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Paper for the House Committee

**Report of the Subcommittee on
Proposed Resolutions under Section 29 of the Public Finance Ordinance (Cap. 2)
and Section 3 of the Loans Ordinance (Cap. 61)**

Purpose

This paper reports the deliberations of the Subcommittee on Proposed Resolutions under Section 29 of the Public Finance Ordinance (PFO) (Cap. 2) and Section 3 of the Loans Ordinance (Cap. 61).

Background

2. In his 2009-2010 Budget Speech, the Financial Secretary (FS) announced that to promote the further and sustainable development of the Hong Kong bond market, the Government intends to implement a programme to issue government bonds. The Government Bond Programme (GBP) will comprise bond issues for institutional and retail investors. The sums raised will be credited to a fund to be established under PFO (the Bond Fund). The Bond Fund will not be treated as part of the fiscal reserves and will be managed separately from other government accounts. The Hong Kong Monetary Authority (HKMA) will be tasked to assist the Government in coordinating the offering of bonds under GBP and manage the investment of moneys in the Bond Fund.

The proposed resolutions

3. On 28 April 2009, FS gave notices that he would, at the Council meeting on 20 May 2009, move a resolution under section 29 of PFO to set up a fund for the purpose of managing sums raised under GBP and a resolution under section 3 of the Loans Ordinance (Cap. 61) to authorize the Government to borrow up to the proposed

limit of HK\$100 billion¹. A Legislative Council (LegCo) Brief on GBP and the proposed resolutions was issued to all Members on the same day.

The Subcommittee

4. The House Committee decided at its meeting on 8 May 2009 that a subcommittee be formed to study the two proposed resolutions (the Subcommittee). To allow time for the Subcommittee to consider the proposed resolutions and report its views, the Government withdrew the notices given for moving the proposed resolutions at the Council meeting on 20 May 2009 (paragraph 3 refers).

5. Under the chairmanship of Hon Jeffrey LAM, the Subcommittee has held four meetings with the Government. The membership list of the Subcommittee is at **Appendix I**.

Deliberations of the Subcommittee

6. The Subcommittee has no objection in principle to the implementation of GBP to promote the further and sustainable development of Hong Kong's bond market. Members examined a number of issues relating to the framework for implementing GBP, the administration and investment of the Bond Fund, as well as the drafting of the proposed resolutions. The deliberations of the Subcommittee are summarized in the ensuing paragraphs.

Considerations for the launch of GBP

7. Subcommittee members including Hon Mrs Regina IP and Hon Ronny TONG have expressed concern about the Government's considerations for launching GBP at this particular timing. Hon Mrs Regina IP has enquired whether the current low interest rate environment, which will enable the Government to issue bonds at lower cost, is the major reason for launching of the programme. The Government has advised that the primary objective of GBP is to promote the further and sustainable development of the local bond market, providing an alternative channel for financial intermediation. The interest rate environment is only one of the factors for considering the appropriate timing for bond issuance. Having regard to other relevant factors, including the demand from institutional investors such as pension funds and insurance companies for Hong Kong (HK) Dollar assets to match their long-term HK Dollar liabilities, the Government considers it an opportune time to implement GBP.

8. Some Subcommittee members including Hon CHAN Kin-por and Hon WONG Kwok-kin have called on the Government to expedite the implementation of

¹ Borrowing ceiling refers to the maximum amount of outstanding principal of bonds issued (i.e. principal amount of bonds issued minus that of bonds redeemed) at any time under GBP.

GBP. Hon CHAN Kin-por is of the view that the Government should make good use of the existing favourable market conditions, and consider increasing the issuance size in response to market demand. To this, the Government has responded that market views on the details of GBP will be sought and necessary adjustments will be made at the implementation stage in response to market needs.

9. Hon James TO has expressed concern about the considerations for determining the timing for issuance of individual bonds under GBP, and the impact of such bond issuance on the securities market. The Government has advised that, as with any other bond issues, the prevailing market conditions are crucial in determining the timing for issuance of individual tranches of government bonds. Relevant considerations include the financial market conditions, investor demand and expected pricing of the bonds. As regards government bonds, there is a correlation among the size, timing and cost of issuance. If the supply of bonds is in excess of market demand, the cost of issuance may go up, lifting the benchmark bond interest rates for other issuers in the market. Careful consideration is therefore required for deciding the size and timing for launching individual tranches of government bonds. Market conditions are an important factor to be taken into account. The Government has further advised that GBP is intended for market development purpose rather than for financing government expenditures. There is flexibility as to the determination of the size and timing for launching individual tranches. In addition, given the relatively modest amount of bond issuance under GBP each year, the impact on the much larger securities market is not expected to be significant.

Mechanism for offering of bonds under GBP

10. The Subcommittee has noted that Recognized Dealers (RDs) and Primary Dealers (PDs) will be appointed to assist in taking forward the institutional tranche of GBP. Market participants (including all authorized institutions and other regulated financial institutions) may apply to HKMA to become RDs who will maintain securities accounts with HKMA to which government bonds may be credited and debited. Among RDs, PDs will be appointed to provide two-way bid and offer quotations to RDs so as to promote the secondary market. Institutional tranche of GBP will be offered by way of competitive tender open to PDs. PDs must indicate the quantity of government bonds applied for and the bid price. Tenders accepted will be allotted in descending order of price bid from the highest to the lowest accepted price. Successful bidders will be allotted government bonds at the price they bid.

11. Hon James TO has pointed out that while the Government plans to offer the institutional tranche of government bonds through competitive tender, this offering mechanism has not been explicitly set out in the proposed resolution under section 3 of the Loan Ordinance. Hon James TO is concerned that there should be a fair and transparent mechanism for issuance and distribution of the government bonds. He has requested the Government to consider setting out explicitly in the proposed resolution under section 3 of the Loans Ordinance that the institutional tranche of GBP

will be issued through competitive tender, or at least "in a fair and reasonable manner".

12. The Government has advised that while the mechanism of competitive tender will be adopted for conventional fixed rate HK Dollar government bonds issued under the institutional tranche of GBP, this mechanism may not be the most effective way to reach the target investors of other types of bonds which may be covered by GBP in the future. For example, for bonds denominated in foreign currencies, a bank syndicate and bookbuilding² structure, rather than competitive tender, would provide a better access to the target foreign investors. The Government therefore considers it necessary to allow sufficient flexibility to determine the exact offering mechanism for specific types of bonds targeting different investors under GBP. Restricting offer of government bonds to institutional investors to competitive tenders would not be desirable from the market development perspective. In addition, the Government considers that terms such as "fair" and "reasonable" may be subject to different interpretations. To address the concerns raised by Hon James TO, the Government has proposed to underline in FS's speech for moving the relevant resolution that competitive tender will be adopted for conventional fixed rate HK Dollar government bonds issued under the institutional tranche of GBP.

13. The Subcommittee has noted that for the retail tranche of GBP, HKMA will engage co-arranger bank(s) to assist in performing the tasks of managing and coordinating the offering of the retail tranche. To facilitate access by individual investors, retail bonds will be distributed through an extensive network of placing institutions which will include placing banks, the Hong Kong Securities Clearing Company and securities brokers. Retail investors can buy or sell retail bonds in the secondary market either over-the-counter or on the stock exchange. To promote liquidity in the secondary market, placing banks will be obliged to make market by quoting bid/ask prices, i.e. the prices at which they will buy and sell retail bonds, on a best-effort basis.

14. Members including Hon WONG Ting-kwong, Hon Abraham SHEK and Hon Tanya CHAN have expressed concern about the arrangements for the offer of bonds to retail investors. They have enquired how the coupon rate and subscription fees charged by placing banks will be determined. Referring to the Government's example to illustrate the price fixing mechanism, Hon Abraham SHEK has sought explanation on the reason for using the yield of the Exchange Fund Notes (EFN) as reference in determining the coupon rate for retail tranche. Dr Hon LAM Tai-fai is of the view that more opportunities should be provided to retail investors to invest in the government bonds.

15. The Government has explained that it is market convention for a bond issuer to use a representative interest rate benchmark to price a retail bond. The yield of

² Bookbuilding refers to the collection of bids from investors through a syndicate of banks. The bookbuilding process helps the bank syndicate to fix a price at which the demand for the bonds meets the needs of the issuer.

EFN is one such benchmark commonly adopted by issuers of HK Dollar bonds. For example, a number of retail bonds issued by the Hong Kong Mortgage Corporation were priced by making reference to the yield of EFN. Another commonly used interest rate benchmark by bond issuers is that one that has been derived from the interest rate swap market. The pricing mechanism of retail bonds to be issued under GBP will follow market convention. However, the exact interest rate benchmark to be used is yet to be determined.

16. The Government has also advised that, following market convention, placing banks will charge retail investors a handling fee when they process retail bond applications for their customers. For the government bonds issued in 2004, the placing banks levied a handling fee of 0.15% on the amount of bonds allotted on their retail clients. The Government will take into account the prevailing market practice and experience in the issuance of government bonds in 2004 in determining the appropriate level of handling fee for the bonds to be issued to retail investors under GBP.

Types of bonds to be issued under GBP

17. Members including Hon CHAN Kam-lam, Hon Mrs Regina IP and Hon Ronny TONG have expressed concern about the issuance of different types of bonds under GBP. They have enquired whether the Government has considered issuing floating rate bonds and asset-backed securities under GBP. Hon Jeffrey LAM has asked the Government to elaborate on the types and tenor of government bonds to be issued, and on whether the Government has sought the views of major market participants in this regard.

18. The Government has advised that its current intention is to issue conventional fixed rate HK Dollar-denominated bonds at the initial stage of the programme implementation. Fixed rate bonds are the major component of government bond programmes in other economies. Views from major market participants including those from the banking, brokerage, insurance and pension sectors have been sought. Most of the respondents are in favour of bonds with shorter tenors, around two to five years, while some insurance companies and pension funds would prefer bonds with tenors up to ten years. It is the intention that during the initial implementation of GBP, the Government will focus on issuing conventional fixed rate bonds with shorter tenors within the range of two to ten years. The Government will monitor the market needs and demands, draw reference from experience gained under GBP and take such factors into account in considering whether, and if so, when to add more variety to GBP by issuing other types of bonds such as floating rate bonds and asset-backed securities. The Government has undertaken to provide LegCo with relevant information in case it considers it appropriate to issue special types of bonds under GBP.

19. Hon James TO has enquired whether the issuance of bonds under GBP would be limited to bonds denominated in HK Dollar and US Dollar by making suitable

amendments to the proposed resolution under the Loans Ordinance. Hon CHAN Kin-por has requested the Government to consider issuing Renminbi (RMB)-denominated bonds to meet the demand of insurance companies looking for RMB assets.

20. The Government has advised that although HK Dollar-denominated bonds will be issued at the initial stage of GBP implementation, it will not rule out the possibility of adding more variety such as foreign currency bonds under GBP, should that be conducive to attracting new foreign investors to the bond market of Hong Kong. In overseas markets where both domestic and foreign currency government bonds are issued, it is not common for restriction to be imposed on the choice of foreign currency denomination. From the market development point of view, such a restriction may reduce GBP's ability to tap new markets and clientele. Hence it does not seem desirable to restrict the denomination of government bonds to be issued under GBP to only HK Dollar and US Dollar.

Name of the Bond Fund

21. Hon Mrs Regina IP has suggested the name "Debt Fund" be used instead of "Bond Fund" so as not to restrict the programme technically to issuing bonds only. She considers that bonds are normally longer-dated papers while the Government has indicated that it intends to issue short-dated papers initially.

22. The Government has advised that while its current plan is to issue bonds of tenors within the range of two to ten years at the initial stage of GBP, it may consider issuing bonds with longer tenors, say, 15 years or longer at a later stage. It is a market convention to label debt securities of tenors of more than one year as bonds. It therefore considers the name "Bond Fund" appropriate. Moreover, the term "Debt Fund" could convey a more generic meaning which may potentially cover other forms of borrowing. For example, a country's borrowing from a multilateral organisation constitutes debt of that government. As the Government only intends to issue bonds under GBP and has no plan to raise other forms of debt, "Bond Fund" is a more appropriate name for describing the fund to be established under GBP. Also, "Debt Fund" in Chinese (債務基金) may have other unintended meanings.

Purpose of the Bond Fund

23. The legal adviser to the Subcommittee has requested the Government to consider whether it is more appropriate to expressly spell out in the resolution the purpose(s) for which the Bond Fund is established so as to provide a convenient reference of the expenditure aspect of the resolution to section 29(1) of PFO.

24. The Government has responded that pursuant to section 29(1) of PFO, paragraphs (e)(i) and (e)(ii) in the proposed resolution under section 29 of PFO set out the purposes for which the Bond Fund is to be established and moneys in the Bond Fund may be expended. These paragraphs provide that FS may expend money from

the Bond Fund for the purposes of (i) repaying the principal, interest and expenses incurred in relation to the sums borrowed under section 3 of the Loans Ordinance for the purposes of the Bond Fund, and (ii) investing in the manner FS may determine, and paying the expenses incurred in relation to the investments. Such approach in reflecting the purposes of the Bond Fund is also in line with that in other resolutions for establishment of funds under section 29(1) of PFO.

25. Members including Hon Mrs Regina IP, Hon James TO and Hon Albert HO are concerned that there are no express provisions in the resolutions setting out the policy objective. Given the Government's reiteration that the policy objective of GBP is to promote the development of the bond market, Hon Mrs Regina IP has suggested adding the following sentence to the proposed resolutions "To give impetus for the further development of the HK Dollar debt market to provide for depth and sophistication thus enhancing Hong Kong's position as a financial centre." Hon Albert HO has stated that Members belonging to the Democratic Party will not support the proposed resolutions if there are no express provisions on the purpose of setting up the Bond Fund.

26. The Government has advised that the policy objective of GBP is already set out in paragraph 1 of the Explanatory Note to each of the proposed resolutions, that is "to promote the further development of the bond market in Hong Kong". The Explanatory Note should be an aid to the construction of the resolutions. In respect of some members' request to set out the policy objective in the proposed resolutions, the Department of Justice has advised against this approach as it may give rise to uncertainty in interpretation of matters such as whether the policy objective stated can or will be achieved by GBP, the Bond Fund or individual elements thereof. Such uncertainty is undesirable, as any litigation arising therefrom may adversely affect the smooth implementation of GBP. This may also dampen investors' interest to invest through GBP and hence will not be conducive to the further development of the bond market in Hong Kong.

27. Members including Hon Paul CHAN, Hon Mrs Regina IP and Hon Miriam LAU have asked for further explanation on reasons for not setting out the purpose of the Bond Fund in the proposed resolutions. Hon Mrs Regina IP considers that the proposed elaboration of the Explanatory Notes has the effect of expanding the scope of the Bond Fund. Hon Mrs Miriam LAU has suggested that consideration be given to adding a preamble to the proposed resolutions to set out the purpose of the Bond Fund.

28. The Government has given consideration to the suggestion of adding a preamble to specify the policy objective of GBP. The Department of Justice has advised that as a general rule, preambles are now rare and are largely confined to statutes of constitutional significance or that ratify agreements. Given this and the concerns about uncertainty in interpretation explained in paragraph 26 above, the Government has advised that it does not consider it appropriate to include a preamble to specify the policy objective of GBP, which has already been set out in paragraph 1

of the Explanatory Note to each of the proposed resolutions. In response to members' further comments, the Government has proposed to further elaborate paragraph 1 of the Explanatory Note to each of the proposed resolutions along the following line (proposed addition in italic and bold print) –

"This Resolution relates to the proposal in the 2009-2010 Budget to promote the further *and sustainable* development of the bond market in Hong Kong. *As mentioned in the Budget Speech, promoting the development of the bond market is important to reinforcing Hong Kong's position as an international financial centre. This can provide more diversified investment products and avenues for financing to attract more overseas capital.*"

The Government has also undertaken to state the policy objective of GBP in FS's speech for moving the motions regarding the two proposed resolutions.

29. The legal adviser to the Subcommittee has advised that Explanatory Notes to resolutions are not part of the legislation and the legal effect of a piece of legislation is to be ascertained from its provisions, and it is up to members to decide whether they consider the Government's suggestion of stating the policy objective of GBP in FS's speech for moving the motions regarding the two proposed resolutions acceptable.

30. Some Subcommittee members including Hon James TO, Hon Albert HO and Hon Mrs Regina IP maintain their view that to ensure the proper use of the sums borrowed under GBP, the purpose of establishing the Bond Fund to promote the further and sustainable development of the local bond market must be set out in the legislation. They consider that any undertaking made by FS in his speech for moving the motions regarding the two proposed resolutions would have no legal effect and therefore they would not accept this approach. The Subcommittee has noted that Hon KAM Nai-wai, Hon James TO and Hon Albert HO have indicated their intention to move motions to add a paragraph (aa) to the proposed resolution under section 29 of PFO to set out that "the purpose of establishment of the Bond Fund is to promote the further and sustainable development of the local bond market". The proposed amendments of these Members are at **Appendices IIa to IIc**.

31. The Government has noted that the proposed paragraph (aa) actually refers to the establishment of the Bond Fund, but not the Government's policy objective as mentioned in FS's Budget Speech. The Government is of the view that to promote the further and sustainable development of the bond market in Hong Kong is the purpose of GBP, rather than the establishment of the Bond Fund. The Government reiterated that it is not advisable to set out the policy objective of GBP in the proposed resolutions in view of the legal uncertainty that may arise.

32. Members including Hon James TO, Hon Albert HO and Hon Mrs Regina IP do not subscribe to the Government's explanation. The Subcommittee has noted that some individual members may propose amendments to the resolution in their names. Some other members including Hon Miriam LAU and Hon CHAN Kam-lam,

however, consider the Government's proposal acceptable. Hon Miriam LAU has pointed out that the statement made by FS in moving the motions regarding the proposed resolutions will be on official record, providing useful reference in case of future disputes. Hon Ronny TONG is of the view that while the alternative of setting out the policy objective in the Explanatory Notes will have no legal effect, a sufficiently clear undertaking in FS's speech for moving the motions regarding the proposed resolutions may be an acceptable arrangement. In view of the Government's advice and members' concerns, the Subcommittee has further examined the legal uncertainty which may arise and the risk of litigation arising therefrom if the policy objective of GBP is set out in the proposed resolution under PFO. Reference has been made to the examples of funds established under section 29 of PFO provided by the legal adviser to the Subcommittee and other relevant supplementary information provided by the Government.

Issuance size

33. Regarding the proposed size of issuance of government bonds, Hon Miriam LAU is of the view that the proposed limit of HK\$100 billion of government bonds to be issued through GBP is not a big sum and may not help promote the development of the local bond market. Hon Jeffrey LAM has enquired the consideration for issuing about HK\$10 to 20 billion of government bonds in the first year of implementation of GBP.

34. The Government has advised that in drawing up the overall issuance size, consideration has been given to the need to take account of the long-term nature of GBP and to provide enough room for the public debt market to grow into a critical mass. The proposed borrowing ceiling represents a long-term target over a period of five to ten years and has been set upon detailed consideration. This notwithstanding, the Government will monitor the implementation of GBP and consider revising the borrowing ceiling having regard to investors' response and market conditions. The approval of LegCo will be sought to raise the ceiling as and when appropriate. The Government has further advised that views from major market participants indicate that the market may be able to digest government bonds of HK\$10 to 20 billion over the course of a year. The Government will solicit further market views and conduct a more detailed assessment with a view to determining the appropriate issuance size for the first year of programme implementation. In the process, due consideration will be given to the prevailing market conditions and impact on other issuers in the market.

Administration of the Bond Fund and implementation of GBP

35. Members including Hon Albert HO, Hon Mrs Regina IP and Hon Tanya CHAN have expressed grave concern about the power of FS in the administration of the Bond Fund under paragraph (b) of the proposed resolution under section 29 of PFO. They have noted that under paragraph (b) of the resolution, FS is empowered to administer the Bond Fund, to direct, or authorize other public officer to administer the Bond Fund and to delegate the power of administration to other public officers.

There is no express provision on the public officers to whom FS may authorize/delegate the power to administer the Bond Fund. Hon CHAN Kam-lam holds a different view in that the power allows flexibility for FS to decide the administration of the Bond Fund to cope with rapid market changes.

36. The Subcommittee has noted that paragraph (b) of the proposed resolution under PFO provides that FS is the Principal Official with the authority to administer the Bond Fund. According to the proposed framework of GBP, FS will delegate the authority to the Financial Services and the Treasury Bureau (FSTB) to administer the Bond Fund. The duties of FSTB will include authorizing expenditure from the Bond Fund, ensuring the amount of investment return credited to the Bond Fund is in line with the "fixed rate" sharing arrangement agreed with HKMA, and preparing returns on the Bond Fund for inclusion in the annual Estimates to be laid before LegCo in the annual budgetary exercise. The process will be subject to the scrutiny of the legislature.

37. In authorizing expenditure from the Bond Fund, FSTB will ensure that only the financial obligations and liabilities associated with bond issuance under GBP are charged to the Bond Fund. Such financial obligations and liabilities include outstanding principals and interest associated with the bond issuance, expenses arising from the procurement of external services (e.g. appointment of co-arrangers to assist in managing and offering of retail bonds under the GBP), and other relevant expenses (e.g. placing fee for placing institutions involved in distributing retail bonds under GBP). FSTB will keep a vigilant oversight of the Bond Fund. As an additional safeguard, the Bond Fund, like other government accounts, will also be subject to the oversight of the Director of Audit under the Audit Ordinance.

38. Hon Mrs Regina IP considers that the provision in paragraph (b) of the proposed resolution under PFO is not adequate for the purpose of clearly delineating the legal and executive responsibilities of FS and HKMA. She has suggested amending paragraph (b) by adding "the said public officer authorized and delegated for the time being shall be HKMA whose duties and responsibilities and powers and limitation of powers thereof shall be set out in Memoranda of Understanding exchanged between FS and HKMA and the said Memoranda of Understanding shall be recorded publicly." Hon Mrs Regina IP has also suggested the Government to consider revising paragraph (b) of the proposed resolution to qualify the word "administer" and to restrict the power of sub-delegation.

39. The Government has advised that paragraph (b) of the proposed resolution under PFO does not provide that FSTB, following delegation by FS, can further delegate the relevant power. As regards Hon Mrs Regina IP's suggestion for including more qualifications for FS to perform the function of administering the Bond Fund, the Government has advised that this is related to the role of HKMA in implementing GBP. According to the proposed framework of GBP, FS will direct HKMA to: (a) assist the Government in coordinating the offering of the bonds under the GBP, which includes performing certain functions of an arranger; and (b) manage

the investment of moneys in the Bond Fund which is placed with the Exchange Fund. Such arrangements will cover, inter alia, the duties of HKMA in preparing and coordinating the offerings of bonds under GBP and managing the investment of moneys in the Bond Fund. These duties will include –

- (a) proposing the timing, size and pricing of individual bond issues under GBP;
- (b) proposing appropriate structure for the offerings of bonds and assisting in the implementation of the arrangements in this regard;
- (c) preparing legal and offering documentation, listing applications and other documents necessary for the offering of bonds;
- (d) assisting in coordinating, managing and executing all processes relating to the tender application, subscription and allotment of bonds;
- (e) arranging for the issuance and redemption of bonds;
- (f) providing for the clearing, settlement and custody of bonds and other ancillary arrangements necessary for the offering of the bonds; and
- (g) managing the investment of moneys in the Bond Fund which is placed with the Exchange Fund and providing an investment income for the Bond Fund on the basis of the "fixed rate" sharing arrangement applicable to the fiscal reserves

40. The Subcommittee has noted that Hon Albert HO may move a motion to amend paragraph (b) of the proposed resolution under PFO to provide that a seven-member Bond Fund Consultation Committee, comprising at least two LegCo Members, should be set up to assist FS in the administration of the Bond Fund. The proposed amendments of Hon Albert HO are at **Appendix IIc**. Members including Hon James TO and Hon Mrs Regina IP have expressed support for Hon Albert HO's proposed amendment. These members are of the view that the proposed Consultation Committee could oversee and safeguard the proper administration of the Bond Fund.

41. The Government has advised that the functions of the proposed Bond Fund Consultation Committee are not clearly set out in the proposed amendments. In any event, the Government does not consider it necessary to set up such a committee for overseeing the administration of the Bond Fund, as FSTB will keep a vigilant oversight of the Bond Fund in accordance with the arrangements under the proposed framework of GBP.

Expense chargeable to and investment of the Bond Fund

42. Hon Albert HO has opined that the sums raised under GBP could be credited to the fiscal reserves rather than to a separately managed Bond Fund established for the purpose of GBP. Hon CHAN Kam-lam is of the view that placing the proceeds raised under GBP in the Bond Fund, which is separate from the fiscal reserves, would be conducive to the transparency of the on-going GBP.

43. The Government has explained that the arrangement to set up a separate Bond Fund to manage sums raised under GBP enables clear presentation and ready assessment of the financial performance of GBP. Such arrangement will also avoid unduly inflating the Government's operating revenue and/or operating expenditure, thus giving an inaccurate picture of the Government's fiscal position, in the years when certain tranches of bonds are issued or due for redemption.

44. Hon Miriam LAU has expressed concern whether sums in the Bond Fund would be transferred to the general revenue or used for financing public projects, as the Bond Fund should not be used for these purposes. Hon James TO has also asked whether the sums in the Bond Fund can be used for public expenses.

45. The Government has advised that paragraphs (e)(i) and (e)(ii) of the proposed resolution under PFO set out the purposes for which the Bond Fund is to be established, and moneys in the Bond Fund may be expended. According to paragraph (g) of the proposed resolution, surplus funds, if any, in the Bond Fund may be transferred to the general revenue only after all financial obligations and liabilities are met in relation to the loans borrowed under GBP and LegCo has given the necessary approval.

46. Members including Hon Albert HO, Hon Mrs Regina IP and Hon Tanya CHAN have expressed concern about the power of FS, under paragraph (e) of the proposed resolution under PFO, to determine the expense and investment of the Bond Fund. These members have enquired about the investment strategy and investment arrangement of the Bond Fund. Hon James TO and Hon Ronny TONG are also concerned about the investment strategy of the Bond Fund and the manner in which the moneys in the Bond Fund will be expended.

47. The Subcommittee has noted that according to paragraph (e) of the proposed resolution under PFO, FS may expend money from the Bond Fund for repaying principal of bonds issued, to meet the financial obligations and liabilities associated with GBP and to make investments. The proceeds raised under GBP will be placed with the Exchange Fund, which bears a similar nature of investment objectives of the Bond Fund, for investment. To provide the Bond Fund with a stable investment return, a "fixed rate" sharing arrangement, in the same manner as the sharing of investment income applicable to the fiscal reserves, will apply to the Bond Fund. In other words, the investment income to be paid by HKMA in relation to the Bond Fund for a year will be calculated on the basis of the average rate of return of the Exchange

Fund's investment portfolio over the past six years or the average annual yield of three-year EFN for the previous year, whichever is higher. Such an arrangement should allow the Bond Fund to benefit from the economy of scale of assets managed under the Exchange Fund. The substantial size of the Exchange Fund can also provide sufficient investment diversification for the achievement of a stable investment return and effective management of risk.

48. Members including Hon Albert HO, Hon Mrs Regina IP, Hon Tanya CHAN and Hon James TO have requested restricting the scope of FS's power under paragraph (e)(ii) of the proposed resolution under PFO, by specifying explicitly in the resolution the investment strategy of the Bond Fund and that the proceeds will be placed with the Exchange Fund for investment.

49. The Government has advised that it is not desirable to set out any specific investment arrangement in paragraph (e)(ii) of the proposed resolution under PFO. In view of the long-term nature of GBP, the implementation details may need to be adjusted having regard to the changes in the market. It would be necessary to allow room for FS to fine-tune the specific investment arrangement under unforeseeable or exceptional circumstances, if any, in the long run. Such an approach is also conducive to ensuring a stable investment return for the Bond Fund. The Government has nevertheless emphasized that a long-term and conservative investment strategy would be adopted.

50. The Government has noted members' concern about the need to exercise prudence in determining the investment strategy and to specify the exact investment arrangement in the resolution for the sake of clarity and certainty. To strike a balance between such concern and the need to allow room for FS to fine-tune the specific investment arrangement under unforeseeable or exceptional circumstances, the Government has proposed to adjust paragraph (e)(ii) of the proposed resolution under PFO along the following line (proposed amendment in italic and bold print) -

"(ii) investing in the manner the Financial Secretary ~~may determine~~ *considers appropriate for the prudent management of the Fund*, and paying the expenses incurred in relation to the investments;"

51. Hon James TO and Hon Albert HO maintain the view that FS should not be given unlimited power to determine the investment of proceeds in the Bond Fund and it is necessary to specify in the resolution that the proceeds in the Bond Fund will be placed with the Exchange Fund for investment in a prudent manner. Their proposed amendments to paragraph (e)(ii) of the proposed resolution under PFO are at **Appendices IIb and IIc**.

52. The Government has stressed that it does not consider it desirable to set out any specific investment arrangements in paragraph (e)(ii) of the proposed resolution under PFO. In view of the long-term nature of GBP, the implementation details may need to be adjusted having regard to market changes. To address members' concerns

in this regard, FS would indicate the intended investment arrangement of the Bond Fund in his speech for moving the motion regarding the relevant proposed resolution. Hon Ronny TONG considers it acceptable if FS would state clearly in such speech that the proceeds in the Bond Fund would be placed with the Exchange Fund for prudent investment.

53. Hon Ronny TONG and Hon Miriam LAU have expressed concern on whether the investment of moneys in the Bond Fund could secure sufficient return for meeting the financial obligations and liabilities in relation to the sums borrowed under GBP. Hon Ronny TONG is concerned about the possible implication on public finance, as shortfall in the Bond Fund will have to be met by transferring funds from the fiscal reserves in the event of investment losses.

54. The Government has reiterated that a long-term and conservative strategy will be adopted for investment of moneys in the Bond Fund to ensure capital preservation and reasonable investment returns for meeting the financial obligations and liabilities in relation to sums borrowed under GBP. Placing the sums in the Bond Fund with the Exchange Fund for investment is considered an appropriate arrangement given the similar investment objectives shared by the two funds. Moreover, the "fixed rate" sharing arrangement will provide the Bond Fund with a stable investment return.

55. Hon Mrs Regina IP has suggested that, in the long run, the Government should consider establishing an investment management corporation to administer the Bond Fund, as in the case of the Government Investment Corporation in Singapore. The Government has responded that it does not see the need for setting up a separate investment management corporation to manage the investment of moneys in the Bond Fund as the approach may involve additional costs for providing for the necessary institutional arrangements. Such an arrangement also may not allow moneys in the Bond Fund to benefit from the economy of scale of assets managed under the Exchange Fund which provides sufficient investment diversification to achieve a stable return for the Bond Fund, especially during the initial phase of the GBP implementation.

56. As regards the practice of overseas jurisdictions in the administration and investment of sums raised through government bond issuance, the Government has provided information on the investment arrangement of the Singapore Government Securities Programme.

Amendments to the proposed resolutions

57. The Subcommittee has noted the amendments to the proposed resolution under PFO proposed by Hon KAM Nai-wai, Hon James TO and Hon Albert HO at **Appendices IIa to IIc**. The Subcommittee has not proposed any amendments to the two proposed resolutions.

Recommendation

58. The Subcommittee has no objection to FS's moving of motions regarding the two proposed resolutions on 8 July 2009.

Advice sought

59. Members are invited to note the Subcommittee's recommendation in paragraph 58.

Council Business Division 1
Legislative Council Secretariat
25 June 2009

Subcommittee on Proposed Resolutions under Section 29 of the Public Finance Ordinance (Cap. 2) and Section 3 of the Loans Ordinance (Cap. 61)

Membership list

Chairman Hon Jeffrey LAM Kin-fung, SBS, JP

Members
Hon Albert HO Chun-yan
Dr Hon David LI Kwok-po, GBM, GBS, JP
Hon James TO Kun-sun
Hon CHAN Kam-lam, SBS, JP
Dr Hon Philip WONG Yu-hong, GBS
Hon Miriam LAU Kin-yee, GBS, JP
Hon Abraham SHEK Lai-him, SBS, JP
Hon WONG Ting-kwong, BBS
Hon Ronny TONG Ka-wah, SC
Hon CHIM Pui-chung
Hon Starry LEE Wai-king
Dr Hon LAM Tai-fai, BBS, JP
Hon Paul CHAN Mo-po, MH, JP
Hon CHAN Kin-por, JP
Hon Tanya CHAN
Hon WONG Kwok-kin, BBS
Hon Mrs Regina IP LAU Suk-yee, GBS, JP

(Total : 18 Members)

Clerk Ms Rosalind MA

Legal Adviser Miss Kitty CHENG

Date 14 May 2009

PUBLIC FINANCE ORDINANCE

AMENDING MOTION TO BE MOVED BY Hon KAM Nai-wai

BOND FUND

RESOLVED the motion to be moved by the Financial Secretary under section 29 of the Public Finance Ordinance (Cap. 2) at the Legislative Council meeting on 8 July 2009 be amended by after paragraph (a) adding paragraph (aa)–

“(aa) The purpose of establishment of the Bond Fund is to promote the further and sustainable development of the local bond market.”

PUBLIC FINANCE ORDINANCE

AMENDING MOTION TO BE MOVED BY Hon James TO

BOND FUND

RESOLVED the motion to be moved by the Financial Secretary under section 29 of the Public Finance Ordinance (Cap. 2) at the Legislative Council meeting on 8 July 2009 be amended by –

(i) after paragraph (a) adding paragraph (aa) “(aa) The purpose of establishment of the Bond Fund is to promote the further and sustainable development of the local bond market.”

(ii) in paragraph (e) deleting “the purposes of-”;

(iii) in paragraph (e) (ii) deleting “investing in the manner the Financial Secretary may determine” and substituting “injecting into the Exchange Fund for investment in a prudent manner”.

PUBLIC FINANCE ORDINANCE

AMENDING MOTION TO BE MOVED BY Hon Albert HO

BOND FUND

RESOLVED the motion to be moved by the Financial Secretary under section 29 of the Public Finance Ordinance (Cap. 2) at the Legislative Council meeting on 8 July 2009 be amended by –

- (i) after paragraph (a) adding paragraph (aa)- “(aa) The purpose of establishment of the Bond Fund is to promote the further and sustainable development of the local bond market.”
- (ii) In paragraph (b) after “who may direct or authorize other public officers to administer the Fund and delegate the power of administration to other public officers” adding-“. The Financial Secretary may often consult the Bond Fund Consultation Committee. The Committee is made up of seven persons. The Financial Secretary is the Chairman of the Committee, other members are to be appointed by the Financial Secretary, and at least two persons elected by the Members of the Legislative Council from among their own number for recommending to Financial Secretary for appointing as committee members”
- (iii) in paragraph (e) deleting “the purposes of-”;
- (iv) in paragraph (e) (ii) deleting “investing in the manner the Financial Secretary may determine” and substituting “injecting into the Exchange Fund for investment in a prudent manner”.