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

Response to the Follow-up Questions and Issues Raised

Purpose

This paper sets out the Administration's response to the relevant questions and issues raised by Members 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) (the Subcommittee) as set out in its letters dated 25 May 2009 and 2 June 2009.

Comments on and Suggested Amendments to the Resolutions

Name of the Bond Fund

2. As mentioned in the paper submitted to the Panel on Financial Affairs for its meeting on 4 May 2009, our current plan is to issue bonds of tenors within the range of two to ten years at the initial stage of the Government Bond Programme (GBP). Going forward, we would consider issuing bonds with longer tenors, say, 15 years or longer. It is a market convention to label debt securities of tenors of more than one year as bonds. Given this, we consider it appropriate to name the fund to be established under the GBP as "Bond Fund".

3. The Subcommittee's letter dated 25 May 2009 puts forward an alternative name, namely "Debt Fund". This term 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 we only intend to issue bonds under the GBP and have no plan to raise other forms of debt, we consider that "Bond Fund" is a more appropriate name for describing the fund to be established under the GBP. Also, "Debt Fund" in Chinese (債務基金) may have other unintended meanings.

Incorporating the policy objective of the GBP into the proposed resolution under the Public Finance Ordinance

4. We have already set out the policy objective of the GBP 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. To further highlight this objective, we propose to elaborate paragraph 1 of the Explanatory Note along the following line – "… *with a view to reinforcing Hong Kong's position as an international financial centre and enhancing stability of Hong Kong's financial system*."

5. We have considered repeating the objective in the resolutions. On balance, 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 the GBP, the Bond Fund or individual elements thereof. Such uncertainty is undesirable. Any litigation arising therefrom may adversely affect the smooth implementation of the GBP. This may also dampen investors' interest to invest through the GBP and hence will not be conducive to the further development of the bond market in Hong Kong.

Providing expressly the purpose of the establishment of the Bond Fund and the investment strategy to be adopted in the resolutions

6. As we have explained in our letter dated 19 May 2009 to the Assistant Legal Adviser of the Legislative Council, pursuant to section 29(1) of the Public Finance Ordinance, paragraphs (e)(i) and (e)(ii) in the proposed resolution under section 29 of the Public Finance Ordinance set out the purposes for which the Bond Fund is to be established and moneys in the Bond Fund may be expended. Such approach in reflecting the purposes of the Bond Fund is in line with that in other resolutions for establishment of funds under section 29(1) of the Public Finance Ordinance.

7. Separately, as we have explained in the supplementary information paper dated 20 May 2009 to the Subcommittee, we do not consider it desirable to set out any specific investment arrangement in paragraph (e)(ii) of the proposed resolution under the Public Finance Ordinance. In view of the long-term nature of the 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 the Financial Secretary (FS) to fine-tune the specific investment arrangement under unforeseeable or exceptional circumstances, if any, in the long run. Such approach is also conducive to ensuring a stable investment

return for the Bond Fund. The above notwithstanding, we would like to emphasize again that a long term and conservative investment strategy would be adopted.

Role of the Hong Kong Monetary Authority (HKMA) in the GBP

8. According to the proposed framework of the GBP, FS will direct the HKMA (a) to assist the Government in coordinating the offering of the bonds under the GBP, which includes performing certain functions of an arranger; and (b) to manage the investment of moneys in the Bond Fund which is placed with the Exchange Fund and provide an investment income for the Bond Fund on the basis of the "fixed rate" sharing arrangement applicable to the fiscal reserves. Such arrangements will cover, inter alia, the duties of the HKMA in preparing and coordinating the offerings of bonds under the GBP (e.g. the drawing up of the timing as well as structure for the offerings of bonds and the distributing structure including dealers and placing institutions), and managing the investment of moneys in the Bond Fund.

Need for qualifying the word "administer" and restriction on sub-delegation under paragraph (b) of the proposed resolution under the Public Finance Ordinance

9. Paragraph (b) of the proposed resolution under the Public Finance Ordinance provides that FS is the Principal Official with the authority to administer the Bond Fund. According to the proposed framework of the GBP, FS will delegate the authority to the Financial Services and the Treasury Bureau to administer the Bond Fund. The Bureau's duties will include authorizing expenditure from the Bond Fund (i.e. ensuring that only the financial obligations and liabilities associated with bond issuance under the GBP are charged to 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 the HKMA; and preparing returns on the Bond Fund for inclusion in the annual Estimates to be laid before the Legislative Council in the annual budgetary exercise. Paragraph (b) of the proposed resolution does not provide that the Bureau being delegated with FS' authority to further delegate such power.

10. The Subcommittee's letter of 25 May 2009 suggests more qualifications for FS to perform the function of administering the Bond Fund. These suggestions actually refer to the role of the HKMA in implementing the GBP, which is explained in paragraph 8 above.

Exchange Fund Bills and Notes Programme and GBP

11. Bonds issued under the GBP will not be eligible for accessing the HKMA's Discount Window. It should be emphasized that Exchange Fund Bills and Notes (EFBNs) are part of the Monetary Base and have at least 100% backing by US dollar assets under the Currency Board arrangements. Since there will not be a similar backing arrangement for the issuance of government bonds under the GBP, it would not be appropriate to render government bonds eligible for accessing the Discount Window under the Currency Board principles.

12. Against this background, yields of EFBNs would tend to be slightly lower than those of government bonds with the same maturities, as EFBNs can be used for accessing the Discount Window, making investors willing to accept a slightly lower yields when bidding for such papers. Such a differentiation between the EFBNs and the other bonds issued by the Government is well-understood by the market and is unlikely to cause any confusion to investors or perceived as unreasonable. Such differentiation in yield only reflects the liquidity premium attached to EFBNs and does not suggest a more inferior status of the government bonds. In fact, with a higher yield of the government bonds, they would be welcomed by banks and other investors in general as a high quality investment tool.

Investment strategy and portfolio of the Singapore Government Securities Programme

13. Under the Singapore Government Securities Programme, all the bond proceeds from the issuance of government securities are placed in the Government Securities Fund (GSF). While it does not appear clear from the Singapore official sources by whom and how the GSF is managed, a staff report on 2005 Article IV Consultation of the International Monetary Fund suggested that the proceeds raised through the issuance of Singapore Government Securities were invested in foreign assets through the Government of Singapore Investment Corporation Ltd (GIC).

14. The GIC is a government company established under the Singapore Companies Act in 1981 with a sole purpose of managing Singapore's foreign reserves. In the Report on the Management of the Government's Portfolio for the Year 2007/08 published by the GIC, it was mentioned that the GIC managed Singapore's foreign reserves with an investment objective of enhancing global purchasing power, and thus achieving a reasonable rate of return above global inflation within the risk tolerance determined by the Government as owner of

the funds. It is not clear how the funds in the GSF are allocated within the GIC. Nevertheless, it is broadly known that the GIC makes investments in three major categories, namely, publicly traded markets (including equities, fixed incomes, currencies, etc.), real estate investments, and private equity and infrastructure investments. Each of the portfolios is managed by a separate asset management company established under the GIC. As at end March 2008, the GIC maintained investments in over 40 countries, with approximately 70% of its assets in publicly traded instruments, and the remaining in other asset classes including real estates and private equity.

Financial Services and the Treasury Bureau
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