LC Paper No. CB(1)1070/14-15
(These minutes have been seen by the Administration)

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Panel on Financial Affairs

Minutes of meeting
held on Monday, 4 May 2015 at 9:30 am
in Conference Room 2 of the Legislative Council Complex

Members present	**:**	Hon CHAN Kin-por, BBS, JP (Chairman) Hon Christopher CHEUNG Wah-fung, SBS, JP (Deputy Chairman) Hon Albert HO Chun-yan 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 Starry LEE Wai-king, 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 SIN Chung-kai, SBS, JP
Member attending	**:**	Hon Emily LAU Wai-hing, JP
Members absent	**:**	Hon James TO Kun-sun Hon Andrew LEUNG Kwan-yuen, GBS, JP Hon Dennis KWOK
Public officers	**:**	<u>Agenda item IV</u>

attending

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

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

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

Mr Francis CHU, JP
Acting Deputy Chief Executive (Monetary)
Hong Kong Monetary Authority

Mr Darryl Chan, JP
Executive Director (Corporate Services)
Hong Kong Monetary Authority

<u>Agenda item V</u>

Mr Patrick HO, JP
Deputy Secretary for Financial Services and the Treasury (Financial Services)3

<u>Agenda item VI</u>

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

Ms Meena DATWANI, JP
Director General (Enforcement)
Hong Kong Monetary Authority

Ms Tess LEUNG
Head (Deposit Protection Scheme)

		Hong Kong Monetary Authority
Attendance by invitation	**:**	<u>Agenda item V</u> Mr Mark DICKENS, JP Chief Executive Officer Financial Reporting Council Ms Wincey LAM Deputy Chief Executive Officer Financial Reporting Council Mr T S CHAN Senior Director, Investigation and Compliance Financial Reporting Council
Clerk in attendance	**:**	Ms Connie SZETO Chief Council Secretary (1)4
Staff in attendance	**:**	Mr YICK Wing-kin Assistant Legal Adviser 8 Ms Angel SHEK Senior Council Secretary (1)4 Ms Sharon CHAN Legislative Assistant (1)4

<u>Action</u>

I. Confirmation of minutes of meeting and matters arising

(LC Paper No. CB(1)793/14-15 — Minutes of the meeting on 2 February 2015)

The minutes of the meeting held on 2 February 2015 were confirmed.

II. Information papers issued since last meeting

(LC Paper No. CB(1)767/14-15(01) — 2013-2014 Annual Report of the Process Review Panel for the Securities and Futures Commission

LC Paper No. CB(1)783/14-15(01) — Hong Kong Monetary Authority Annual Report 2014)

2. Members noted the information papers issued since the last regular meeting held on 13 April 2015.

III. Date of next meeting and items for discussion

(LC Paper No. CB(1)780/14-15(01) — List of outstanding items for discussion)

3. Members agreed to discuss the following items proposed by the Administration at the next regular meeting scheduled for 1 June 2015:

(a) Briefing by the Financial Secretary ("FS") on Hong Kong's latest overall economic situation;

(b) Proposal to attract enterprises to establish corporate treasury centres in Hong Kong; and

(c) Pilot programme to enhance talent training for the insurance sector and asset and wealth management sector.

4. Members further agreed that the next regular meeting on 1 June 2015 should start at 9:30 am so as to allow sufficient time for discussion of the above three items.

IV. Briefing on the work of Hong Kong Monetary Authority

(LC Paper No. CB(1)780/14-15(02) — Paper provided by the Hong Kong Monetary Authority)

Briefing by the Administration

5. 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 Acting Deputy Chief Executive (Monetary)/HKMA ("Acting 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, banking supervision, development of the financial market and 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)833/14-15(01)) were issued to members vide Lotus Notes e-mail on 8 May 2015.)

Discussion

Risks of interest rate rise on liquidity flow and property market

6. Mr CHAN Kam-lam observed that under the linked exchange rate ("LER") system, Hong Kong interest rates would likely adjust in tandem with the normalization of interest rates in the United States ("US") in the near future. The trend of massive fund inflow into Hong Kong since 2008 accumulated to about $900 billion (or US$110 billion) in the first quarter of 2015 might revert and liquidity drain might occur with increase in the US interest rates. Mr CHAN enquired if there were measures to delay adjustment of Hong Kong interest rates with a view to averting a sudden and severe liquidity drain from Hong Kong. The Chairman enquired about the rationale for possible fund outflow from Hong Kong along the US interest rate rise, given that movement in the Hong Kong interest rates should follow that of the US interest rates.

7. Mr Kenneth LEUNG sought HKMA's assessment on the timing of adjustment of the Hong Kong interest rates. He opined that while the Hong Kong interest rates would not rise as soon as the US interest rates started to climb, the time lag and the resulting interest rate differential would only be temporary. Given the operation of the LER system, the pace and extent of adjustment of the interest rates of Hong Kong and US would be aligned in the medium to longer term.

8. Mr SIN Chung-kai enquired whether the impacts on Hong Kong arising from the US interest rate rise might be moderated or counteracted by an increase in the interest rate for Hong Kong Dollar deposits. It was because the increase in the interest rates of Hong Kong would attract investors to hold Hong Kong Dollar vis-à-vis other currencies which were undergoing monetary easing.

9. CE/HKMA said that the pace of US interest rate rise was still uncertain. Indeed, there was difference between market expectations and the US Federal Reserve's forecasts regarding the pace of the US interest rate hikes in the coming few years. CE/HKMA said that it was difficult to predict when the Hong Kong interest rate would start to rise, as it would depend on the pace of the US interest rate adjustment. In any case, the Hong Kong interest rates would track closely the US interest rates sooner or later.

10. On the concern about a possible liquidity drain occurring in Hong Kong, CE/HKMA explained that under the Currency Board system which underpinned the LER system, the Monetary Base of Hong Kong Dollar would expand or contract in response to capital inflow or outflow respectively. Any net inflow of funds into Hong Kong resulting in expansion of Hong Kong Dollar Monetary Base would be fully matched by a corresponding increase in foreign reserves, which were held in high quality and short-term US Dollar-denominated debt securities with high liquidity in the Backing Portfolio of EF. When the US interest rates adjusted upward, the resulting interest rate differential would induce investors to sell Hong Kong Dollar and buy US Dollar for the purpose of interest rate arbitrage. Subsequent contraction of the Hong Kong Dollar Monetary Base under the Currency Board system would then exert pressure for Hong Kong interest rates to rise. As it would take time for fund flows to adjust in response to interest rate changes, it was not expected that the anticipated liquidity drain would take place abruptly. CE/HKMA further pointed out that while the quantitative easing of US had ended, Japan expanded its Qualitative and Quantitative Easing and the European Central Bank ("ECB") had introduced monetary easing which might partly offset the normalization of monetary policy in US, though it remained uncertain how long ECB's monetary easing programme would last or whether it would be expanded in the near future. Nevertheless, compared to the Euro and some other major currencies, the Hong Kong economy and other emerging economies as well as macro financial stability were more susceptible to influence from the US Dollar.

11. Noting that some multinational companies and enterprises incorporated in Hong Kong had announced plans to re-structure their businesses or re-locate their place of incorporation from Hong Kong, Mrs Regina IP enquired if HKMA had observed signs of fund outflow from Hong Kong by business conglomerates.

12. CE/HKMA said that under the Currency Board system, HKMA could keep track of changes in the Hong Kong Dollar Monetary Base including the net capital inflow or outflow into/from Hong Kong. While it was noted that there was a net inflow of around $71.5 billion (or about US$9.2 billion) into the

Hong Kong Dollar in the recent period, given the numerous transactions taking place daily, it would be difficult to identify the parties involved in individual transactions.

13. Referring to page 4 of the powerpoint, Mr SIN Chung-kai noted that according to forecasts by the US Federal Reserve, US interest rates would be about 0.6% at end-2015 to 3% at end-2017. He sought HKMA's views about the potential impact of the forecasted US interest rate rise on the Hong Kong property market, including whether there would be major consolidation of flat prices and the extent of price adjustment, and whether the US interest rate rise would in fact have stronger impact on the property market than the capital inflows into Hong Kong.

14. Mr WONG Kwok-hing expressed concern about continuous rise in the local residential property prices in spite of the demand side management measures implemented by the Government in the past few years. He sought HKMA's advice for investors and home buyers with regard to the potential risks of an interest rate hike on the local property market.

15. CE/HKMA said that the prospective US interest rate rise was expected to result in adjustments in asset prices around the world. However, it would be difficult to forecast the magnitude of asset price adjustment having regard to the uncertain pace of the US interest rate rise. Adjustment of mortgage interest rates was subject to a complicated mechanism affected by the supply and demand of credits in the market and might not fully correspond to changes in the US interest rates and the Hong Kong interbank offered rate ("HIBOR"). As observed, the mortgage interest rates in Hong Kong had risen in the past few years when HIBOR had remained at low levels. CE/HKMA said that the asset markets of Hong Kong could be influenced by a host of factors other than interest rates, such as correction in the buoyant equity market. Given the extremely low interest return from bank deposits and the prevailing sentiment and perception that the stock market would continue to rally, investors' risk appetite might grow. But investors' expectation of the future asset prices might change when the US Federal Reserve raised interest rates, thereby increasing the risks of major price adjustment in the assets market.

16. On the countercyclical measures having regard to the evolving cycle of the property market, CE/HKMA said that HKMA had implemented the seventh round of countercyclical macroprudential measures in late February 2015 on property mortgage loans to safeguard banking and financial stability. As the cyclical movement of property market was a complicated mechanism subject to various factors (e.g. supply and demand in residential flats, property prices and acquisition costs, and mortgage interest rates), it would be difficult to predict how the cycle would evolve. Nevertheless, it was certain that the current

extremely low interest rate environment, with mortgage interest rate of some 2.25%, was unusual and would not last indefinitely and might change as the US interest rates normalized. Mortgage borrowers should therefore be vigilant of the risks of a mortgage interest rate rise in Hong Kong, and duly assess their repayment ability to withstand such risks.

17. Noting CE/HKMA's remarks that the mortgage interest rates might not adjust in tandem with the US interest rates and HIBOR, Ms Starry LEE sought further explanation on the operation of the mortgage interest rates, given the understanding that due to the LER system, Hong Kong could not use interest rate as a tool to regulate the property market.

18. CE/HKMA explained that banks would determine their respective mortgage interest rates having regard to their funding source, costs and credit risks, etc. Although the mortgage interest rates had risen over the past few years from 1% to 2.25% at present while the US interest rates and HIBOR had remained stable at extremely low levels, it was unlikely that the mortgage interest rates could go further upward before the on-set of US interest rate rise, in light of the current abundant liquidity in the interbank market, meaning relatively low cost of funding, and market competition. However, mortgage interest rates would rise eventually when interbank liquidity decreased as a result of US interest rate rise, bringing HIBOR closer to the US interest rates.

19. The Chairman conveyed concerns of banks that under HKMA's latest prudential supervisory measures, some clients could not obtain mortgage loans despite their holding lots of assets. He enquired whether HKMA would discuss with banks regularly, with a view to gauging the effectiveness of the measures and assisting banks to resolve issues encountered during the course of implementation.

20. CE/HKMA said that implementation of the prudential supervisory measures would inevitably affect the plans of some potential home buyers. The issues mentioned by the Chairman concerned home buyers who held substantial amount of assets but their incomes were not sufficient to meet the relevant debt-servicing ratio ("DSR") cap. For mortgage loans assessed based on the net worth of the mortgage borrowers, they were subject to a different set of requirements and calculation methods. DCE(B)/HKMA said that the prudential supervisory measures launched in late February 2015 tightened the maximum loan-to-value ratio for underwriting mortgage loans by banks in respect of self-use residential properties of relatively lower value, and lowered DSR cap for borrowers buying a second residential property for self-use, etc. As a standard practice, HKMA would conduct briefing sessions to gauge feedback from banks after a round of prudential supervisory measures had been implemented for two to three months. HKMA would also issue guidelines and

"Frequently Asked Questions and Answers" to clarify matters raised by banks. For instance, HKMA had issued two circulars to all authorized institutions to provide further guidance on issues relating to the seventh round of countercyclical macroprudential measures. A briefing session would soon be held to gauge the views of banks on this round of measures.

Stock market and RMB trading and settlement

21. Referring to the recent remarks made by Mr Charles LI, Chairman of the Hong Kong Exchanges and Clearing Limited, to the media about the record-high stock trading volumes in early April 2015 and the opportunities brought by this "new era" of the Hong Kong stock market, Ms Starry LEE sought HKMA's views of the potential impact of the recent rally in the stock market on the financial stability of Hong Kong.

22. Mr Jeffrey LAM expressed concern about the possible risks associated with the recent stock market rally which was contributed partly by increased market turnover in the southbound trading under the Shanghai-Hong Kong Stock Connect ("S-HK SC"). He observed that there were warning signs of increasing risks as investors appeared to be overly optimistic about the performance in the stock market and more inexperienced investors swarmed to engage in speculative trading of stocks with low vigilance. Mr LAM enquired about HKMA's risk assessment in this regard, particularly when there might be an abrupt liquidity drain following the prospective US interest rate hike.

23. CE/HKMA explained that the interconnection of equity markets between Hong Kong and Shanghai under S-HK SC would naturally result in greater interactions between the two markets. Changes and new dynamics in Hong Kong's equity market would emerge and market participants should understand and adapt to the new market characteriztics, including greater market volatilities as a result of the stock connect and increasing fund flows from the Mainland into Hong Kong. The transition from a "bull market" to "bear market" might be characterised by excess optimism in the future stock prices, and investors might withdraw their investment from the stock market and convert the proceeds into foreign currencies when stock market performance no longer matched with their expectations, thus leading to capital outflow. CE/HKMA reiterated that the Currency Board system would ensure that the Monetary Base was fully backed by high quality and highly liquid US debt securities to counteract capital outflows if occurred. The process of capital outflow as a result of an US interest rate increase was expected to be orderly and continuous, but it could be more rapid in response to major correction in the stock market, which was difficult to predict. CE/HKMA said that HKMA would be vigilant of the impacts on the financial stability of Hong Kong arising from the rallied stock market, and monitor developments from a number of

perspectives including capital flows, offshore RMB liquidity, operation of the payment and settlement systems, and risk management by banks for equity-related lending activities.

24. Mr NG Leung-sing observed that RMB trade settlement and payments in Hong Kong continued to grow in terms of the average daily turnover of Hong Kong RMB Real Time Gross Settlement, and RMB trade settlement handled by banks. He enquired whether HKMA considered it necessary to expand the existing capacity of the relevant trade and settlement systems to better cope with the increasing daily market turnover, in particular in anticipation of enhanced regional market connection between China and its neighbours following establishment of the Asian Infrastructure Investment Bank ("AIIB").

25. CE/HKMA responded that the soundness and efficiency of financial infrastructures, including the payment and settlement systems, was a prerequisite to maintaining the financial stability of Hong Kong. All along, HKMA attached great importance to maintaining a smooth operation of the payment and settlement systems, having regard to their capacities in coping with the number of daily transactions in particular. He assured members that HKMA would continue to ensure adequacy of the information technology and backup systems of the payment and settlement systems in Hong Kong in accommodating the surge in market turnovers and numbers of transaction.

26. Mrs Regina IP expressed concern about the potential adverse impact of political instability on the Hong Kong stock market and the Hong Kong Dollar exchange rate if the proposals on the method for selecting the Chief Executive in 2017 would not be passed by the Legislative Council.

27. CE/HKMA pointed out that issues relating to the constitutional reform were outside the purview of HKMA. However, from the perspective of maintaining financial stability including during times of political instability, it was incumbent upon HKMA to endeavour to ensure a smooth operation of the banking and financial systems such as enhancing the resilience of banks, and managing EF prudently with a view to ensuring that sufficient financial resources were in place to withstand possible shocks arising from financial and political adversities.

28. Noting that RMB customer deposits and outstanding RMB certificates of deposit ("CDs") had declined in early 2015 with moderation in the issuance of RMB dim sum bonds, Mr NG Leung-sing sought HKMA's assessment as to whether the decline in both areas was only a temporary phenomenon. CE/HKMA said that the RMB pool in Hong Kong (including RMB customer deposits and RMB CDs) could be affected by a number of factors, including the movements of the exchange rate of RMB. As observed, RMB had slightly

weakened against the US Dollar in 2014 and stabilized in the recent months, which might have dampened some investors' incentive to allocate to RMB assets in their investment portfolio. As regards the moderated growth in RMB dim sum bonds, it was largely hinged on issuers' demand, prevailing bond yields and development of the economy at large. CE/HKMA said that notwithstanding some moderation in the recent period, he still held an optimistic view about the potential development of the RMB business in Hong Kong.

29. In reply to Ms Starry LEE's enquiry about the progress of the prospective Qualified Domestic Individual Investor ("QDII2") scheme in the Mainland, CE/HKMA said that he understood that the relevant Mainland authorities were considering relaxation for qualified domestic individual investors to invest in overseas markets. If materialized, he hoped that the initiative would attract Mainland individual investors to utilize Hong Kong's platform for making investments.

Performance of the Exchange Fund

30. Referring to page 31 of the powerpoint on EF's investment income and the substantial investment loss of $52.7 billion and $33.2 billion in foreign exchange in 2014 and the first quarter of 2015 respectively, Mr Kenneth LEUNG enquired whether HKMA still adopted a long-term investment strategy for EF's investment in foreign exchange instead of actively adjusting the strategy and portfolio in response to changes in the foreign exchange market. In view that the US Dollar would remain strong against other currencies along with the US interest rate rise in the coming years, the Chairman was concerned that EF's investment return from assets held in the relatively weaker currencies would continue to decline. He enquired about HKMA's strategy to avert further deterioration in EF's investment income from foreign exchange.

31. Mr SIN Chung-kai expressed concern about the cumulative loss of as much as $85.9 billion in EF's investment income from foreign exchange in the past five consecutive quarters. He also noted that the investment income of EF payable to the fiscal reserves placed with EF had decreased from $36.8 billion for 2013 to $27.5 billion for 2014, while the amount payable for the first quarter of 2015 was only some $11.4 billion. He enquired about HKMA's investment strategy to achieve greater stability of fee payable to the fiscal reserves, and the reasons for a higher fixed rate of fee payment at 5.5% for 2015 compared to 3.6% for 2014 to the fiscal reserves in spite of the declining investment income of EF.

32. CE/HKMA explained that assets of EF were mainly held in the US Dollar with the rest diversified into other currencies. For those assets held in other currencies, their investment return, when translated into Hong Kong Dollar, would inevitably fluctuate having regard to cyclical movements of the US Dollar against other currencies. When the US Dollar weakened, which was the case in 2002-2003 and 2006-2007, EF recorded book gains in foreign exchange in those years. Whereas when the US Dollar strengthened, as in the second half of 2014 and the first quarter of 2015, there would be book loss in foreign exchange for EF. As such, the investment strategies of EF were to diversify the currency mix in order to even out foreign exchange loss and gain in the medium to long term. While HKMA would suitably fine-tune the investment strategy and currency mix for EF's investment, it was not advisable to make aggressive short-term speculation of the movements of the US Dollar and other currencies, taking into account the high risks associated with the unpredictable foreign exchange market conditions. CE/HKMA added that the market might have already priced in the possible US interest rate rise and ECB's monetary easing, therefore the US Dollar might not experience greater volatilities in the second half of 2015. But it was also possible that the market might react strongly to the US interest rate hike.

33. On the fee payable to fiscal reserves, CE/HKMA advised that under the current arrangement with the Government, the return on the fiscal reserves placed with EF was calculated based on the average annual rate of return of EF's Investment Portfolio over the past six years with a view to enhancing the stability of investment return for the fiscal reserves. As observed, such arrangement could help smooth out the return volatility in the medium to long term for the placement of the fiscal reserves with EF. As regards the lower fixed rate of fee payment for 2014 than for 2015, it was due to the relatively poor investment performance of a year had fell out of range in the fee calculation for 2015.

Asian Infrastructure Investment Bank

34. Mr WONG Kwok-hing enquired about the progress of work to take forward the initiative for Hong Kong in joining AIIB, and asked why related information was not included in the current briefing.

35. CE/HKMA noted that the Government had indicated it would pursue actively the possibility of Hong Kong joining AIIB. As AIIB was a development bank, while HKMA would provide assistance as appropriate, it was the FS' Office and the Financial Services and the Treasury Bureau which were taking the lead in taking forward the initiative. He envisaged that it would be mutually beneficial to AIIB and Hong Kong if Hong Kong could capitalize

on the opportunity to act as a platform for AIIB to perform part of its treasury activities.

Anti-money laundering

36. Mr Albert HO noted that banks might receive instructions from the Joint Financial Intelligence Unit or other enforcement agencies from time to time to freeze the bank accounts of certain clients in connection with investigation on suspicious activities of money laundering, yet the banks could not disclose to the clients concerned the reasons involved. Referring to complaints he had received from members of the public about the freezing of their bank accounts for excessively long periods without explanation from the banks concerned, Mr HO were concerned that investigation and enforcement actions in relation to suspected money laundering activities might affect innocent parties, and had given rise to litigations between the banks and their clients in some cases. He enquired about the number of cases which involved freezing of bank accounts suspected of money laundering, amount of frozen assets/funds involved, number of associated litigations, and the loss, if any, incurred by banks/clients in recent years.

37. While HKMA did not have the statistics requested by Mr Albert HO in hand, DCE(B)/HKMA said that HKMA had been actively discussing with banks and relevant law enforcement agencies to improve the process through which suspicious funds in bank accounts were temporarily frozen, including looking at the lead-time between notice was served on banks to temporarily freeze the accounts and orders from the court for freezing bank accounts under investigation was granted. Since some of the cases in question were sub judice, he was unable to further comment on the matter at this stage.

V. Annual briefing on the work of the Financial Reporting Council

(LC Paper No. CB(1)780/14-15(03) — Paper on "Progress Report on the work of the Financial Reporting Council" provided by the Financial Reporting Council

LC Paper No. CB(1)780/14-15(04) — Background brief on the work of the Financial Reporting Council prepared by the Legislative Council Secretariat)

Briefing by the Administration

38. At the invitation of the Chairman, the Chief Executive Officer, Financial Reporting Council ("CEO/FRC") briefed members on the governance structure of FRC, its major achievements in 2014 and focus of work in 2015. The Deputy Chief Executive Officer, FRC and Senior Director, Investigation and Compliance, FRC ("SD/FRC") then briefed members, through a powerpoint presentation, on the work of FRC in the past year.

> (*Post-meeting note*: The notes of the powerpoint presentation (LC Paper No. CB(1)833/14-15(02)) were issued to members vide Lotus Notes e-mail on 8 May 2015.)

Discussion

Investigation and enquiry work of FRC

39. Mr WONG Kwok-hing sought explanation on the surge in the number of pursuable complaints received by FRC from nine cases in 2010 to 33 cases in 2014. Noting that FRC had completed four investigations and one enquiry only in 2014, he expressed concern that complaints received by FRC had not been handled in a timely manner.

40. SD/FRC responded that the major reasons for the increase in number of complaints received by FRC included the growing public awareness of the functions and work of FRC, which had entered its eighth year of operation since its establishment in 2007, and better understanding between FRC and other regulatory bodies on their respective regulatory purviews and the cases referral mechanism. Moreover, development of new accounting and auditing standards due to increasing complexity in business transactions had also generated more complaints. He said that the time required to complete an investigation or enquiry was influenced by a host of factors including the complexity of the case, and the irregularities or non-compliance involved. CEO/FRC added that among the existing 28 outstanding investigations, 22 of them were initiated in 2014. FRC was capable of handling these outstanding investigations in a prudent and timely manner with its existing resources. It was envisaged that the outstanding cases would be completed in 12 months.

41. Mr Kenneth LEUNG enquired if a summary of a complaint handled by FRC would be uploaded on its website for reference by the public and the audit profession. CEO/FRC responded that after completion of each investigation, where appropriate, FRC would refer the investigation report to the Hong Kong Institute of Certified Public Accountants ("HKICPA"), which would then determine if any disciplinary action was warranted. At the same time, FRC

would issue a press release on a no-name basis summarizing the major issues covered in the investigation and its major findings. After HKICPA had completed its disciplinary proceedings, an executive summary of the report containing the names of the parties concerned would be uploaded on FRC's website.

Independent auditor oversight reform

42. In response to Mr Kenneth LEUNG's enquiry, the Deputy Secretary for Financial Services and the Treasury (Financial Services)3 ("DS(FS)3") confirmed that following completion of the public consultation on the proposals for the auditor regulatory reform in September 2014, the Administration would publish the consultation conclusions soon and planned to brief FA Panel on the outcome of the consultation and the way forward before summer 2015.

43. Mr Kenneth LEUNG remarked that the audit profession had reservations about some major proposals of the reform. He asked whether the Administration would consider launching another public consultation exercise with a view to reaching a consensus with the audit profession before introducing the relevant amendment bill into the Legislative Council.

44. DS(FS)3 responded that after completion of the public consultation in September 2014, the Administration had identified a few areas for further engagement with relevant stakeholders, including HKICPA, with a view to enhancing mutual understanding and facilitating formulation of a way forward that would balance the interests of all parties concerned. He assured members that after issue of the consultation conclusions, there would still be room for discussing certain details with stakeholders when preparing the amendment bill within the framework of the consultation conclusions.

Cross-border cooperation on disclosure of information involving state secrets

45. Mr Albert HO pointed out that in 2012, a Mainland company listed in Hong Kong - China High Precision Automation Group Limited ("CHPAG") used "state secret" as the reason for refusing to provide information to its Hong Kong auditor. Subsequently, the auditor resigned on grounds of a lack of access to information necessary for performing the audit for CHPAG. The company then appointed another accounting firm as its auditor. Having received written assurance from the Mainland authorities on CHPAG's transactions which involved state secrets, the new auditor was satisfied that the financial statements of the company were true and fair. Mr HO said that the case had reflected the discrepancies between the accounting standards in Hong Kong and the Mainland. He queried if such discrepancies had impacts on the

local audit profession and the work of FRC. He also asked if a standard practice was adopted in Hong Kong for the conduct of audit for companies involved in state secrets.

46. CEO/FRC responded that normally FRC would not comment on individual cases. Moreover, he had a conflict of interest as he was involved in the case mentioned by Mr Albert HO when he was Head of Listing of Hong Kong Exchanges and Clearing Limited ("HKEx"). He therefore could not reveal the details of the case to Panel members. Nonetheless, he clarified that the financial statements of CHPAG were prepared in accordance with the Hong Kong Financial Reporting Standards and not the China Accounting Standards for Business Enterprises. The major point of consideration in the case was whether the auditor had gained a sufficient amount of assurance about the financial information of the company to conclude the auditing work.

47. CEO/FRC added that strictly speaking, most of the commercial documents kept in the Mainland might not be state secrets, although there could be difficulties for Hong Kong regulators including FRC to gain access to such documents under the existing Mainland regulations. FRC was discussing with the Ministry of Finance and the China Securities Regulatory Commission, and contemplated to sign Memoranda of Understanding with them by the end of 2015 to resolve the issue in that regard. As for documents involving state secrets, which mainly concerned the defence industry, the Hong Kong regulators were exploring possible means to address the issue by making reference to the practices in overseas jurisdictions, e.g. requiring an auditor to sign a statement declaring its conformity to the relevant official secrets law before it was exposed to state secrets or asking the relevant authorities to confirm the general tenor of a document without disclosing the actual document to the auditor.

Risk-based financial statements review programme

48. Mr NG Leung-sing noted that FRC had engaged external reviewers to assist in the risk-based financial statements review programme with a view to enhancing work efficiency. He expressed concerns about the cost-effectiveness for hiring external reviewers for the task, and the potential conflict of interest if the external reviewers were practising accountants.

49. CEO/FRC responded that the external reviewers assisted in the programme on a pro bono basis. In 2014, FRC engaged 11 external reviewers in the relevant work, including four professionals from the Big Four accounting firms, four professionals from medium-sized accounting firms, and three academics. To ensure sufficient checks and balances, two external reviewers were involved in the review of financial statements of a company. All external

reviewers were subject to stringent requirements on declaration of interests and they were not involved in cases in which they had a conflict of interest. Their work was kept confidential according to the secrecy provisions in the Financial Reporting Council Ordinance (Cap. 588). All financial statements reviewed by the external reviewers were re-examined by staff of FRC to ensure their comments to the financial statements were consistent, correct and in accordance with FRC's policy. CEO/FRC took note of Mr NG Leung-sing's comment that FRC should allocate sufficient manpower resources to ensure that the financial statements would be reviewed in a timely manner.

VI. Deposit Protection Scheme (Amendment) Bill 2015

(LC Paper No. CB(1)780/14-15(05) — Administration's paper on "Proposed Enhancements to the Deposit Protection Scheme")

Briefing by the Administration

50. With the aid of a powerpoint presentation, the Deputy Secretary for Financial Services and the Treasury (Financial Services)1 ("DS(FS)1") briefed members on the legislative proposals to enhance the Deposit Protection Scheme ("DPS"), with a view to accelerating the payout process for affected depositors in case there was a banking crisis. These proposals included adopting a "gross payout" approach to determine the DPS compensation, enhancing certainty for the determination of the Quantification Date ("QD") and enabling the issue of electronic notices in addition to the conventional paper-form notices to notify the affected depositors of the compensation arrangements.

(*Post-meeting note*: The notes of the powerpoint presentation (LC Paper No. CB(1)833/14-15(03)) were issued to members vide Lotus Notes e-mail on 8 May 2015.)

Discussion

Level of compensation and coverage of the DPS

51. Mr Albert HO enquired if the Administration had plans to review the $500,000 compensation limit of the DPS. Mr NG Leung-sing asked whether

there was a mechanism for reviewing the compensation limit of the DPS at regular intervals.

52. DS(FS)1 advised that the compensation limit was $100,000 per depositor per DPS Member bank when the DPS was implemented in 2006, and the limit was raised to $500,000 in 2011. The current compensation limit provided full protection for around 90% of depositors in Hong Kong. She said that in considering whether to adjust the compensation limit for the DPS, besides having regard to the level of full coverage provided to depositors, the Government would take into account other factors, including stability of the banking system, other initiatives contributing to financial stability such as the plan to introduce an effective resolution regime for financial institutions in Hong Kong, and the latest developments in deposit protection regimes in major international financial markets. The Government considered that the current compensation limit was appropriate and had no plan to adjust the limit for the time being.

53. Noting the increasing popularity of insurance-linked savings products among depositors due to the return of these products compared to that of fixed deposits, Mr WONG Kwok-hing asked if deposits in such products were covered by the DPS. DS(FS)1 replied that those products were not covered under the DPS. Insurance-related saving products and other products which were investment in nature were not covered by the DPS. In this connection, the Chairman said that the Office of the Commissioner of Insurance had been studying the proposal to establish a Policyholders' Protection Fund with a view to enhancing protection for holders of life and non-life insurance policies.

"Gross payout" approach

54. Mr Albert HO and Mr James TIEN enquired about the rationale for adopting the gross payout approach for determining compensation under the DPS. Mr HO asked, in the event that the compensated depositors became default, whether the bank concerned would be affected as these depositors could not settle their outstanding debts and liabilities owed to the bank. Mr TIEN asked whether the gross payout approach would impact on the insolvency of a bank.

55. DS(FS)1 explained that, under the existing net payout approach for determining the amount of deposit compensation under the DPS, all liabilities owed by a depositor to a failed bank had to be set off against his/her aggregate balance of deposits with the bank. The net payout approach was a relatively complicated and time-consuming process as it would involve detailed calculations and extensive checking of relevant records and was a major hurdle to achieving a speedy payout. According to the Hong Kong Deposit Protection

Board ("HKDPB"), it could take up to six weeks to make full compensation payments to depositors under the existing net payout approach though an interim payment could be made within two weeks. It was envisaged that the implementation of the gross payout approach would enable the HKDPB to make full compensation payments in around one week, and hence would provide affected depositors with more ready access to liquid funds , strengthen their confidence in the banking system, and reduce any contagion effect during a banking crisis.

56. The Director General (Enforcement) Hong Kong Monetary Authority ("DG(E)/HKMA") emphasized that the adoption of the proposed gross payout approach would not extinguish a depositor's liabilities to the bank. The depositor was still obliged to settle any outstanding debt owed to the bank or its liquidator after receiving the deposit compensation. She further explained that any deposit in excess of $500,000 would still be set-off against the depositor's liabilities owed to the bank. As not many depositors had liabilities in the same bank, coupled with the fact that the creditor hierarchy in the insolvency of a bank would remain unchanged and that the charge off rates of liabilities was chronically low in Hong Kong, the impact of the gross payout approach on insolvency, i.e. the potential reduction in liquidation assets for distribution to creditors, would be marginal.

57. In response to the question raised by Mr Albert HO and Mr Christopher CHEUNG, DG(E)/HKMA confirmed that the gross payout arrangement would be the same if the deposit concerned had been taken as a security to a loan with the same bank.

58. Mr NG Leung-sing said that the banking industry supported the proposed gross payout approach in general as it would simplify the compensation determination process. Mr CHAN Kam-lam and Mr SIN Chung-kai also expressed support for the gross payout approach. Mr CHAN pointed out that, under the current net payout approach, a depositor could place his/her deposits in another bank in order to separate their liabilities from deposits and thus maximize the protection available under the DPS. Moreover, he noted that a borrower could be required to provide valuable collateral other than deposit for obtaining a bank loan. Hence, the dis-application of set-off against deposit under the DPS might not have a material impact on a bank. Mr SIN Chung-kai sought information from the Administration on latest international developments in deposit protection regimes.

59. DS(FS)1 advised that a number of member jurisdictions of the Financial Stability Board, including Australia, Canada, France, Singapore, Switzerland and the United Kingdom, had already changed from a net payout to a gross payout approach in order to speed up the compensation payout process,

while the European Union had issued a directive in 2014 to adopt the gross payout approach in the near future. In addition, the deposit insurance scheme launched in the Mainland in May 2015 had adopted the gross payout approach for compensation determination. DG(E)/HKMA supplemented that, according to the crisis management review conducted by the International Monetary Fund in the fourth quarter of 2013, the net payout arrangement was an impediment to achieve swifter payout. In addition, the rehearsal conducted by the HKDPB revealed that the net payout approach could lead to delay to reimbursement of compensation to depositors. It was recommended that Hong Kong should change the present net payout to a gross payout approach, which would particularly provide enhanced protection to small depositors in the event of a banking crisis.

60. Mr SIN Chung-kai asked if the existing $2.4 billion DPS Fund would be sufficient to cover potential compensation payments under the proposed gross payout approach. DS(FS)1 advised that as not many depositors had liabilities with the same bank, it was expected that the amount of compensation payments required under the gross payout approach would not increase significantly. DG(E)/HKMA explained that the DPS Fund was mainly to cover the costs incurred during the payout process. The HKDPB had in place a standby credit facility from the Exchange Fund to meet the funding requirement for compensation payments. Given that the existing DPS Fund size ($2.4 billion) only represented 0.14% of the protected deposits whereas the target fund size was set at 0.25% of the protected deposits, banks would need to continue making contributions to the DPS Fund. But the level of premium rates would remain unchanged. DG(E)/HKMA further pointed out that, although the contributions to be paid by banks might slightly increase due to a larger base of protected deposits, the banking industry welcomed the adoption of the gross payout approach as it could streamline the payout process thus help lower costs on information technology systems and costs on labour.

61. Noting that the banking industry had indicated support for the proposals, the Chairman asked whether dissenting views had been received during the public consultation conducted in 2014. DS(FS)1 said that the respondents were supportive of the proposals. In addition, some respondents had made comments and suggestions on some technical and operational matters relating to the proposals. The Government would publish the consultation conclusions shortly setting out the major views received from respondents and the Government's responses.

Determination of the QD

62. Mr WONG Kwok-hing enquired how the proposal relating to determination of the QD would enhance protection for depositors.

DG(E)/HKMA advised that the deposit compensation was the aggregated amount of the principal balance and interest accrued on the protected deposits. Where deposits were denominated in foreign currencies, the deposits would need to be converted into Hong Kong dollars according to the relevant market exchange rates. Hence, a QD would be required for determining the amount of interest accrued on the protected deposits and the exchange rate adopted for converting a foreign currency deposit into Hong Kong dollars. However, the existing definition of the QD might create some uncertainties in determining the QD and could cause delay in making compensation payments to the depositors. To ensure that the compensation payments could be made in an expeditious manner, the Government suggested to amend the definition of the QD by defining the QD as the date a winding-up order had been made by the Court or the date on which the Monetary Authority had served a notice to the HKDPB to trigger the DPS, whichever was the earlier. The interests of the depositors could be better protected with the enhanced certainty of the QD for a speedy payout.

Issuance of electronic notices

63. Mr NG Leung-sing enquired how the HKDPB could ensure the reliability, safety and effectiveness of electronic notices issued to depositors during the payout process. DG(E)/HKMA said that technological safeguards like encryption and password protection would be used to ensure the reliability and safety of electronic communications. She further explained that electronic notices would be issued to depositors with valid email addresses and who were used to receiving electronic communications from the bank. In addition to electronic notices, the depositors concerned would still receive conventional paper notices.

Conclusion

64. The Chairman concluded that members did not object to the Administration's plan to introduce the proposed legislative amendments into Legislative Council in 2015.

VII. Any other business

65. There being no other business, the meeting ended at 12:18 pm.

Council Business Division 1

Legislative Council Secretariat
7 July 2015