protection for the OFC regime in order not to jeopardize the market development. Mr NG noted that under the current proposal, an OFC would be governed by a board of directors which would provide an additional layer of oversight for shareholders but individual directors on the board were not required to be licensed under SFO. Mr NG queried how the directors, in particular non-executive and independent directors, could be held responsible for the affairs of the OFC as proposed. He also enquired about the differences in the regulatory requirements for OFCs and conventional companies, and suggested that the Administration should make reference to the regulatory requirements of other fund jurisdictions to ensure that the proposed regime would not be overly restrictive.

54. DS(FS)1 said that, similar to the conventional company model, the directors of an OFC were subject to statutory and fiduciary duties. SD(IP)/SFC said that as an OFC was a fund investment vehicle in corporate form, its characteristics would be similar to a conventional limited company in that the board of directors would bear legal responsibilities for the affairs of the company although the day-to-day management and investment functions of the OFC must at all times be delegated to an investment manager licensed by or registered with SFC. The OFC directors would be subject to the same fiduciary duties as those of the directors of conventional companies under CO as well as the common law. She added that directors of conventional companies were also not required to be licensed under SFO.

55. Mr Kenneth LEUNG enquired whether the OFC proposal would entail amendments to CO and whether OFCs would be subject to similar requirements for companies under CO requirements. DS(FS)1 said that it was envisaged that the enabling provisions would be provided in SFO instead of CO having regard that most of the CO requirements were not applicable to OFCs. Setting out the regulatory regime of OFC in one principal legislation (i.e. SFO) and its subsidiary legislation would also facilitate easy reference by market practitioners. DS(FS)1 further said that the proposed legislative framework was still at a conceptual stage. It might be necessary to make appropriate amendments to CO in drafting the legislative proposals concerned.

56. Mr Albert HO enquired about the investment scope of OFCs and related regulation (i.e. SFC authorization, product due diligence and risk management), in particular whether OFCs would be allowed to make

high-risk investments. DS(FS)1 advised that the initial thinking was that an OFC might invest in asset classes broadly in line with those of a traditional investment fund within the remit of SFO, and aligned with those types of investment activities which were subject to licensing and regulation by SFC under SFO. SD(IP)/SFC supplemented that publicly offered OFCs would need to comply with the applicable SFC product codes, such as requirements for diversification of investment and risk disclosure, whereas privately offered OFCs would be provided with more flexibility in pursuing their investment strategies subject to compliance with basic governance principles and conduct requirements to be observed by their investment managers.

Development of asset management industry

57. Noting that the new OFC regime and the future mutual recognition of funds between Hong Kong and the Mainland would complement each other in development, the Chairman enquired about the regulation on the sale of funds authorized in Hong Kong to Mainland investors. DS(FS)1 advised that SFC had been discussing with the relevant Mainland authorities on the mechanism for mutual recognition of funds in both places, including the requirements on qualified funds, eligibility of fund managers, etc. The details would be provided to the market after they had been approved by the Central People's Government. She added that, as the proposed OFC option would give flexibility to fund managers to meet market demand, it would complement the mutual recognition of funds initiative in attracting more funds to domicile in Hong Kong.

VI Briefing on the proposed regulatory regime on stored value facilities and retail payment systems

(LC Paper No. CB(1)1180/13-14(07) — Administration's paper on "Proposed Regulatory Regime for Stored Value Facilities and Retail Payment Systems in Hong Kong")

Briefing by the Administration

58. At the invitation of the Chairman and with the aid of a powerpoint presentation, the Deputy Secretary for Financial Services and the Treasury (Financial Services)1 and Head (Financial Infrastructure Development),

HKMA ("H(FID)/HKMA") briefed members on the proposed regulatory regime for stored value facilities ("SVF") and retail payment systems ("RPS"), the new supervisory and enforcement powers to be vested in HKMA and the transitional arrangements. H(FID)/HKMA remarked that the Administration planned to introduce the relevant Bill into LegCo in the 2014-2015 legislative session.

> (*Post-meeting note:* The Notes of the powerpoint presentation (LC Paper No. CB(1)1215/13-14(02)) were issued to members vide Lotus Notes email on 9 April 2014.)

Discussion

Application of the proposed licensing criteria on physical presence in Hong Kong

59. Mr WONG Kwok-hing supported adopting physical presence in Hong Kong as one of the licensing criteria for SVF issuers to facilitate HKMA's supervision over issuers. Mr SIN Chung-kai welcomed the Administration's initiative to enhance the regulatory regime of SVF and RPS which would increase customer protection. As regards the licensing criteria of SVF issuers, he pointed out that some online payment systems might operate internationally across a number of jurisdictions and might not have physical presence in Hong Kong as Hong Kong's market was relatively small. Mr SIN enquired whether such payment systems would be regulated under the proposed regulatory regime.

60. The Executive Director (Financial Infrastructure), HKMA ("ED(FI)/HKMA") responded that the proposed regulatory regime required an SVF issuer operating an online payment system to be physically present in Hong Kong by establishing a locally incorporated company. Otherwise, it would not be granted a licence and would be prohibited from soliciting business in Hong Kong. If the unlicensed SVF issuer continued its online operations targeting the members of the public in Hong Kong, the Administration and HKMA would notify the relevant regulator of the home jurisdiction of the unlicensed SVF issuer of its unlawful activities in Hong Kong, and also, inform the members of the public in Hong Kong that the issuer was unlicensed and the float (i.e. all money received from the users) given to the issuers might not be adequately protected.

61. Mr SIN Chung-kai expressed concern about the difficulty to define whether a SVF issuer was "soliciting business", in particular when the issuer might not proactively solicit business in Hong Kong. Pointing out that some online shops operated overseas and did not have physical presence in Hong Kong would only receive payment and arrange delivery of goods to Hong Kong, Mr SIN enquired whether the online shop or the entity responsible for delivering the goods or both would be regulated under the proposed regulatory regime.

62. ED(FI)/HKMA responded that a SVF issuer operating business in Hong Kong would be subject to the proposed regulatory regime. Local companies offering supporting service to a SVF issuer should make sure that the SVF issuer was licensed. ED(FI)/HKMA added that companies in Hong Kong providing any technical and operational support to an unlicensed SVF issuer might be subject to the proposed regulatory regime.

Implementation of the proposed regulatory regime

63. On the criterion that SVF issuer must meet a minimum on-going capital requirement, i.e. the aggregate amount of its paid-up capital should not be less than HK$25 million, Mr WONG Kwok-hing expressed concern about the adequacy of the proposed capital level and whether the SVF issuer would become insolvent if it failed to meet the requirement.

64. ED(FI)/HKMA responded that SVF was a means to facilitate customers' payment for goods and services and to individuals' accounts. Money received from users of a SVF was kept by the SVF issuer before it was used for payments. The proposed regulatory regime would focus on the protection of users' float maintained by SVF issuers. For instance, all licensed SVF issuers should have in place adequate protection arrangements for the float, and to keep the float separate from the issuer's other funds to prevent misuse of the float for other purposes by the issuer.

65. Mr Kenneth LEUNG sought further details on the Administration's proposal to exempt single-purpose SVF from the mandatory licensing regime. Mr LEUNG pointed out that a corporation with a number of subsidiaries operating different kinds of business might issue SVF for customers purchasing goods or patronizing the services of its various subsidiaries. He enquired whether the corporation concerned would be regarded as a single-purpose SVF and be exempted from the licensing regime.

66. ED(FI)/HKMA said that the Administration and HKMA had carefully considered the issue of not regulating single-purpose SVF from the licensing regime. Single-purpose SVF was common in Hong Kong and took a variety of forms like prepaid coupons issued by cake shop and deposits paid to a tailor. The example of a corporation with a number of subsidiaries operating different kinds of businesses, which might issue SVF for customers purchasing goods or patronizing the services of its various subsidiaries, would likely fall within the definition of multi-purpose SVF and be subject to the licensing regime. Also, comments received in the public consultation conducted in May 2013 suggested that the incorporation of single-purpose SVF into the licensing regime might cause inconvenience to the public. The Administration and HKMA also considered that certain multi-purpose SVF (like multi-purpose value cards used in local universities) which could only be used within, or within close proximity to the issuer's premises, or for the purchase of a limited range of goods or services from a limited number of shops or services providers might be considered for exemption. HKMA would take into account the prevailing market circumstances in granting exemption for SVF issuers from the licensing requirement.

Protection of data privacy

67. In response to Mr WONG Kwok-hing's enquiry about measures to be included in the proposed regulatory regime to protect privacy of users' personal data so as to avoid recurrence of incidents of data breach similar to the Octopus Cards incident in 2010 (i.e. involving the sharing of Octopus cardholders' personal data by the Octopus Cards Limited with its business partners), ED(FI)/HKMA pointed out that licensed SVF issuers were subject to safety and security requirements which included, among other things, to be in compliance with the data protection regulation in Hong Kong. A licensed SVF issuer would not be allowed to use the personal data of its customers for other purposes without customers' prior consent. Mr WONG suggested that the relevant Bill should explicitly specify measures on protection of personal data privacy.

Regulation of bitcoins

68. Mr Kenneth LEUNG enquired whether bitcoins would be regarded as a SVF and regulated under the proposed regulatory regime. Mr LEUNG also said that he learnt from a recent meeting with the Chief Executive of HKMA that bitcoins were not regarded as a kind of currency in circulation, and HKMA considered that bitcoins should be subject to the regulatory regime under the Anti-Money Laundering and Counter-Terrorist Financing

(Financial Institutions) Ordinance (Cap. 615) which was in line with the international practice. Mr LEUNG enquired whether the relevant Bill would regulate the use of bitcoins.

69. ED(FI)/HKMA responded that HKMA regarded bitcoins as virtual commodity as their value was not backed by any physical items, issuers or real economic activities. Bitcoins also did not fall under the definition of SVF and RPS as they would not be used as a medium of exchange given that they were susceptible to significant fluctuations in price. While there was currently no specific legislation for regulating bitcoins, HKMA would continue to remind the public about the risks in investing in bitcoins, including significant fluctuations in price.

Conclusion

70. The Chairman concluded that members did not oppose the Administration's plan of introducing the relevant Bill into LegCo in the 2014-2015 legislative session.

VII Any other business

71. There being no other business, the meeting ended at 12:24 pm.

Council Business Division 1
Legislative Council Secretariat
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