

## ITEM FOR FINANCE COMMITTEE

### CAPITAL INVESTMENT FUND HEAD 965 – ASIAN DEVELOPMENT BANK Subhead 101 Shares in Asian Development Bank

Members are invited –

- (a) to accept the financial implication, estimated at \$4,660.4 million, of subscription by Hong Kong to the Fifth General Capital Increase of the Asian Development Bank; and
- (b) to approve an increase in the financial commitment for subscription to shares in the Asian Development Bank from \$87.69 million by \$146.0 million to \$233.69 million to provide for the 4% paid-in portion of the Fifth General Capital Increase.

### PROBLEM

Hong Kong has to decide whether it should subscribe to the Fifth General Capital Increase (GCI V) of the Asian Development Bank (ADB) with a paid-in portion of US\$18.6 million (or HK\$146.0 million)<sup>1</sup> to be paid over a ten-year period and a remaining callable portion of US\$575.0 million or (HK\$4,514.4 million) that will constitute a contingent liability for the Government.

**/PROPOSAL .....**

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<sup>1</sup> US dollar are converted to HK dollar using the exchange rate of US\$1 = HK\$7.85 which is the upper bound of convertibility zone of 7.75-7.85 under the Linked Exchange Rate system, and allowed 0.01% transaction cost.

**PROPOSAL**

2. We propose that Hong Kong should subscribe to GCI V of ADB.

**JUSTIFICATION**

3. Since the establishment of ADB in 1966, there have been four general capital increases to enlarge its capital base. With the approval of the Finance Committee of the Legislative Council (LegCo), Hong Kong has subscribed in full to its entitled shares in all four cases.

Encl. 1

4. On 29 April 2009, the Board of Governors of ADB approved a draft Resolution of general capital increase of 200% with a paid-in component of 4%. Each member is entitled to subscribe up to a 200% increase in its shareholding (Enclosure 1). Based on the current amount of its shareholding of 19 270 shares at the ADB, Hong Kong will be able to subscribe 38 540 additional shares under GCI V as follows –

- (a) 4% of the additional shares (i.e. 1 542 shares) as paid-in shares; and
- (b) 96% of the additional shares (i.e. 36 998 shares) as callable shares.

This would involve an actual payment of US\$18.6 million (or HK\$146.0 million) for the paid-in shares and a contingent liability of US\$575.0 million (or HK\$4,514.4 million) for the callable shares<sup>2</sup>.

5. We consider that Hong Kong should subscribe to GCI V for the reasons set out below –

**(a) Importance of Hong Kong's membership at the ADB**

ADB is one of the few formal international organisations in which Hong Kong is a member. Hong Kong's separate membership in ADB is a practical demonstration of Hong Kong's autonomy in international financial affairs under the "One Country, Two Systems" principle. Hong Kong should therefore participate actively in the activities of ADB. In particular, this GCI V initiative is largely in response to the call by G20 Leaders to increase resources of multilateral development banks to support growth in developing countries amid the global financial crisis. Hong Kong should not be left out in such an important initiative.

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<sup>2</sup> As the callable shares are denominated in Special Drawing Rights (SDRs), the amount of contingent liability will fluctuate with the SDR exchange rate.

**(b) Hong Kong's continued commitment to the ADB**

GCI V is the first general capital increase of ADB after 1997. Prior to 1997, ADB had four general capital increases and Hong Kong has subscribed in full in all cases. The subscription to GCI V will be a clear demonstration of Hong Kong's continued commitment to ADB after the handover. As a matter of fact, Hong Kong has also contributed to previous replenishments to the Asian Development Fund (ADF) of ADB including three replenishments after 1997<sup>3</sup>.

**(c) Expectation of Hong Kong's commitment**

Hong Kong joined the ADB in 1969 and has benefited substantially from ADB's lending programmes. In the period from 1972 to 1980, Hong Kong obtained five loans totalling US\$101.5 million from ADB to finance various infrastructure projects<sup>4</sup>. All loans were repaid in full by 1987<sup>5</sup>.

Given that Hong Kong's per capita GDP<sup>6</sup> is amongst the highest in the region, there is general expectation for Hong Kong to subscribe to the general capital increase of ADB. In addition, all member economies of ADB have subscribed in full in all the past four general capital increases. It is therefore expected that all members, including our peers in the region, would do the same in this round. If Hong Kong chooses to opt out, we would become a clear outlier and attract international attention.

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<sup>3</sup> ADF is a concessional lending window of the ADB to support poverty reduction and improve the quality of life. Since the handover, Hong Kong has contributed to three replenishments of ADF: (i) US\$16.28 million in 2001 (ADF VIII); (ii) US\$19.19 million in 2005 (ADF IX); and (iii) US\$26.25 million in 2009 (ADF X).

<sup>4</sup> The loans from ADB were used to finance construction of public housing projects (Shatin Urban Development (Housing) Project (Wo Che Estate and Sha Kok Estate) and the second Shatin Urban Development Project (part of the development of Shatin New Town and the construction of Mei Lam Estate)), sewage (Shatin Sewage Treatment Plant Stage 1), polyclinic (Shatin Hospital Polyclinic Project) and other infrastructure project (Lok On Pai Sea Water Desalting Plant).

<sup>5</sup> With its per capita GDP exceeding ADB's threshold for development assistance, Hong Kong is no longer eligible for ADB assistance. Graduation from ADB assistance will be triggered when a member reaches a Gross National Income per capita benchmark (\$6,275 in 2006 US dollar). Hong Kong "graduated" from ADB assistance in 1998.

<sup>6</sup> In 2009, Hong Kong's per capita GDP is US\$29,902.

**FINANCIAL IMPLICATIONS**

6. The overall financial implication arising from Hong Kong's subscription of 38 540 additional shares under GCI V is estimated to be about US\$593.6 million (or HK\$4,660.4 million).

7. This includes 4% paid-in portion of US\$18.6 million (or HK\$146.0 million)<sup>7</sup>. Hong Kong will make its payment based on a pre-agreed payment schedule of ten annual instalments between 2010-11 and 2019-20. The arrangement is to first settle 40% of the paid-in portion (US\$7.44 million or HK\$58.4 million) in five equal annual instalments, and then settle the remaining 60% (US\$11.16 million or HK\$87.6 million) in the next five years when ADB encashes the promissory notes issued to it. The payment schedule is set out at Enclosure 2. We will make sufficient provision in the Annual Estimates to meet the cash flow requirements in relevant years.

Encl. 2

8. ADB also offers three accelerated payment options that shorten the payment period to one, three or five years and give credit (i.e. discount) for making early payments<sup>8</sup>. However, these options are considered unattractive as the discount rates are much lower than the projected investment return for the fiscal reserves.

9. The remaining portion of US\$575.0 million (or HK\$4,514.4 million) is subject to call only as and when required by ADB<sup>9</sup>. Since the callable shares are valued at SDR, the amount of contingent liability will vary with the exchange rate of SDR against US dollar. It should be noted that there has never been any call on the callable shares in the history of ADB. Furthermore, under the ADB Charter, the callable capital can only be utilised after ADB has explored all its available resources to settle its obligations at the time of financial distress.

10. Hong Kong's subscription to ADB shares would not have any direct monetary returns as ADB is a non-profit multinational financial institution for regional development. Net income generated from its lending operations is used to fund ADB's future operations.

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<sup>7</sup> The paid-in portion of 1 542 shares is valued at US\$12,063.5 per share which is the maximum amount to be paid by members.

<sup>8</sup> Discount rates for the three accelerated payment options are 1.434%, 1.149% and 0.862% respectively.

<sup>9</sup> The callable portion of 36 998 shares is valued at SDR10,000 each and computed to US dollar using the USD/SDR as at end January 2010 (i.e. US\$ 1.554/SDR). SDR is a currency basket comprising US dollar, Euro, Japanese yen and British pound. The amount of contingent liability will fluctuate with the SDR exchange rate.

11. There will be very moderate additional administrative costs<sup>10</sup> involved in Hong Kong's subscription to GCI V, and they will be absorbed by the Financial Services and the Treasury Bureau and Hong Kong Monetary Authority.

## **PUBLIC CONSULTATION**

12. We consulted the LegCo Panel on Financial Affairs on the proposal on 8 April 2010. Members were generally supportive of Hong Kong's subscription to GCI V on the consideration that Hong Kong should continue its commitment to the ADB as in the past.

## **BACKGROUND**

13. ADB is a multilateral financial institution for regional development with the principal goal of poverty reduction. To achieve the goal, ADB provides both financial and technical assistance to governments for specific projects and programmes.

14. General capital increase is the periodic replenishment of ADB's authorized capital stock. According to the ADB Charter, the lending and borrowing authority of ADB are bounded by the size of its subscribed capital stock. An increase in the size of capital stock of ADB is therefore necessary in order to ensure that ADB can continue its lending activities without disruption<sup>11</sup>. Since its establishment in 1966, ADB has had four general capital increases and all member economies subscribed in full in all cases<sup>12</sup>.

15. The proposed GCI V would triple ADB's subscribed capital stock to 10,638,933 shares from 3,546,311 shares at present. Each member is entitled to subscribe up to a 200% increase in its current shareholding. Nevertheless, they are not obliged, but are expected, to take up any or all of their allocated shares. If a member economy does not subscribe in full to its allocated shares, its voting power would drop proportionately.

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Financial Services and the Treasury Bureau  
April 2010

<sup>10</sup> The administrative costs are mainly the telegraphic transfer charges for remitting the payments to ADB.

<sup>11</sup> The enlargement of subscribed capital stock also ensures the ADB's equity-to-loan ratio staying at the comfortable level that would help ADB preserve its AAA credit rating for bond issuance.

<sup>12</sup> Including the original subscription, Hong Kong currently holds 1 350 paid-in shares and 17 920 callable shares. The latter implies a contingency liability (callable portion of shares) equivalent to US\$278.5 million (about HK\$2,186.3 million) for Hong Kong.

## Share entitlement of members under GCI V

A. Regional member	Entitled shares			B. Non-regional member	Entitled shares		
	Total	Paid-in	Callable		Total	Paid-in	Callable
Afghanistan	2,390	96	2,294	Austria	24,080	963	23,117
Armenia	21,114	845	20,269	Belgium	24,080	963	23,117
Australia	409,480	16,379	393,101	Canada	370,172	14,807	355,365
Azerbaijan	31,472	1,259	30,213	Denmark	24,080	963	23,117
Bangladesh	72,256	2,890	69,366	Finland	24,080	963	23,117
Bhutan	440	18	422	France	164,712	6,588	158,124
Brunei Darussalam	24,924	997	23,927	Germany	306,136	12,245	293,891
Cambodia	3,500	140	3,360	Ireland	24,080	963	23,117
PRC	456,000	18,240	437,760	Italy	127,900	5,116	122,784
Cook Islands	188	8	180	Luxembourg	24,080	963	23,117
Fiji Islands	4,812	192	4,620	Netherland	72,588	2,904	69,684
Georgia	24,162	966	23,196	Norway	24,080	963	23,117
Hong Kong, China	38,540	1,542	36,998	Portugal	24,080	963	23,117
India	448,020	17,921	430,099	Spain	24,080	963	23,117
Indonesia	385,400	15,416	369,984	Sweden	24,080	963	23,117
Japan	1,104,420	44,177	1,060,243	Switzerland	41,300	1,652	39,648
Kazakhstan	57,072	2,283	54,789	Turkey	24,080	963	23,117
Kiribati	284	11	273	UK	144,524	5,781	138,743
South Korea	356,492	14,260	342,232	US	1,104,420	44,177	1,060,243
Kyrgyz Republic	21,164	847	20,317	Subtotal	2,596,632	103,863	2,492,769
Lao	984	39	945				
Malaysia	192,700	7,708	184,992				
Maldives	284	11	273				
Marshall Islands	188	8	180				
Micronesia, Federated States of	284	11	273				
Mongolia	1,064	43	1,021				
Myanmar	38,540	1,542	36,998				
Nauru	284	11	273				
Nepal	10,404	416	9,988				
New Zealand	108,680	4,347	104,333				
Pakistan	154,160	6,166	147,994				
Palau	228	9	219				
Papua New Guinea	6,640	266	6,374				
Philippines	168,608	6,744	161,864				
Samoa	232	9	223				
Singapore	24,080	963	23,117				
Solomon Island	472	19	453				
Sri Lanka	41,040	1,642	39,398				
Taipei, China	77,080	3,083	73,997				
Tajikistan	20,268	811	19,457				
Thailand	96,348	3,854	92,494				
Timor-Leste	700	28	672				
Tonga	284	11	273				
Turkmenistan	17,916	717	17,199				
Tuvalu	100	4	96				
Uzbekistan	47,668	1,907	45,761				
Vanuatu	472	19	453				
Vietnam	24,152	966	23,186				
Subtotal	4,495,990	179,841	4,316,149				
<b>Total (A+B)</b>	<b>7,092,622</b>	<b>283,704</b>	<b>6,808,918</b>				

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<b>GCI V Payment Schedule</b>		
<b>Fiscal Year</b>	<b>Cash Payment / Note Encashment</b>	
	<b>US\$</b>	<b>HK\$ equivalent*</b>
<b>2010/11</b>	1,488,153.36	11,683,172.08
<b>2011/12</b>	1,488,153.36	11,683,172.08
<b>2012/13</b>	1,488,153.36	11,683,172.08
<b>2013/14</b>	1,488,153.36	11,683,172.08
<b>2014/15</b>	1,488,153.36	11,683,172.08
<b>2015/16</b>	2,232,230.04	17,524,758.11
<b>2016/17</b>	2,232,230.04	17,524,758.11
<b>2017/18</b>	2,232,230.04	17,524,758.11
<b>2018/19</b>	2,232,230.04	17,524,758.11
<b>2019/20</b>	2,232,230.04	17,524,758.11
<b>Total</b>	<b>18,601,917.00</b>	<b>146,039,650.95</b>
		<b>say 146,050,000</b>

\* US dollar amounts are converted into HK dollars using the exchange rate of US\$1 = HK\$7.85, being the upper bound of the convertibility zone of 7.75-7.85 under the Linked Exchange Rate system, plus 0.01% contingency.

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