Legislative Council Panel on Financial Affairs

Government Bond Programme

PURPOSE

This paper briefs Members on the framework of the Government Bond Programme (the "Programme") and the two relevant resolutions to be introduced by the Government.

BACKGROUND

2. In his 2009-10 Budget Speech, the Financial Secretary announced that to promote the further and sustainable development of our bond market, the Government intends to implement a programme to issue government bonds. The sums raised will be credited to a fund to be established under the Public Finance Ordinance. The fund will not be treated as part of the fiscal reserves and will be managed separately. Market views on the details of the bond programme will be sought and necessary adjustments will be made at the implementation stage having regard to market needs.

3. Following the announcement, we have solicited the views of major market practitioners on the relevant details of the Programme, including the size of the programme and individual issues, tenor, denomination, frequency of issue, target clientele, etc. Having regard to these views and taking into account the relevant factors, we have worked out the framework of the Programme and prepared the relevant resolutions for implementing the Programme.

CONSIDERATONS AND OBJECTIVES OF THE PROGRAMME

4. At present, the Hong Kong bond market, especially the government bond sector, is relatively small when compared with those of Asian and other advanced economies. The public debt market in Hong Kong comprises primarily the Exchange Fund Bills and Notes ("EFBN") issued to help banks manage liquidity through the Discount Window. In view that the EFBN Programme is operated under the overriding objective of exchange rate stability and that the amount issued is driven by the inflow of US Dollar under the Currency Board system, it leaves little room for issuance for market development reason.

5. The relatively modest size of the bond market has resulted in a restricted investor base. Given this, institutional investors such as pension funds and insurance companies have limited interest in such instruments in Hong Kong because of the restricted supply of high quality public debt paper. The small investor base in turn discourages corporate issuers from raising funds through bonds. The restricted bond market has also prevented Hong Kong Dollar bonds from being included in major global benchmark bond indices, which many international investment funds track. For example, for inclusion in the Citigroup's World Government Bond Index, there would have to be at least US$20 billion worth of government bonds outstanding.

6. We see the need for a sustainable, systematic government bond programme to broaden and deepen the local bond market with a view to promoting its further and sustainable development. The establishment of a larger Hong Kong Dollar bond market through a more systematic government bond programme would bring about the following benefits -

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

(b) to satisfy the demand of institutional investors such as pension funds and insurance companies for investments to match their long-term Hong Kong Dollar liabilities;

(c) to meet retail demand for high quality and stable investments;

(d) to improve liquidity in secondary market trading through more sizeable issues under the bond programme;

(e) to broaden investor base of Hong Kong Dollar bonds;

(f) to help grow the local bond market into a critical mass recognized by global benchmark indices, thereby attracting foreign investors into the Hong Kong bond market; and

(g) apart from the equity market and banking system, to develop another channel for financial intermediation for corporations so as to maintain financial stability and to strengthen Hong Kong's position as an international financial centre, thereby promoting economic growth.

FRAMEWORK OF THE PROGRAMME

7. In drawing up the overall issuance size, consideration has been given to the needs to take account of the long-term nature of the Programme and to provide enough room for the public debt market to grow into a critical mass, such that it can better attract investors and help promote market development. Upon detailed consideration, we propose that the borrowing ceiling[1] be set at HK$100 billion. The proposed ceiling represents a long-term target over a period of five to ten years. Given the on-going nature of the Programme, the proposed ceiling should give the Government the flexibility required for making necessary adjustments to the issuance size and tenor of individual tranches in response to prevailing market conditions. In this connection, we will seek the Legislative Council ("LegCo")'s approval for a resolution under section 3 of the Loans Ordinance to authorize the Government to borrow up to the proposed limit of HK$100 billion (see paragraph 17 below).

8. Given the primary objective of the Programme to promote the development of the local bond market, it is proposed that bonds to be issued under the Programme will mainly be denominated in Hong Kong Dollar. The Programme will comprise bond issues for institutional and retail investors respectively. For a diversified tenor mix and to meet market demand, bonds of tenors within the range of two to ten years will likely be issued at the initial stage of the Programme. Going forward, consideration will be given to issuing bonds with longer tenors (say, 15 years or longer) so as to enable the Programme to develop a more complete yield curve. In addition, arrangements will be made to seek listing status for the bonds to be issued under the Programme.

9. Views from major market participants indicate that the market may be able to digest government bonds of HK$10-20 billion over the course of a year. We will solicit further market views and conduct a more detailed assessment with a view to determining the appropriate issuance size for the first year of Programme implementation. In the process, due consideration will be given to the prevailing market conditions and impacts on other issuers in the market.

10. Sums raised under the Programme (less for example expenses deducted at source) will be credited to a fund ("Bond Fund") to be established under the Public Finance Ordinance. The Bond Fund 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

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[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 the Programme.

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 the Loans Ordinance. We will seek LegCo's approval for a resolution under section 29 of the Public Finance Ordinance for the establishment of the Bond Fund (see paragraph 16 below).

11. 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 Programme. The Hong Kong Monetary Authority ("HKMA") will be tasked to manage the Bond Fund, and 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 the 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. The rate for 2009 is 6.8%.

12. The HKMA will be tasked to assist the Government in coordinating the offering of the bonds under the Programme. In so doing, 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 the Programme. Expenses arising from the procurement of the relevant services by the HKMA will be met by the Bond Fund.

THE RESOLUTIONS

13. Section 3(1) of the Loans Ordinance stipulates that the Government may, in such manner and on such terms and subject to such conditions as may be agreed between the Government and any person, borrow from such person such sum or sums and for such purposes as may be approved by resolution of the LegCo.

14. Section 29(1) of the Public Finance Ordinance provides that the LegCo may by resolution provide for the establishment of funds to which moneys appropriated for the purpose, and such other moneys received for the purposes of the Government as may be specified in the resolution, may be credited and from which moneys may, under the authority of a funds warrant issued by the

Financial Secretary, be expended for the purposes for which the funds were established subject to such conditions, exceptions and limitations as may be specified in the resolution.

15. We will seek LegCo's approval for a Resolution each under section 29 of the Public Finance Ordinance and section 3 of the Loans Ordinance respectively for implementation of the Programme. The Department of Justice has advised that the Resolution under section 29 of the Public Finance Ordinance should be passed by LegCo before the latter's approval is sought for the Resolution under section 3 of the Loans Ordinance.

16. The purpose of the Resolution under section 29 of the Public Finance Ordinance is to establish the Bond Fund for the management of the sums raised under the Programme (see paragraphs 10-11 above).

17. The purpose of the Resolution under section 3 of the Loans Ordinance is to authorize the Government to borrow 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 authorization that may be outstanding by way of principal at any time. The Resolution requires that sums borrowed (less for example expenses deducted at source) be credited to the Bond Fund (see paragraph 7 above).

WAY FORWARD

18. We plan to move the two relevant resolutions in LegCo on 20 May 2009 tentatively.

Financial Services and the Treasury Bureau
April 2009