

For information

Legislative Council Panel on Financial Affairs

Investment of Fiscal Reserves – “Future Fund”

Purpose

The Government has decided to establish a Future Fund (FF) with effect from 1 January 2016 with a view to securing higher returns for the fiscal reserves. This is part of the fiscal measures to cope with the foreseeable long-term fiscal challenges arising from an ageing population and slower economic growth. This paper explains the key features of FF and the underlying considerations.

Establishment of FF

2. In his Budget Speech for 2015-16, the Financial Secretary (FS) announced the decision to establish an FF for placement in longer-term investments with a view to securing higher returns.

3. With the agreement of the Hong Kong Monetary Authority (HKMA) on the implementation details, FF will be established on 1 January 2016. FF is a long-term investment tool and will remain an integral part of the fiscal reserves.

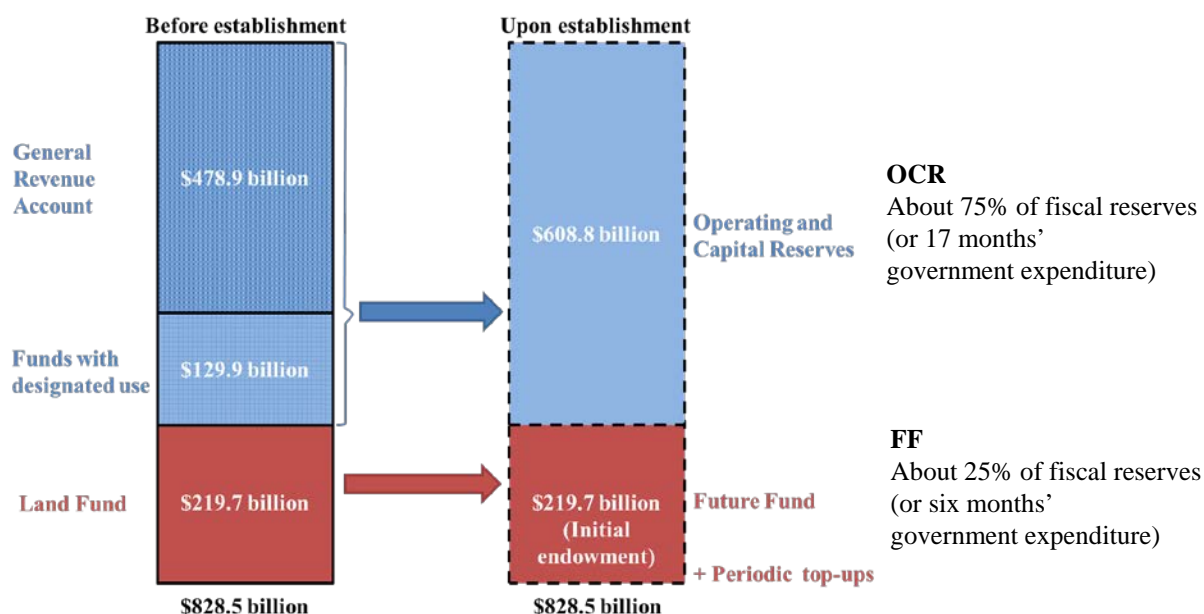
4. FF will be placed with the Exchange Fund for an initial period of ten years from 1 January 2016 to 31 December 2025. The Fund would be subject to the same investment management regime and oversight by the Exchange Fund Advisory Committee. Separately, HKMA should consult FS and the Secretary for Financial Services and the Treasury once a year on the asset allocation for FF.

5. The management and utilisation of FF will continue to be bound by the legislative and governance framework provided under the Resolution on the Land Fund and the Public Finance Ordinance (Cap. 2). Expenditure from FF will require approval of the Legislative Council according to the existing legislation.

Components

6. FF will comprise –
- an **initial endowment** of \$219.7 billion, to be notionally held against the balance of the Land Fund;
 - periodic top-ups** from Government as FS may determine each year. This will be notionally held against the General Revenue Account (GRA); and
 - interest** on investment of FF, which shall be calculated and compounded on an annual basis.
7. An illustration of the distribution of the fiscal reserves, before and upon establishment of the FF, is as follows –

Distribution of Fiscal Reserves upon Establishment of the Future Fund (Illustration based on 31 March 2015 position)



The part of the fiscal reserves outside FF will be referred to as “Operating and Capital Reserves” (OCR). Based on the above illustration, FF and the OCR would be equivalent to about six months and 17 months of government expenditure respectively.

Investment and Returns

8. Since April 2007, the Government and the HKMA have arranged for the Government's fiscal reserves to be invested as part of the **Investment Portfolio (IP)** of the Exchange Fund. The investment income on fiscal reserves shall be calculated on the basis of the higher of –

- (a) the average annual investment return of the Exchange Fund's IP for the past six years; and
- (b) the average annual yield of three-year Exchange Fund Notes¹ for the previous year, subject to a minimum of zero percent.

9. The rate of return on fiscal reserves since 2007 ranged from 3.6% to 9.4% and averaged at 6.1% per annum.

10. The IP of the Exchange Fund under the 2007 arrangement between HKMA and Government seeks to preserve capital and meet short-term liquidity needs. The investment mix covers primarily bonds, supplemented by some equities.

11. In recent years, the Exchange Fund has also set up a **Long-Term Growth Portfolio (LTGP)**. The investment mix covers asset classes that may offer higher returns in the medium to long term, but such asset classes are usually of longer-term nature and are associated with higher risks. The LTGP of the Exchange Fund provides an alternative investment option for FF, which aims to achieve within acceptable risks a return that is higher over the medium to long term than the return for the rest of the fiscal reserves under the 2007 arrangement.

12. The current investment mix of LTGP includes private equities and investments in properties outside Hong Kong. LTGP's annualised internal rate of return since inception till end 2014 was 13.5%.

13. About 50% of FF will be set aside for incremental placement with the Exchange Fund's LTGP to be built up gradually over a period of around three years. The rest will be placed with IP or other investment assets.

¹ Upon cessation of the issuance of three-year Exchange Fund Notes (EFN) in January 2015, the "average annual yield of three-year EFN" in the formula will be replaced by "average annual yield of three-year government bond (GB)" with effect from 1 January 2016.

14. In line with the long-term savings and investment objectives and having regard to the unique nature of LTGP-linked investment products, the investment returns arising from FF during the course of the placement shall be retained by the Exchange Fund for reinvestment. Interests on the FF placement with the Exchange Fund shall be due for payment to Government upon completion of the placement period. For disclosure purposes, the balance of FF and its notional rate of return will be reported in both HKMA and Government annual financial statements.

Withdrawal

15. As a long-term savings scheme, withdrawal of the FF before 31 December 2025 is not allowed except in emergencies. Where it is envisaged that OCR is likely to drop to or below six months' equivalent of gross government expenditure, and where FS sees a need to withdraw funding from FF, FS may direct that the placement be aborted, in whole or in part, whereupon the FF placement shall be released to the Land Fund and the GRA respectively within a reasonable period. The detailed exit arrangement will be subject to discussion with HKMA.

Salient Features

16. The salient features of FF are summarised below –

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| (a) | Tenure | Ten years from 1 January 2016 to 31 December 2025. |
| (b) | Initial Endowment | FF initial endowment to be notionally held against the Land Fund balance of \$219.7 billion. |
| (c) | Investment Allocation | About 50% of FF will be set aside for incremental placement with the Exchange Fund's LTGP to be built up gradually over a period of around three years. |
| (d) | Interest on FF | Interest shall be calculated and compounded on an annual basis. Interest earned by FF will be retained by the Exchange Fund for reinvestment and will not be paid to Government until end of the ten-year placement, or on a date as directed by FS. |

- (e) **Periodic Top-up** To be determined by FS, if any, and to be made on 1 July every year.
- (f) **Withdrawal** Withdrawal before 31 December 2025 not allowed except in emergencies. HKMA will be consulted on the terms of withdrawal.
- (g) **Extension of the Placement** Subject to the direction of FS, the FF placement arrangement may be extended beyond 31 December 2025. HKMA will be consulted on the terms of extension.

Impact on Government Expenditure

17. FF is a notional savings (rather than expenditure) account held within the fiscal reserves. FF is intended to support the Government's long-term expenditure needs. Meanwhile, Government remains committed to expenditure programmes needed to promote long-term economic growth and serve the needs of the community. From 2010-11 to 2015-16, total government expenditure and total recurrent expenditure increased cumulatively by 46% and 45% respectively, outpacing the growth of around 30% in the economy. Recurrent expenditure on education, social welfare and health alone increased by \$60 billion or around 50%. The increase in government expenditure in recent years is by no means conservative.

18. The Government has also been investing phenomenally in infrastructure and the economy during these five years. Capital works expenditure has grown from \$50 billion per annum five years ago to \$70 billion in 2015-16 and is expected to rise to over \$70 billion in the coming few years. This covers more than roads and rails which are conducive to social and economic development. It also includes projects meeting housing and land-related needs, hospital projects, elderly facilities and arts, cultural and sports initiatives.

19. Our fiscal reserves stand at about 20 to 23 months of government expenditure in the medium term. We would continue to make the best use of our resources to serve the immediate as well as longer-term needs of the community.

Background

20. The Working Group on Long-Term Fiscal Planning presented in March 2014 a quantitative appraisal on the medium to long term fiscal challenges that Hong Kong would face, on account of the demographic projections based on the 2011 population census and the trend projections on economic growth and government expenditure. According to the long-term projections set out in the Working Group Report, Government's overall fiscal position in the short to medium term remains healthy. However, a structural deficit could surface within a decade or so even if public services are to be maintained at the then existing levels, should government expenditure growth keep exceeding Gross Domestic Product and revenue growth.

21. In addition to promoting economic growth, preserving, stabilising and broadening the revenue base and containing expenditure growth, the Working Group recommended that a savings scheme be established to cope with the foreseeable long-term fiscal challenges. Setting up an FF is not a total solution but would help alleviate the pressure of future generations.

22. As at end March 2015, the fiscal reserves of Government stood at some \$828.5 billion, broken down as follows –

(\$ billion)	As at 31 March 2015
General Revenue Account	478.9
Funds with designated use	129.9
Capital Works Reserve Fund	76.4
Capital Investment Fund	1.4
Civil Service Pension Reserve Fund	27.0
Disaster Relief Fund	-*
Innovation and Technology Fund	1.0
Loan Fund	2.5
Lotteries Fund	21.6
Land Fund	219.7
Total	<u>828.5</u>

*Fund balance less than \$0.1 billion.