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

Supplementary Information

Purpose

This paper provides supplementary information on the Government Bond Programme (GBP) in response to the letter dated 14 May 2009 from the Subcommittee on Proposed Resolutions under Section 29 of the Public Finance Ordinance (Cap. 2) and Section 3 of the Loans Ordinance (Cap. 61) (Subcommittee).

Types of Bonds to be Issued

Whether floating rate bonds would be issued and if so, the possible mechanism for offering of such bonds

2. Similar to a fixed rate bond, a floating rate bond has a fixed tenor and pay coupons at regular intervals such as quarterly. However, a floating rate bond differs from a fixed rate bond in that its coupon payments, instead of being fixed throughout the tenor of the bond, may vary with market rates in accordance with a pre-determined formula. For example, the coupon payments of a floating rate bond may be set to be the three-month HIBOR (Hong Kong Interbank Offered Rate) on a series of pre-determined dates with a premium or discount.

3. An issuer, for example a bank, may wish to issue a floating rate bond when it needs to match its interest cashflow on the asset side which is also floating. An issuer may also take into account the relevant costs of issuance and expectation on future interest rate movements to determine whether to issue a floating rate or fixed rate note. To some extent, the choice could also be driven by investor demand. Very often, the difference between a fixed rate bond and a floating rate bond may not be material to an institutional investor

because a floating rate bond holder can readily enter into an interest rate swap with other counterparty to obtain fixed rate income stream if he so wishes. However, a retail investor who does not have ready access to the interest rate swap market may want to buy a floating rate bond if he considers that income stream in floating rate better suits his need.

4. We note that fixed rate bonds are still the major components of government bond programmes in other economies. At this stage, we intend to focus on issuing fixed rate bonds under the GBP. That said, we will monitor the market needs and demands and take such factors into account in considering whether to add more variety to the GBP by issuing other types of bonds such as floating rate bonds further down the road.

Whether asset-backed securities could be issued under the proposed framework of the GBP

5. As we have mentioned in the supplementary information paper dated 7 May provided to the Panel on Financial Affairs (FA Panel), our current intention is to issue a basic form of bonds only at the initial stage of the GBP implementation. However, we would not rule out the possibility of adding more variety to the types of bonds to be issued under the GBP including asset-backed securities, but that would have to be considered having regard to market conditions and response as well as the experience gained under the GBP. Such asset-backed securities, if issued in the future, could be covered under the currently proposed resolution under the Loans Ordinance.

Request for the Government to provide to Legislative Council, as and when appropriate, information note(s) on its plan(s) for issuing special type of bonds (e.g. convertible bonds or asset-backed securities) before commencing the issuance exercise(s)

6. As noted above, we will monitor market conditions and demands and take such factors into account in considering whether to add more variety to the GBP by issuing other types of bonds in the future. Should it be considered appropriate to issue special types of bonds under the GBP, we shall be prepared to provide the Legislative Council with relevant information in advance.

Mechanism for Offering of Bonds under GBP

Determination and possible level of subscription fees charged by the placing banks on retail investors

7. Following market convention, placing banks charge retail investors a handling fee when they process retail bond applications for their customers. For the government bonds issued in 2004, the placing banks levied a handling fee of 0.15% of the amount of bonds allotted on their retail clients. We will take into account the prevailing market practice and our experience of government bond issuance in 2004 in determining the appropriate level of handling fee for the bonds to be issued for retail investors under the GBP.

Reasons for using the yield of Exchange Fund Notes (EFN) as the reference for determining the coupon rate for retail tranche

8. The question has arisen from an example used for illustrating the price fixing mechanism of a retail bond issued by a corporate issuer during our presentation at the Subcommittee meeting on 14 May 2009. It is the market convention for a bond issuer to use a representative interest rate benchmark to price a retail bond. The yield of EFN is one such benchmark commonly adopted by issuers of Hong Kong Dollar (HKD) bonds. For example, a number of retail bonds issued by the Hong Kong Mortgage Corporation (HKMC) were priced by making reference to the yield of EFN. Another commonly used interest rate benchmark by bond issuers is one derived from the interest rate swap market.

9. The pricing mechanism of retail bonds to be issued under the GBP will follow the market convention. However, the exact interest rate benchmark to be used is yet to be determined.

Offering of bonds for institutional tranche

10. As we have explained in the supplementary information paper dated 7 May provided to the FA Panel, Recognized Dealers (RDs) and Primary Dealers (PDs) will be appointed to assist in taking forward the part of the GBP

for institutional investors. The government bonds will be offered by way of a competitive tender open to PDs. A few days in advance of the tender day, the Hong Kong Monetary Authority (HKMA) will announce the amount of government bonds on offer. All tender applications must reach the HKMA during tendering hour on the tender day. PDs must indicate the quantity of government bonds applied for and the bid price. Tenders accepted will be allotted in descending order of price bid from the highest to the lowest accepted price. Successful bidders will be allotted government bonds at the price which they bid. The tender results, including the amount of government bonds allotted and the average accepted price, will be announced on the tender day on Reuters screen, Bloomberg and any other means as advised by the HKMA. Secondary market trading on government bonds among RDs can start right after settlement is completed on the following day.

11. Similar to the practice of the government bond programmes in many other economies, the above mechanism of competitive tender will be adopted for the conventional fixed rate HKD government bonds issued under the institutional tranche of the GBP. However, this mechanism may not always be the most effective way to reach the target investors of other types of bonds which may be added to the GBP in the future. For example, assuming that bonds denominated in foreign currencies would be issued under the GBP in the future, the target investors for such bonds could be foreign investors in overseas markets, in which case a bank syndicate and bookbuilding[1] structure, rather than competitive tender, would provide the requisite access to these target foreign investors and a representation of their demand for the bonds, making it more effective in offering the foreign currency bonds to the target investors.

12. In view of the above, we consider it necessary to allow sufficient flexibility for the Government to determine the exact offering mechanism for specific types of bonds targeting different investors under the GBP. Restricting offer of government bonds to institutional investors only through competitive tenders would not be desirable from the market development perspective. That said, having regard to the concerns and request raised by a Member, we will underline in the speech for moving the relevant resolution that the mechanism of competitive tender will be adopted for the conventional fixed rate HKD government bonds issued under the institutional tranche of the GBP as

[1] Bookbuilding refers to the collection of bids from investors through a syndicate of banks. The bookbuilding process helps the bank syndicate to fix a price at which the demand for the bonds meets the needs of the issuer.

mentioned in paragraph 10 above.

Investment of the Bond Fund

Suggestion of setting up an investment management corporation to administer the placement and investment of the Bond Fund

13. Given the objectives of preserving capital and generating reasonable investment returns for covering the financial obligations and liabilities under the GBP, we consider that a long-term and conservative investment strategy should be adopted for moneys in the Bond Fund. As we have explained in the supplementary information paper dated 7 May provided to the FA Panel, we consider it an appropriate arrangement to place moneys in the Bond Fund with the Exchange Fund for investment as both share a similar nature of investment objectives. The "fixed rate" sharing arrangement, in the same manner as the sharing of investment income applicable to the fiscal reserves, will provide the Bond Fund with a stable investment return.

14. We do not see the need for setting up a separate investment management corporation to manage the investment of the moneys of the Bond Fund as the approach may involve additional costs for putting up the necessary institutional arrangements. Such an arrangement also may not allow the moneys in the Bond Fund to benefit from the economy of scale of assets managed under the Exchange Fund which provides sufficient investment diversification to achieve a stable return for the Bond Fund, especially during the early years of the GBP implementation.

Suggestion to narrow the scope of the Financial Secretary (FS)' power under paragraphs (b) and (e)(ii) of the proposed resolution under the Public Finance Ordinance and specify explicitly in the resolution that the proceeds in the Bond Fund will be placed with the Exchange Fund for investment by HKMA as authorized by FS

15. Under paragraph (b) of the proposed resolution under the Public Finance Ordinance, the Bond Fund is to be administered by FS, who may direct or authorize other public officers to administer the Fund and delegate the power

of administration to other public officers. According to the proposed framework of the GBP, FS will delegate the authority to the Financial Services and the Treasury Bureau (FSTB) to administer the Fund to ensure that only the financial obligations and liabilities arising from bond issuance under the GBP are charged to the Bond Fund. FS will direct the HKMA to assist the Government in coordinating the offering of the bonds under the GBP, which includes performing certain functions of an arranger, and 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.

16. 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 and it would be necessary to allow room for 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 that a long term and conservative investment strategy would be adopted.

Whether the sums raised under GBP would be credited to the fiscal reserves rather than to a separately managed Bond Fund which would not be treated as part of the fiscal reserves, and the differences between the two; overseas practice in the issuance of government bonds

17. According to the proposed resolution under the Loans Ordinance, sums raised under the GBP will be credited to the Bond Fund to be established under the Public Finance Ordinance. It is our policy decision that the Bond Fund, being a Government account to be administered by FS or public officer(s) who is/are delegated by FS with such power of administration, will not be treated as part of the fiscal reserves and will be managed separately from other government accounts. FSTB will assist FS in maintaining a vigilant oversight of the Bond Fund to ensure that only the financial obligations and liabilities arising from bond issuance under the GBP are charged to the Bond Fund.

18. The arrangement to set up a separate Bond Fund to manage sums raised under the GBP enables clear presentation and ready assessment of the financial performance of the GBP. Such arrangement will also avoid unduly inflating the Government's operating revenue and/or operating expenditure, thus giving an inaccurate picture of the Government's fiscal position, in the years when certain tranches of bonds are issued or due for redemption.

19. As regards the overseas practice in the issuance of government bonds, they can be broadly divided in two groups: one premised on satisfying the government's financing needs and one intended for market development purpose. In the case of the former, which is a common cause for most government bond programmes around the world, proceeds raised are used to meet government expenditures, thus functioning as fiscal reserves to the government. In other cases, such as the Singapore Government Securities Programme which is maintained for market development purpose, proceeds raised are credited to a Government Securities Fund, which is currently managed by the Government of Singapore Investment Corporation.

Other Relevant Issues

Conversion clause to be included in the offering documents of the bonds, if any, to provide for conversion of HKD denominated bonds in the event that HKD ceased to be the legal tender of Hong Kong

20. Article 111 of the Basic Law states that the HKD, as the legal tender in the Hong Kong Special Administrative Region, shall continue to circulate. Given this, there is no cause for concern that the HKD will cease to be the legal tender of Hong Kong and a conversion clause is not necessary. Also, according to market participants active in the debt market, they are not aware of the practice of including a conversion clause in the bond issuance documentation or offering circular to deal with the issue of demonetization of the local currency.

Quantity of bonds issued by other public sector entities in the market

21. The size of bond issuance by the Airport Authority (AA),

Kowloon-Canton Railway Corporation (KCRC) and HKMC in 2009 (up to 14 May 2009) is as follows -

	Total Issuance Size (HK$ million)		
Calendar Year	AA	KCRC	HKMC
2009 (as at 14 May 2009)	500	8,230	8,892

Factors for consideration in determining the timing for issuance and whether impact on local securities market would be taken into account

22. As with any other bond issues, the prevailing market conditions are crucial in determining the timing for the issuance of individual government bonds. The relevant considerations include an assessment of the general financial market conditions, investor demand and expected pricing of the bonds. In the case of government bonds, there is also a strong interaction between the size and timing of issuance, because if the supply of bonds is in excess of market demand, the cost of issuance may go up as a result, lifting the benchmark bond interest rates for other issuers in the market. Careful consideration therefore needs to be taken on the timing as well as size of individual tranches of government bonds. In short, they should best be issued according to prevailing market demand. The GBP, which is intended for market development purpose rather than for financing government expenditures, allows such flexibility to be exercised since we do not need to raise any rigid amount of funds in a particular time frame. In addition, given the modest amount of bond issuance under the GBP each year, it is not expected to have a significant impact on the much larger securities market.

Whether the issuance of bonds under GBP would be limited to bonds denominated in HKD and US Dollar (USD) by making suitable amendments to the proposed resolution under the Loans Ordinance

23. Although HKD bonds will be issued at the initial stage of the GBP implementation, we would not rule out the possibility of adding more variety such as foreign currency bonds under the GBP, if that is assessed to be useful in attracting new foreign investors to our bond market. In overseas markets where both domestic and foreign currency government bonds are issued, it is not common to find any restriction on the choice of foreign currency denomination. From the market development point of view, such a restriction

would reduce the GBP's ability to tap new markets and clientele as they emerge. Hence it does not seem desirable to restrict the denomination of government bonds to be issued under the GBP to HKD and USD.

Financial Services and the Treasury Bureau
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