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Panel on Financial Affairs

Meeting on 8 April 2013

**Background Brief on
Proposal to raise the maximum amount of borrowings under the
Government Bond Programme**

Purpose

This paper sets out the background of the Government Bond Programme ("GBP"), and summarizes the major views and concerns raised by Members on the subject at committee meetings during the Fourth Legislative Council ("LegCo").

Background

Initiative to promote the Hong Kong bond market

2. The Financial Secretary ("FS") announced in his 2009-2010 Budget Speech in February 2009 the Government's intention to implement a programme to issue government bonds (i.e. the Government Bond Programme ("GBP")) to promote the further and sustainable development of the Hong Kong bond market. The sums raised from GBP would be credited to a fund (i.e. Bond Fund) to be established which would not be treated as part of the fiscal reserves and would be managed separately from other government accounts.

3. On 28 April 2009, FS gave notices to move at the Council meeting on 20 May 2009: (a) a resolution under section 29 of the Public Finance Ordinance (Cap. 2) ("PFO") to set up the Bond Fund for the management of the sums raised under GBP; and (b) a resolution under section 3 of Loans Ordinance (Cap. 61) ("LO") to authorize the Government to borrow for the purposes of the Bond Fund up to the proposed limit of HK\$100 billion or equivalent.

Framework of the Government Bond Programme

4. The Administration briefed the Panel on Financial Affairs ("FA Panel") on the framework of GBP and the two proposed resolutions at the meeting on 4 May 2009. The subject was further discussed at a special meeting of the FA Panel on 11 May 2009. Details of the framework of GBP and the two proposed resolutions are as follows:

- (a) The overall issuance size of GBP or the borrowing ceiling¹, will be set at HK\$100 billion. The proposed ceiling represents a long-term target over a period of five to ten years. The proposed resolution under section 3 of LO will authorize the Government to borrow up to the proposed limit of HK\$100 billion.
- (b) GBP will comprise bond issues for institutional and retail investors. The bonds to be issued will mainly be denominated in Hong Kong Dollar.
- (c) Bonds of tenors within the range of two to ten years will be issued at the initial stage of GBP. Consideration will be given to issuing bonds with longer tenors (say, 15 years or longer) at a later stage. Arrangements will be made to seek listing status for the bonds to be issued under the Programme.
- (d) Sums raised under GBP (less for example expenses deducted at source) will be credited to the Bond Fund which will not be treated as part of the fiscal reserves and will be managed separately from the general revenue. It will be used to repay principal, meet the financial obligations and liabilities associated with the Programme and make investments. If there is a positive balance in the Bond Fund after all financial obligations and liabilities are met in relation to the programme, the surplus funds may be transferred to the general revenue. Any shortfall of funds for fulfilling the financial obligations and liabilities in respect of the Programme may be financed from the general revenue in accordance with LO. The proposed resolution under section 29 of PFO is for the establishment of the Bond Fund.

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.

- (e) A long-term and conservative investment strategy will be adopted for the Bond Fund with the objectives of preserving capital and generating reasonable investment returns for covering the financial obligations and liabilities under the GBP. The Hong Kong Monetary Authority ("HKMA") will be tasked to manage the Bond Fund. The same "fixed rate" sharing arrangement for investment income applicable to the fiscal reserves will apply to the Bond Fund. In other words, the investment income to be paid by HKMA on 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 Exchange Fund Notes for the previous year, whichever is the higher.
- (f) HKMA will be tasked to assist the Government in coordinating the offering of bonds under GBP. It will engage banks and/or financial institutions as primary dealers for offering bonds for institutional investors, co-arrangers for managing and offering of retail bonds, and placing institutions for distributing bonds to retail investors, etc., to provide the necessary assistance in implementing GBP. Expenses arising from the procurement of the relevant services by HKMA will be met by the Bond Fund.

Passage of the two resolutions

5. At the meeting of House Committee on 8 May 2009, Members agreed to form a subcommittee to study the two proposed resolutions. 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") held four meetings with the Administration to discuss related issues. The Subcommittee had no objection in principle to the implementation of the GBP and did not oppose to the Administration's moving motions regarding the two proposed resolutions. The Council passed the two proposed resolutions at its meeting on 8 July 2009. The passed resolutions are at **Appendix I**.

Issuance of iBond under the Government Bond Programme

6. In his 2011-2012 and 2012-2013 Budget Speeches, FS announced the issuance of two sets of iBond under GBP to promote the development of the retail bond market in Hong Kong and provide another investment alternative to Hong Kong residents in the then high inflation environment. In each exercise, up to \$10 billion of iBond was issued with a maturity of three years and targeted Hong Kong residents. Interest was paid to bond holders once

every six months at a rate linked to the inflation rates of Hong Kong of the last half-year period, subject to a minimum rate of one per cent.

Deliberations of the FA Panel and the Subcommittee

7. The major views and concerns raised by Members during meetings of the FA Panel and the Subcommittee are summarized in the ensuing paragraphs:

Purpose of the Bond Fund

8. Some Members considered that the two proposed resolutions should contain express provisions setting out the policy objective of the Bond Fund. The Administration advised that the policy objective of GBP was already set out in paragraph 1 of the Explanatory Note to each of the proposed resolutions, i.e. "to promote the further development of the bond market in Hong Kong". In view of Members' concern, the Administration agreed to further elaborate paragraph 1 of the Explanatory Note to each of the proposed resolution in order to specify the policy objective of GBP and undertook to state this policy objective in FS's speech for moving the motions regarding the two proposed resolutions. Some Subcommittee Members maintained their views that the proposed resolution under section 29 of PFO should state the purpose for establishing the Bond Fund and had proposed amendments to the proposed resolution to add 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 by Members were negated at the Council meeting of 8 July 2009.

Issuance size of the Government Bond Programme

9. Regarding the maximum amount of borrowing under GBP, some Members considered that the proposed limit of HK\$100 billion was not a big sum and might not help promote the development of the local bond market. These Members considered that the borrowing ceiling should be increased if there was favourable market response to GBP. The Administration advised that in drawing up the overall issuance size, consideration had been given to the long-term nature of GBP and the need to provide enough room for the public debt market to grow into a critical mass. The proposed borrowing ceiling represented a long-term target over a period of five to ten years and had been set upon detailed consideration. The Government would monitor the implementation of GBP and consider revising the borrowing ceiling having regard to investors' response and market conditions. The approval of LegCo would be sought to raise the ceiling as and when appropriate.

Expense chargeable to and investment of the Bond Fund

10. Some Members expressed concern whether the sums in the Bond Fund would be used for financing public projects, or for public expenses. The Administration advised that according to paragraph (g) of the proposed resolution under section 29 of PFO, 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.

11. Concerns were also expressed on FS's power in determining the expense and investment of the Bond Fund. Some Members noted that while paragraph (e) of the proposed resolution under section 29 of PFO provided that 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 investment strategy and investment arrangement of the Bond Fund were not set out in the resolution. These Members considered that the resolution should restrict FS's power in making investments of the Bond Fund, specify explicitly the investment strategy of the Fund and that the proceeds raised under GBP would be placed with the Exchange Fund for investment. The Administration advised that it would not be desirable to set out any specific investment arrangements in the proposed resolution as given the long-term nature of GBP, it would be necessary to allow room for FS to fine-tune the specific investment arrangement under unforeseeable or exceptional circumstances having regard to market changes. To address Members' concern, the Administration agreed to adjust paragraph (e)(ii) of the proposed resolution under section 29 of PFO to provide that the Bond Fund would be invested in the manner FS considered "appropriate for the prudent management of the Fund". Besides, FS would indicate the intended investment arrangement of the Bond Fund in his speech for moving the motion regarding the proposed resolution. Some Members maintained their views that it was necessary to set out the investment arrangements in the relevant resolution and subsequently proposed amendments to the resolution to this effect. The proposed amendments by Members were negatived at the Council meeting of 8 July 2009.

Considerations for the launch of bonds and mechanism for offering bonds under the Government Bond Programme

12. Some Members sought information on the Government's considerations in determining the timing for issuance of individual bonds under GBP, and the possible impact of such bond issuance on the securities market. The Government advised that the prevailing market conditions were crucial in determining the timing for issuance of individual tranches of

government bonds. Relevant considerations included the financial market conditions, investor demand and expected pricing of the bonds which would be taken into account in deciding the size and timing for launching individual tranches of government bonds. As regards the impact on the securities market, given the relatively modest amount of bond issuance under GBP each year, the impact on the market was not expected to be significant.

13. Some Members stressed the need to put in place a fair and transparent mechanism for issuance and distribution of the government bonds. There was also a suggestion from Members for setting out explicitly in the proposed resolution under section 3 of LO that the institutional tranche of GBP be issued through competitive tender. The Administration explained that while the mechanism of competitive tender would be adopted for conventional fixed rate HK Dollar government bonds issued under the institutional tranche of GBP, this mechanism might not be the most effective way to reach the target investors of other types of bonds to be covered by GBP. Hence, it was necessary to allow sufficient flexibility for the Administration in determining the exact offering mechanism for specific types of bonds targeting different investors under GBP. As for the retail tranche of GBP, to facilitate access by individual investors, retail bonds would be distributed through an extensive network of placing institutions which will include placing banks, the Hong Kong Securities Clearing Company and securities brokers.

Types of bonds to be issued under the Government Bond Programme

14. Some Members expressed concern about the types of bonds to be issued under GBP and asked if asset-back securities and floating rate bonds would be included. The Government advised that its current intention was to issue conventional fixed rate HK Dollar-denominated bonds with shorter tenors within the range of two to ten years at the initial stage of GBP implementation. The Government would monitor the market needs and demands, draw reference from experience gained under GBP in considering whether, and if so, when to add more variety to the Programme by issuing other types of bonds such as floating rate bonds and asset-backed securities.

15. On some Members' suggestion that bonds denominated in other currencies, such as Renminbi, should be considered under GBP, the Administration responded that although HK Dollar-denominated bonds would be issued at the initial stage of GBP implementation, it would 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.

Discussions at Council Meetings

16. During the Fourth LegCo, Members have raised three written questions on the issuance of government bonds and inflation-liked retail bonds at the Council meeting of 28 October 2009, 26 October 2011, and 23 May 2012. The major issues covered in these questions included the criteria used for calculating the amount of HK\$3,500 million two-year Government Bonds offered under the Institutional Bond Issuance Programme in 2009 and the authority for determining the amount, the timing for issuing the retail Government bonds, the review on the criteria and process regarding the issuance size, pricing, issuance, subscription and trading of iBond, and whether the Government has subsidized the interest payments of iBond. Details of the LegCo questions and the Administration's replies are given in the hyperlinks in **Appendix II**.

Recent developments

17. In his 2013-2014 Budget Speech, FS announced that the Government would launch the third iBond issue up to \$10 billion under GBP to address the current low-interest rate environment. Moreover, as at early February 2013, outstanding bonds issued under GBP totalled about HK\$70 billion. Owing to the sustained growth in the demand from investors and financial institutions in Asia and other emerging markets for high quality public debt papers, including Hong Kong Dollar government debt, the Government would expand GBP to meet the criteria of certain global benchmark bond indices to attract more investors and to further promote the sustainable development of the local bond market. The Government would expand the size of GBP from the current HK\$100 billion to HK\$200 billion to provide adequate room for the Programme to continue in the next five years.

18. The Administration will brief the FA Panel on the proposal to raise the maximum amount of borrowings under GBP at the Panel meeting on 8 April 2013.

Relevant papers

19. A list of relevant papers is at **Appendix II**.

**Resolution moved by the Financial Secretary under
the Public Finance Ordinance (Cap. 2)
passed by the Legislative Council 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.

**Resolution moved by the Financial Secretary under
the Loans Ordinance (Cap. 61)
passed by the Legislative Council 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.

Appendix II

List of relevant papers

Date	Event	Paper/Minutes of meeting
4 May 2009 and 11 May 2009	The Panel on Financial Affairs discussed the Government Bond Programme (GBP)	<p><u>Discussion Paper</u> (LC Paper No. CB(1)1469/08-09(01))</p> <p><u>Legislative Council Brief</u> (G6/123/5C)</p> <p><u>Administration's supplementary information</u> (LC Paper No. CB(1)1507/08-09(01))</p> <p>Minutes for meetings on <u>4 May 2009</u> (LC Paper No. CB(1)2092/08-09) and <u>11 May 2009</u> (LC Paper No. CB(1)2519/08-09)</p>
May to June 2009	The Subcommittee on Proposed Resolutions under Section 29 of the Public Finance Ordinance (Cap. 2) and Section 3 of the Loans Ordinance (Cap. 61) scrutinized the proposed resolutions concerned	<p><u>Proposed resolution under Section 29 of the Public Finance Ordinance (Cap.2)</u></p> <p><u>Proposed resolution under Section 3 of the Loans Ordinance (Cap.61)</u></p> <p><u>Legislative Council Brief</u> (G6/123/5C)</p> <p><u>Report of the Subcommittee</u> (LC Paper No. CB(1)2049/08-09)</p>
8 July 2009	The Legislative Council passed the proposed resolutions under Section 29 of the Public Finance Ordinance (Cap. 2) and Section 3 of the Loans Ordinance (Cap. 61) moved by the Financial Secretary	<p><u>Hansard</u></p>

Date	Event	Paper/Minutes of meeting
28 October 2009	Hon Mrs Regina IP raised a written question regarding the issuance of government bonds	Hansard
7 July 2011	The Administration announced the launch of the first inflation-linked retail bond (iBond)	Press Release
26 October 2011	Hon Frederick FUNG raised a written question regarding the review of the issuance of iBond	Hansard
23 May 2012	Hon Mrs Regina IP raised a written question regarding the issuance of iBond	Hansard
28 May 2012	The Administration announced the launch of the second iBond	Press Release