For discussion
on 8 April 2013

Legislative Council Panel on Financial Affairs

Proposal to Raise the Maximum Amount of Borrowings under the Government Bond Programme

PURPOSE

This paper briefs Members on our proposal to raise the maximum amount of borrowings under the Government Bond Programme ("GBP") from HK$100 billion to HK$200 billion by way of a resolution to be moved by the Administration under the Loans Ordinance (Cap. 61)("LO").

BACKGROUND

2. To implement a proposal in the 2009-10 Budget to promote the sustainable development of the bond market in Hong Kong, the Legislative Council ("LegCo") passed, on 8 July 2009, a resolution under section 29 of the Public Finance Ordinance (Cap. 2) ("PFO") authorising the Administration to set up the Bond Fund for managing sums raised under the GBP, and a separate resolution under section 3 of the LO authorising the Administration to borrow a maximum amount of outstanding principal at any time of HK$100 billion or equivalent for the purposes of the Bond Fund. The resolutions are appended at **Annex A**. The GBP, consisting of an institutional part ("institutional GBP") and a retail part ("retail GBP"), was established following the passage of these resolutions to issue Government Bonds ("GBs").[1]

3. On 27 February 2013, the Financial Secretary announced in the 2013-14 Budget the following GBP-related initiatives to further promote the sustainable development of our bond market –

(a) to expand the size of the GBP from the current HK$100 billion to HK$200 billion so as to provide adequate room for the GBP to continue in the next five years; and

[1] Bonds issued under the institutional GBP and retail GBP will be referred to as "institutional GBs" and "retail GBs" respectively.

(b) to launch a further issuance of inflation-linked retail bond ("iBond") with a size of up to HK$10 billion to maintain the growth momentum of the local retail bond market after two previous iBond issuances.

CONSIDERATIONS

Review of Progress of the Development of the Bond Market of Hong Kong since the Launch of the GBP

4. As at end March 2013, the total outstanding amount of GBs is HK$70.5 billion, in which HK$ 50.5 billion have been issued for the institutional GBP (**Annex B**), with tenors ranging from 2 to 10 years. For the retail GBP, two iBonds of HK$10 billion each were issued in July 2011 and June 2012. We have reviewed the implementation of the GBP with a view to formulating its way forward. A summary of the progress made by the GBP is set out in paragraphs 5 to 13.

(a) Ensured a steady and consistent supply of high quality public debt paper to the market

5. Hong Kong Monetary Authority ("HKMA") is the representative of the Administration in the implementation of the GBP. Institutional GBs are issued in a systematic and consistent manner to promote transparency and predictability in the market. HKMA has put in place a well-established process of announcing in advance tentative issuance schedule in July and January each year, covering bond tenders to be made in the six-month period starting from September and March respectively.

6. The supply in each six-month issuance schedule, covering a range of tenors from 2 to 10 years, is set with a view to striking a reasonable balance between providing a consistent supply of bonds on one hand, while ensuring that the market is able to absorb the new supply on the other. We would engage primary dealers ("PDs") before finalising the issuance schedules to assess market appetite.[2] Market players supports this steady supply of institutional GBs, as it enables them to gauge the demand, and prepare necessary funding, for bidding institutional GBs in the next six months. For the financial year ending March 2013, a total of HK$64.5 billion GBs, with tenors ranging from 2 to 10 years, have been issued under 24 tenders since the launch of the GBP in July 2009 as follows -

[2] Under the two dealership frameworks of the institutional GBP, PDs are appointed to assist HKMA in implementing the institutional GBP.

Financial year	Amount issued
2009-10	HK$11.5 billion
2010-11	HK$16.0 billion
2011-12	HK$19.0 billion
2012-13	HK$18.0 billion
Total	**HK$64.5 billion**

Additional institutional GBs totalling HK$6.5 billion are scheduled for issuances between May and August 2013. Subject to the passage by LegCo of the proposed resolution to expand the size of the Bond Fund, issuances to be made from September 2013 onwards will be determined and announced in the tentative issuance schedules due for announcement in July 2013 and January 2014.

(b) Deepened penetration and broadened investor bases: non-bank institutional investors

7. The issuance parameters (i.e. the tenors and issue sizes, etc.) of individual institutional GBs are determined to optimise the penetration of bonds to different types of investors. In particular, bonds with varying maturities are issued to meet demand from commercial banks (for short-term papers), investment funds (for medium-term papers), and pension funds and life insurance companies (for long-term papers). Overall, institutional GBs are well received by investors. The bid-to-cover ratios, i.e. the ratios of bonds applied for to bonds issued at the tenders, averaged 3.32, suggesting an excess demand for GBs.[3]

8. A wide array of local and foreign institutional investors have been attracted to and participated in the market. Apart from commercial banks, which have traditionally been biggest investors in Hong Kong dollar bonds, non-bank end-investors such as insurance companies, pension funds, investment funds and foreign public sector investors also participated in the market (**Annex C**). According to market feedback, some of these non-bank investors had never participated in the Hong Kong dollar bond market before and were attracted by the institutional GB tenders.

(c) Local bond market recognized by global bond benchmark indices

9. Institutional GBs have been admitted into a number of benchmark bond indices, such as the Barclays Asian Local Currency Diversified Bond Index and the Markit iBoxx ABF Pan-Asia Index. This helps attract

[3] A bid-to-cover ratio of over 2 is usually regarded as representing a considerable demand in competitive tenders.

benchmark-tracking investors, such as fund managers, to the local bond market. It is worth-noting that the Hong Kong dollar bond market only managed to get into some of these indices following the implementation of the GBP.[4]

(d) Built benchmark sizes under the GBP to improve liquidity in the secondary market

10. Institutional GBs have been issued in a more sizeable manner each time. This reduces the number of outstanding bonds and minimises market fragmentation. Likewise, re-opening is used as far as practicable to reach the same objective. The number of institutional GBs outstanding at end March 2013 was 10 instead of 20 had all bonds been issued through new issuances. It is worth-noting that two issues of the outstanding institutional GBs have already reached a size of over US$1 billion (i.e. over HK$7.8 billion). Such a size is considered by the investing community as efficient for trading and investment purposes, which help promotes secondary market liquidity. The Administration will continue to consider the need to introduce relevant measures to improve the liquidity of institutional GBs.

(e) Broadened investor base: retail investors

11. Under the retail GBP, the Administration has issued thus far two series of 3-year iBonds, each with a size of HK$10 billion, to Hong Kong residents under the GBP. The relevant subscription detail is as follows –

	Number of valid applications	**Total valid application amount (HK$)**	**Allotment of bonds to valid applications**	**Percentage of first-time bond investors**
2011	155,835	13,157,530,000	1 to 45 units	Over 15%
2012	332,467	49,836,180,000	1 to 4 units	10%

12. The two iBond issuances have met with enthusiastic responses. In particular, both the total number of valid applications and the total application amount for iBond in the second issuance set new records in the local retail bond market. 10-15% of those investors who have subscribed iBond in the two issuances were first-time investors, as they specifically opened an investment account due to the iBond issuance. We believe that iBond issuances have further enhanced the investing public’s awareness of and interest in bonds, through participating in the subscription and trading process, and hence promoting the development of a retail bond market in Hong Kong.

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[4] For example, to be eligible for the Barclays Asian Local Currency Diversified Bond Index, the minimum outstanding size of individual bonds must be at least ¥35 billion (around HK$2.8 billion). Institutional GBs are the only Hong Kong dollar government bonds that have reached such a size.

(f) Another channel for financial intermediation for corporations

13. More private sector entities have conducted Hong Kong dollar debt issuances since the establishment of the GBP. Between 2008 (i.e. before implementation of the GBP) and 2012, issuances made by the non-public segment increased from around HK$138 billion to almost HK$243 billion (**Annex D**), representing an annual growth of approximately 12.8%. Such a growth, if managed on a sustainable basis, is conducive to enhancing the effectiveness of the local bond market as a financial intermediation channel to complement the banking sector and equity market. This will in turn help maintain financial stability and strengthen Hong Kong's position as an international financial centre.

Growing Demand for Hong Kong Dollar Bonds

14. As foreshadowed in the Administration's proposal to launch the GBP in 2009, the borrowing ceiling of HK$100 billion represented a long-term target over a period of five or more years. Given the situation of global financial markets, the demand from investors and financial institutions for high quality public-debt papers (including those denominated in Hong Kong dollar) is increasing. Indeed, it is expected that there will be a steady increase in demand for such papers from financial institutions due to regulatory developments. For instance, the liquidity coverage ratio requirement under Basel III is expected to come into effect in January 2015, under which banks are required to hold a certain ratio of top quality assets like high quality public-debt papers. It is likely that some banks will hold such papers before these regulatory requirements come into effect. So far, Hong Kong and Singapore are the only two jurisdictions attaining a credit rating AAA[5] in the Asian region. High quality public sector debt papers from this region will very likely form part of the investment portfolios of financial institutions in meeting relevant regulatory requirements.

15. Furthermore, the size of the Hong Kong dollar public-debt market remains relatively small when compared to other financial markets in both the developed world and in the region (such as Malaysia and Singapore). Our market is not sizeable enough to be admitted into some of the most widely tracked global bond benchmark indices in the investing community, e.g. the Citigroup World Government Bond Index ("WGBI"), whose entry requirement was increased to US$50 billion (i.e. around HK$390 billion) from US$20

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[5] Fitch, Moody's and Standard & Poors ("S&P") assign AA+, Aa1 and AAA long-term local currency credit ratings respectively to the Government of the Hong Kong Special Administrative Region.

billion in 2010[6]. As at end February 2013, the total amount of Hong Kong dollar public-debt papers eligible for inclusion in such indices was around US$10.9 billion (i.e. around HK$85.2 billion). Although Citigroup has already started monitoring the Hong Kong dollar government bond market since April 2012 with a view to including it in the WGBI, they would only do so after all the entry requirements, in particular a minimum relevant market size of at least US$50 billion, are met. In the Asian region, the bond markets of Singapore and Malaysia have already been included in the WBGI since 2005 and 2007 respectively[7].

16. In light of the above, the on-going and sustainable implementation of the GBP is crucial to promote the further development of the local bond market. The outstanding amount of bonds issued under the GBP is projected at HK$87 billion after completing the third iBond issuance and the announced issuances under the institutional GBP, i.e. an issuance quota of HK$13 billion is expected to remain at end August 2013. Such a size is not sufficient for the next tranche of six-monthly issuance of institutional GBs from September 2013 onward, not to mention meeting the growing demand and expanding to a scale eligible for inclusion in some of the most widely tracked global bond benchmark indices. If the ceiling remains unadjusted, investors, particularly institutional investors, may question whether the Administration has a serious commitment to developing the local bond market, and may reduce their participation. Raising the maximum amount of borrowings is thus necessary to continue to operate the GBP in a sustainable manner.

FURTHER DETAILS OF THE ENLARGED PROGRAMME

17. The proposed additional HK$100 billion (in amount of outstanding principal) will provide room for further issuances under the GBP for the next five years, thus allowing the Administration to maintain flexibility to adjust the issuance size and tenor of individual tranches in response to prevailing market conditions. When considering the types and other parameters of future GB issuances under the GBP, our overriding objective is to promote the further development of the local bond market.

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6 The latest admission criteria are –

(a) Market Size: The outstanding amount of a market's fixed-rate public-debt papers with remaining maturity of at least one-year must total at least US$50 billion, €40 billion, or ¥5 trillion for the market to be considered eligible for inclusion.

(b) Credit: The minimum credit quality of A-/A3 by both S&P and Moody's for all issuers.

(c) Barriers to Entry: A market being considered for inclusion should actively encourage foreign investor participation and show a commitment to its own policies.

7 As at mid-March 2013, based on the source from Bloomberg about the bond market of Malaysia and Singapore, the total amount of Malaysia Ringgit and Singapore Dollar public-debt papers eligible for inclusion in WGBI was estimated to be around US$78.2 billion (i.e. around RM244.6 billion) and US$58 billion (i.e. around SGD72.4 billion) respectively.

Issuance Framework

18. A flexible approach will be taken to ensure that issuance parameters (e.g. choice of issuance size and tenor) of individual bond issuances are conducive to the long-term development of the local bond market. Due consideration will continue to be given to prevailing market conditions such as market demand, interest rates, and potential impacts on other prospective bond issuers in the Hong Kong, as well as the GBP's capacity to support the development of different segments of the bond market.

Proportion of Issuance of Institutional and Retail Bonds

19. In view of the overriding objective of the GBP to promote the further development of the local bond market, the Administration will not set limits for the proportion of institutional and retail GBs under the GBP. We will continue to issue both institutional and retail bonds, having regard to the prevailing market conditions and sustainability of the GBP.

Management of Proceeds

20. The management of funds under the GBP will continue to follow the existing framework, i.e. in accordance with the resolution passed on 8 July 2009 in relation to the PFO. All proceeds raised under the GBP will be credited to the Bond Fund. Expenses include interest payments and principal repayment for bonds issued under the GBP as well as other relevant expenses (e.g. expenses for external services) will be met by the Bond Fund. The Bond Fund does not form part of fiscal reserves and is managed separately from the Government accounts. The Fund is placed with the Exchange Fund for investment and attracts investment income on the basis of the "fixed rate" sharing arrangement applicable to fiscal reserves.

THE RESOLUTION

21. On 8 July 2009, LegCo passed a resolution under section 3 of the LO to authorise the Administration to borrow from time to time for the purposes of the Bond Fund such sums not exceeding in total HK$100 billion or equivalent, being the maximum amount of all borrowings under the authorisation that may be outstanding by way of principal at any time. We will seek LegCo's approval of a resolution under the LO to raise the maximum amount of borrowings that may be outstanding by way of principal to HK$200 billion.

WAY FORWARD

22. The Administration plans to move the proposed resolution in LegCo to expand the size of the GBP within this legislative year. Subject to LegCo's approval of the resolution by way of a positive vetting process, we will have certainty to plan ahead the timing of the forthcoming and future GBs under both the institutional and retail parts of the GBP, including the proposed third issuance of iBond.

23. Members are invited to note the legislative proposal outlined in this paper.

Financial Services and the Treasury Bureau
27 March 2013

Annex A

L.N. 168 of 2009

PUBLIC FINANCE ORDINANCE

RESOLUTION OF THE LEGISLATIVE COUNCIL

Resolution made and passed by the Legislative Council under section 29 of the Public Finance Ordinance (Cap. 2) on 8 July 2009.

RESOLVED that—

(*a*) there is established a fund to be known as the "Bond Fund" in English and "債券基金" in Chinese;

(*b*) the Fund is to be administered by the Financial Secretary, who may direct or authorize other public officers to administer the Fund and delegate the power of administration to other public officers;

(*c*) the following are to be credited to the Fund—

  (i) sums borrowed under section 3 of the Loans Ordinance (Cap. 61) that are required to be credited to the Fund by any resolution of the Legislative Council approving the borrowing;

  (ii) sums received by way of interest, dividends or investment income earned in respect of the sums held in the Fund;

  (iii) any appropriations from the general revenue that may be approved by the Legislative Council;

  (iv) any other sums that may be received for the purposes of the Fund;

(*d*) earnings from interest or dividends on investments of the Fund are to be retained for the purposes of the Fund;

(*e*) the Financial Secretary may expend money from the Fund for the purposes of—

  (i) repaying or, if appropriate, paying the principal of, interest on, and expenses incurred in relation to, any sums that have been borrowed under section 3 of the Loans Ordinance (Cap. 61) for the purposes of the Fund; and

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

(*f*) the Director of Accounting Services, under the authority of a funds warrant issued by the Financial Secretary, is to pay from the Fund any sums that may be required to meet expenditures from the Fund; and

(*g*) the Financial Secretary may transfer from the Fund to the general revenue the balance held in the Fund, if so approved by the Legislative Council, when all financial obligations and liabilities are met in relation to any sums that have been borrowed under section 3 of the Loans Ordinance (Cap. 61) for the purposes of the Fund.

Pauline NG Man-wah
Clerk to the Legislative Council

8 July 2009

Explanatory Note

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.

2. This Resolution establishes a fund known as the Bond Fund ("the Fund"). The Fund will be administered by the Financial Secretary or public officers under the Financial Secretary's authority. The Fund will have sums borrowed under section 3 of the Loans Ordinance (Cap. 61) ("the loans"), sums received by the Fund by way of interest, dividends or investment income, appropriations from the general revenue, and any other sums received for the purposes of the Fund. Earnings from interest or dividends on investments of the Fund will be retained in the Fund. The Fund will be used to repay the loans, meet related financial obligations and liabilities, and make investments. If the Fund has a positive balance after all financial obligations and liabilities are met in relation to the loans, the surplus funds may be transferred to the general revenue.

L.N. 169 of 2009

LOANS ORDINANCE

RESOLUTION OF THE LEGISLATIVE COUNCIL

Resolution made and passed by the Legislative Council under section 3 of the Loans Ordinance (Cap. 61) on 8 July 2009.

RESOLVED that—

(*a*) the Government be authorized to borrow from any person from time to time for the purposes of the Bond Fund established by a resolution made and passed under section 29 of the Public Finance Ordinance (Cap. 2) such sums not exceeding in total $100 billion or equivalent, being the maximum amount of all borrowings made under this paragraph that may be outstanding by way of principal at any time; and

(*b*) sums borrowed under paragraph (*a*) are to be credited to the Bond Fund.

Pauline NG Man-wah
Clerk to the Legislative Council

8 July 2009

Explanatory Note

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.

2. This Resolution authorizes the Government to borrow for the purposes of the Bond Fund such sums not exceeding in total $100 billion or equivalent, being the maximum amount of all borrowings under the authorization that may be outstanding by way of principal at any time, and requires that the sums be credited to the Bond Fund.

Annex B

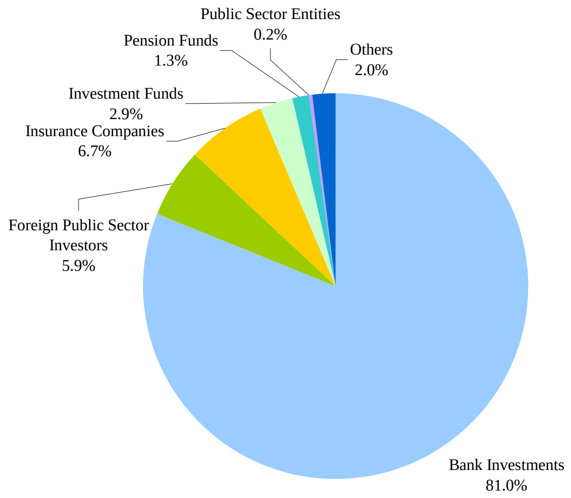
Maturity profile of institutional GBs outstanding at financial year ending 31 March 2013

	Expiry date	Issue code	Issue size (HK$ bn)	Total issue size (HK$ bn)
Short-term	Sep 2013	02GB1309	3.5	23.5
	Mar 2014	02GB1403	3.5	
	Nov 2014	05GB1411	10.0	
	May 2015	03GB1505	6.5	
Medium-term	Dec 2015	05GB1512	8.0	14.0
	Dec 2016	05GB1612	4.0	
	Feb 2018	05GB1802	2.0	
Long-term	Jan 2020	10GB2001	7.5	13.0
	Aug 2021	10GB2108	4.0	
	Jan 2023	10GB2301	1.5	
			Total	**50.5**

Source: HKMA

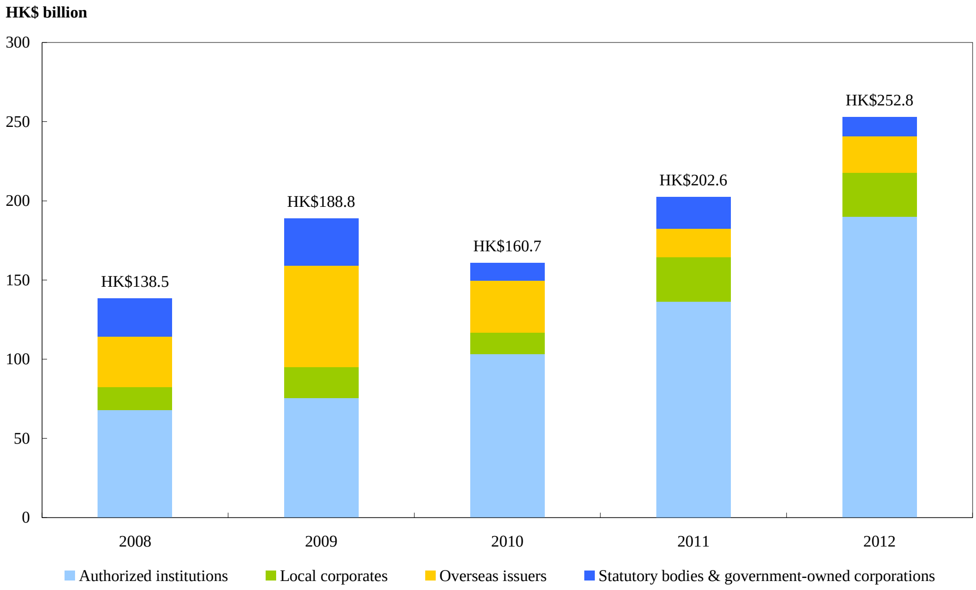
<u>**Annex C**</u>

Percentage breakdown of investors of institutional GBs at tenders



Source: HKMA

Issuances of Hong Kong dollar debt instruments by non-government issuers (2008-2012)[8]



Source: HKMA

[8] Although the statutory bodies and government-owned corporations are "public" entities in the legal sense, they are typically considered as non-public issuers by the market. Hence, they are categorised as "non-government" issuers as well.