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Legislative Council Panel on Financial Affairs

Government Bond Programme －

Supplementary Information

Purpose

This paper provides supplementary information on the Government Bond Programme (GBP) in response to the letter dated 5 May 2009 from the Panel on Financial Affairs.

Considerations and Analysis for the Launch of the GBP

2. The size of local debt market has grown steadily over the past decade, dominated by Hong Kong dollar debt securities. Nonetheless, the Hong Kong bond market, especially the government bond sector, is relatively small when compared with those of Asian economies and other advanced economies (see chart at **Annex A**). The public debt market in Hong Kong comprises primarily the Exchange Fund Bills and Notes (EFBN), while the Government has issued only a limited quantity of bonds. The EFBNs are part of the Monetary Base under the Linked Exchange Rate System and are issued to help banks manage liquidity and access the Discount Window. The EFBN Programme is operated under the overriding objective of exchange-rate stability and its growth is governed by the inflow of US Dollar under the Currency Board system. This leaves little room for issuance for market development reason.

3. The relatively modest size of the bond market has resulted in a restricted investor base. 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 (WGBI), there would have to be at least US$20 billion (about HK$156 billion) worth of government bonds outstanding. As far as Hong Kong is concerned, as at end 2008, the amount of outstanding government bonds which are eligible for inclusion in the WGBI was only HK$72 billion.

4. A research study[1] by the International Monetary Fund (IMF) suggests that a well-developed government bond market can be seen as a necessary condition for the development of the corporate bond market. In particular, the existence of a liquid government benchmark yield curve is often viewed as the foundation of a healthy bond market. Moreover, the investor base built with the development of the government bond market could also contribute to the growth of local corporate bond markets. There is empirical evidence suggesting that countries with larger outstanding government debt securities tend to have larger corporate bonds markets. In most cases, financing needs of governments are the dominating factor behind some of the sizeable public debt markets. In other cases such as Chile and Malaysia, government bonds are issued mainly for the purpose of market development. Likewise, in Singapore, the government does not need to issue government bonds to finance its expenditures. It has operated substantial fiscal surpluses for many years and accumulated sizeable reserves. Thus, the Singapore Government Securities programme is also maintained mainly for market development reasons. As a result, the debt market in Singapore has grown substantially since the launch of the programme and the market perceives that the programme is pivotal to the development of the bond market in Singapore in recent years.

5. In order to further promote the development of the bond market in Hong Kong, attract more investors and enhance liquidity of the market, it would be important to grow the size of the local debt market. An effective way to achieve this would be to launch a regular government bond programme as a useful supplement to the existing EFBN Programme. The adoption of the previous approach of one-off issuances on an ad-hoc basis by the Government is unlikely to be able to achieve this objective.

6. Development of the bond market, along with the development of the equity market and the banking sector, is key to reinforcing Hong Kong's status as an international financial centre. While issuers, investors and intermediaries are the three most important groups of participants in a debt market, debt financing involves a much larger number of peripheral participants that help facilitate the whole debt issuance process, e.g. those providing accounting, legal and banking services. The development of a more mature debt market would benefit a wide array of essential ancillary services, which would be beneficial to the development of Hong Kong as an international financial centre.

[1] "Anatomy of Corporate Bond Markets: Growing Pains and Knowledge Gains", Pipat Luengnaruemitchai and Li Lian Ong, IMF working paper 152, July 2005

Further Details of the GBP

Types of Bonds to be Issued under the GBP

7. At the initial stage of the Programme implementation, our current intention is to issue only plain vanilla bonds. That said, 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 built under the GBP.

8. With regard to the securitization exercise in 2004, out of the five tranches of bonds and notes securitised on the net toll revenues of the Aberdeen Tunnel, Cross-Harbour Tunnel, Lion Rock Tunnel, Shing Mun Tunnel, Tseung Kwan O Tunnel and Lantau Link issued in May 2004, two are still outstanding, with Retail Tranche C to mature in 2011 and Institutional Class A2[2] to mature in 2016.

Mechanism for Executing the GBP

9. The GBP will comprise issues of institutional and retail bonds. For the institutional tranche, Recognized Dealers (RDs) and Primary Dealers (PDs) will be appointed to assist in taking forward the part of the GBP for institutional investors. Market participants (including all authorized institutions and other financial institutions) may apply to the Hong Kong Monetary Authority (HKMA) to become RDs, which maintain securities accounts with the HKMA to which government bonds may be credited and debited. They will be appointed on criteria similar to those applicable to RDs of the EFBN Programme.

10. Among the RDs, PDs will be appointed to provide two-way bid and offer quotations to RDs so as to promote the secondary market. Apart from the obligation to make two-way bid and offer quotations, PDs will also be required to underwrite any unsubscribed portion of the government bonds in any issue for the institutional tranche. As in government bond programmes of other jurisdictions, PDs will be able to participate in competitive tenders in the primary offer for the institutional tranche of the GBP. The appointment of PDs will be based on objective, quantitative and open criteria which include the activity of the market player in the EFBN market.

[2] The Institutional Class A2 Notes is callable prior to its scheduled maturity date at the discretion of the issuer.

11. Under the abovementioned arrangement, the government bonds will be offered by way of a competitive tender open to PDs. At least four business days in advance of each tender day, the 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. Settlement will be effected on the first business day immediately following the relevant tender day. The HKMA will credit the nominal value of the government bonds allotted to the relevant PDs to their securities accounts maintained with the HKMA upon receipt of payments. Secondary market trading on government bonds among RDs can start from the same day onwards.

12. In addition, the HKMA will invite PDs to broadcast bid/offer indicative prices for government bonds on the CMU (Central Moneymarkets Unit) Bond Price Bulletin of the HKMA for better transparency. The Electronic Trading Platform will also provide a channel for RDs to provide indicative quotes and execute trades.

13. As regards the retail tranche of the GBP, the HKMA will engage co-arranger bank(s) to assist in performing the tasks of managing and coordinating the offering of the retail tranche. The co-arranger bank(s) will be selected through a set of open, transparent and fair tendering procedures on the basis of objective criteria such as experience, knowledge, capabilities and resources.

14. To facilitate access by individual investors, retail bonds will be distributed through an extensive network of placing institutions which will include placing banks, the Hong Kong Securities Clearing Company (HKSCC) and securities brokers. To maximize the opportunity for participation by the brokerage industry, all securities brokers who have accounts in the Central Clearing and Settlement System will be admitted to participate and submit applications via HKSCC on behalf of their customers.

15. Retail investors can buy or sell retail bonds in the secondary market either over-the-counter or on the stock exchange. With a view to promoting liquidity in the secondary market, placing banks will be obliged to make market by quoting bid/ask prices, i.e. the prices at which they will buy and sell retail bonds, on a best-effort basis.

Proportion of Bond Issues for Institutional as well as Retail Investors

16. There is no fixed proportion of bond issues for institutional and retail investors. The exact size of individual bond issues, whether they belong to the institutional or retail tranche, will be determined having regard to relevant factors including the market views on the prevailing market conditions, market demands, and impact on other issuers in the market. If there is very strong demand for a retail issue, we can consider increasing the size of that particular issue or putting out an additional issue in a short period of time. This is one of the common approaches adopted by the market.

Minimum Subscription Amount for Retail Issues

17. To facilitate access of retail investors, it is noted that retail bonds in Hong Kong are commonly issued in denomination of HK$50,000. We will take into account such a market practice and our experience of government bond issuance in 2004 (when the nominal value of the retail tranche was set at HK$50,000) in determining the minimum subscription amount for retail issues under the GBP.

Determination of Yields for the Government Bonds and Changes in Yields in the Secondary Market

18. The yields of the bonds to be issued under the GBP, like any other bonds, will have to be determined by the market, and prevailing market conditions such as the interest rate environment will be the relevant determining factors. As market conditions tend to vary over time, it is difficult to provide a reasonable projection of the relevant government bond yields at this early stage.

19. As noted above, the government bonds in the institutional tranche will be offered to PDs through competitive tenders, as is practised in most government treasury bond issuance programmes in other developed markets. 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.

20. For the retail tranche, the usual market practice is to pre-announce an indicative coupon rate and a price fixing mechanism, based on prevailing market conditions, several days prior to the beginning of the offering period, which usually lasts for seven to ten days. The actual yield of the bond will be

determined under the price fixing mechanism on the price fixing day by making reference to the relevant benchmark market interest rates on that day. The price fixing day usually falls shortly after the end of the offer period

21. After the bond is issued, its price will be determined by market interest rates. In general, if interest rates rise, bond prices will fall accordingly. Likewise, if interest rates decline, bond prices will rise. Thus, when an investor sells a bond in the secondary market before maturity, he/she may make a profit or incur a loss due to price fluctuations. Nonetheless, if the investor holds the bond till maturity, he/she will collect the full sum of the principal, and will have earned the interests paid according the coupon rate of the bond.

Possible Benefits to Investors

22. For retail investors, with the establishment of a larger Hong Kong Dollar bond market through a more systematic government bond programme, it would meet the demand of retail investors for high quality and stable investment, particularly under the existing environment. It would also help widen the investment choices for institutional investors such as pension funds and insurance companies, thereby encouraging more diversified financial products to be made available to their customers at the retail level.

23. It should be stressed that the demand of investors for government bonds is not only dependent on the yield of the bond but also other relevant factors such as their risk appetite and the risk and return of alternative investment products such as deposits at banks which are close to zero at the moment. The demand can also be influenced by investors’ assessment of interest rate risks -- reselling a bond when market interest rates are going up may sometimes lead to a trading loss. It is understood that individual investors often tend to hold bonds until maturity in order to mitigate the risk of incurring such kind of trading loss.

24. For institutional investors, GBP offers them an opportunity to invest in stable and high-quality fixed income instruments. For example, insurance companies and pension funds usually have long-term Hong Kong dollar liabilities in their balance sheets. Investment managers need to source long-term Hong Kong dollar bonds to match these liabilities in terms of duration and currency. However, as the supply of long-term Hong Kong dollar bonds is limited, investment managers sometimes have to match these liabilities with short-term Hong Kong dollar bonds and US dollar bonds. GBP serves to fill this market gap by providing market participants with a better choice and at the same time stimulating other issuers to issue long-term Hong Kong dollar bonds. This will help the bond market to grow and provide more choices to

investors in the long run.

Investment of the Bond Fund and Expected Returns

25. The sums raised under the GBP will be credited to a Bond Fund to be established under the Public Finance Ordinance. It will be managed separately from the general revenue and will not be treated as part of the fiscal reserves. With the primary objective of the GBP to promote the further and sustainable development of the local bond market, the Bond Fund so established is primarily used to repay principal of bonds issued, to meet the financial obligations and liabilities associated with the GBP and to make investments. To fulfil these purposes, a long-term and conservative investment strategy is needed 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.

26. We consider it appropriate to place the proceeds raised under the GBP with the Exchange Fund, which bears a similar nature of investment objectives of the Bond Fund, for investment. A core part of the Exchange Fund investment strategy is to preserve capital, ensure sufficient liquidity for maintaining monetary and financial stability, and achieve an investment return that preserves the long-term purchasing power of the Exchange Fund. Similarly, the investment objectives of the Bond Fund are to preserve capital and to generate reasonable investment returns, which will not involve speculative activities.

27. To provide the Bond Fund with a stable investment return, a “fixed rate” sharing arrangement, in the same manner as the sharing of 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 higher.

28. Such an arrangement should allow the Bond Fund to benefit from the economy of scale of assets managed under the Exchange Fund. The substantial size of the Exchange Fund can also provide sufficient investment diversification for the achievement of a stable investment return and effective management of risk. The investment returns of the Exchange Fund during 1994-2008 are at **Annex B**. During this period, the compound annual investment return is 6.1%. The current return sharing arrangement on

government funds management by the HKMA[3] has provided a stable investment return since its adoption in 2007 and protection against market volatility.

29. For 2009, the investment return will be 6.8% according to the "fixed-rate" sharing arrangement as explained above. Given the volatility of the financial market, it is difficult to project the possible investment return of the Bond Fund for years beyond 2009.

30. As mentioned above, the investment income of 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 higher. The latter (i.e. average annual yield of the three year Exchange Fund notes for the previous year) will provide a floor to the investment return to the Bond Fund. Given this, the principals of bond issues should remain intact and the probability of insufficiency of the Bond Fund in meeting the financial obligations and liabilities associated with the GBP should be very low.

Additional Manpower Required and Administrative Cost Incurred for Implementation

31. On the implementation of the GBP, the preparatory work and relevant follow-up work are currently accommodated by the Financial Services and the Treasury Bureau and HKMA through internal redeployment of existing staff.

32. As mentioned above, to effectively offer bonds to the market, the HKMA will engage bank(s) and/or financial institution(s) as co-arranger(s) for managing and offering of retail bonds, as placing institutions for distributing bonds to retail investors, etc., to provide the necessary assistance. Expenses arising from the procurement of the relevant services by the HKMA will be met by the Bond Fund. These expenses can only be determined at a later stage upon the completion of the tendering process in due course.

Risk Disclosure

33. Arrangements will be made to seek listing status for the bonds to be issued under the GBP to satisfy investors' demand for financial disclosure and improve transparency. At the same time, since some institutional investors will only invest in listed securities, the listing of bonds issued under the GBP

[3] From 1998 to 2006, the investment income paid by the HKMA for the fiscal reserves for a year was calculated on the basis of the actual overall rate of return for the Exchange Fund for that year.

will help increase the demand for these bonds. The Government is committed to adhering to a high level of transparency and information disclosure for the bonds to be issued under the GBP, by making reference to common industry standards on the offering documents as well as the use of “plain language” documents in the retail bond offers.

34. Arrangements will also be made to carry out a market awareness programme with the help of co-arranger banks appointed for managing and offering of retail government bonds. To increase general public awareness about the GBP and promote investor education, announcements will be made to provide the public with the latest information about the GBP. A dedicated website will also be established to facilitate access to information about the GBP.

Enhancement of Liquidity of the Secondary Market

35. As for secondary market trading, a key part of our strategy is to apply the commonly used technique of reopening existing bonds as far as practicable to build up the size of individual bond issues over time so as to improve liquidity in the secondary market. Notwithstanding the fact that liquidity would probably be thin at the early stage of the GBP given a limited initial market size, we will require appointed PDs in the institutional tranche to provide two-way bid offer quotations for the bonds so as to promote secondary market trading. The PDs will be invited to broadcast bid/offer indicative prices for the government bonds on the CMU Bond Price Bulletin for better transparency. The Electronic Trading Platform will also provide a channel for the market players involved to provide indicative quotes and execute trades. We will also collaborate with industry associations to encourage a wider use of repo instruments among market players to further provide liquidity to the bonds. As for the retail tranche, placing institutions responsible for distributing retail government bonds will be required to make market by quoting the prices at which they will buy and sell retail bonds on a best effort basis. We will closely monitor the circumstances and review the need for taking any further measures for promoting secondary market liquidity.

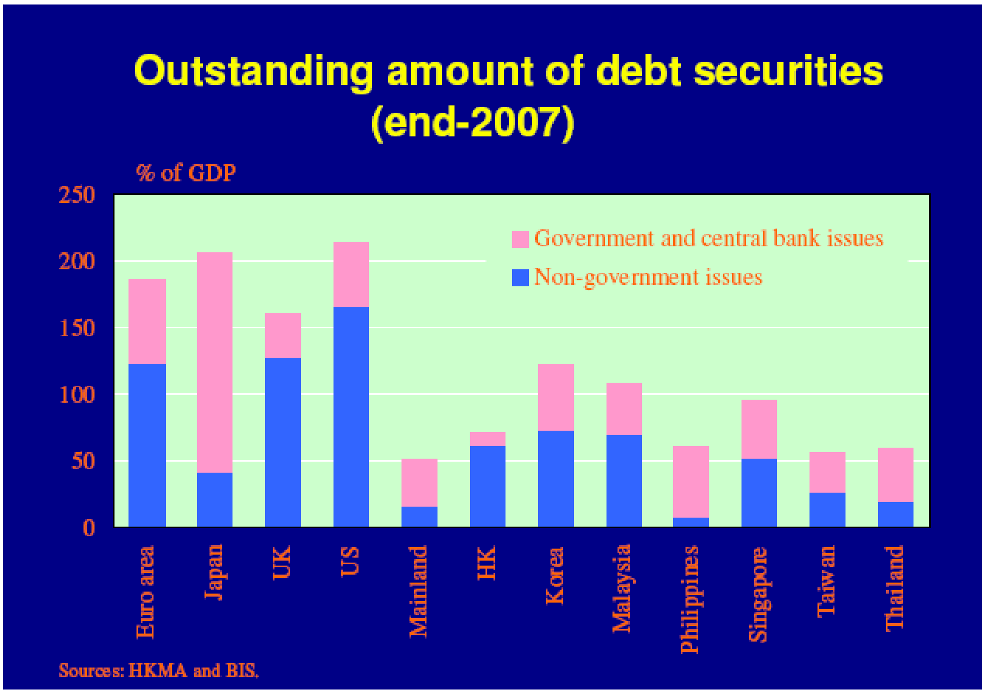
Feedback of the Industry on the GBP

36. As part of our preparatory work, we have engaged in extensive discussion with market participants (including those from the banking, brokerage, insurance and pension funds sectors) about our plan to launch the GBP. The industry is in general supportive of the proposal, and indicates interest to participate. As regards Members’ questions about the banking

sector, in face of a large quantity of surplus funds in the banking system at present, banks tend to have keen interest in investing in government bonds, especially those at the shorter end of the yield curve. Separately, the issuance of retail bonds would provide an additional source of fee income to the retail banks. It is expected that the GBP would be well received by the banking sector as well as their customers.

Financial Services and the Treasury Bureau
7 May 2009

Annex A



Outstanding amount of debt securities
(end-2007)
% of GDP
250
200
150
100
50
0
Government and central bank issues
Non-government issues
Euro area
Japan
UK
US
Mainland
HK
Korea
Malaysia
Philippines
Singapore
Taiwan
Thailand
Sources: HKMA and BIS.

Annex B

Investment Returns of the Exchange Fund
1994-2008

Year	Investment Return
1994	2.4%
1995	10.8%
1996	5.1%
1997	6.1%
1998	12.1%
1999	10.8%
2000	4.8%
2001	0.7%
2002	5.1%
2003	10.2%
2004	5.7%
2005	3.1%
2006	9.5%
2007	11.8%
2008	-5.6% (unaudited)
Compound Annual Investment Return (1994-2008)	6.1%

Source: HKMA