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小組委員會有關
根據＜借款條例＞第3（1）條提出的決議

二零零四年一月十六日的會議跟進事項

多謝你在二零零四年一月二十一日的來函。

爲回應你要求索取列於跟進事項第1（a）項的投資指引，隨函附上政府發給各有需要管理政府基金的政策局及部門作參考的「投資指引」。該指引祇用英文刊載。

至於跟進事項第1（b）項，政府並沒有發給法定機構特定的投資指引。這些機構各自設有它們的財務／投資委員會，用以制定它們本身的投資策略及指引來符合它們特定的目標和要求。法定機構，例如香港房屋委員會，機場管理局，九廣鐵路公司，投資於債券的信貸評級會取決於

它們本身的投資策略，而該投資組合中的資產必須擁有投資級別或以上的信貸評級。

「投資指引」的電子版會根據你來信上指定的電郵地址另外發給梁美琼女士。

財經事務及庫務局局長

(袁民忠　　　　代行)

副本存：陳鑑林議員（主席）

二零零四年一月二十八日

Investment Guide

The Treasury
Hong Kong

March 1999
[updated January 2004]

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CHAPTER 1 - INTRODUCTION AND OVERVIEW

1.1 Purpose of the Guide

1.1.1 There are an increasing number of funds being managed by government departments. They may be in the form of :-

- donations,
- funds set up for schemes of special/designated purposes,
- money of general public held for administrative or legal proceeding purposes, or
- operating surplus of trading funds or financially autonomous bodies.

1.1.2 This Guide prepared by the Treasury aims at providing a handy reference for government departments who are required to set up and manage funds. It outlines the key steps in investment planning and the necessary controls for investment dealing activities in departments. In addition, specific features of funds managed by government departments, such as statutory requirements, and some other useful investment references are highlighted for attention. They are, however, by no means exhaustive.

1.1.3 Funds managed by government departments may differ in nature and in size, and are mostly subject to different authority to invest. This Guide is not intended to dictate the investment operations in departments. Taking into account the guidelines and references given in this Guide, departments are advised to formulate their own investment strategies and guidelines to meet their specific requirements and environments. The approval from the respective authorities to invest should always be sought and observed and the responsibility to comply with the requirements of the relevant authorities and to ensure accountability remains with the controlling officers.

1.2 Basic Steps in Funds Management

1.2.1 The basic steps in funds management by departments are summarized in the following chart, which will be elaborated in the subsequent chapters.

1. Observe the requirements/restrictions specified in the legal authority to invest and/or by the approving authority
2. Ascertain the fund size & project cash requirement in short term, medium term and long term
3. Determine the investment objectives
4. Formulate the investment strategy
5. Select the counterparties
6. Seek the endorsement on investment objectives, strategy and counterparties from the approving authority
7. Manage investment dealing and settlement activities
8. Keep accounts, assess performance & report to management
9. Review & feedback

CHAPTER 2 - KEY AREAS FOR INVESTMENT PLANNING

2.1 <u>Authority to Invest</u>

2.1.1 The authority for investment of funds by government departments is usually given by a statutory provision. The related Ordinance stipulates the approving authority for investment matters and may give specific investment directions. For example,

Types of funds	***Examples***	***Related statutory provisions on investment of funds***
Donation	Agricultural Products Scholarship Fund of the AFCD	S 9D of Agricultural Products (Marketing) Ordinance "The trustee may invest any of the moneys of the fund in investments of any kind whether such investments are permitted for the investment of trust funds or not, subject, in the case of investments which are not so permitted, to the prior approval of the Financial Secretary."
Fund for specific scheme	Traffic Accident Victims Assistance Fund of the SWD	S 8 of Traffic Accident Victims (Assistance Fund) Ordinance "The Director may invest any moneys of the fund in such investments as the Financial Secretary may direct, whether or not such investments are investments authorized under the Trustee Ordinance."
Money held on behalf of third parties	Bankruptcy Estates Account of the ORO	S 128A (1) of Bankruptcy Ordinance "Whenever the cash balance standing to the credit of ....(the Bankruptcy Estates Account) is in excess of the amount which, in the opinion of the Official Receiver, is required for the time being to answer demands in respect of debtor's estates, the Official Receiver may deposit the whole or any part of that excess with a bank."
Surplus Fund	Surplus fund of the Housing Authority	S 13 (1) of Housing Ordinance "Any moneys in the hands of the Authority which are not immediately required for the purposes of the Authority may be invested in such securities as may be approved by the Financial Secretary: Provided that, during such time as any moneys are due by the Authority to the Government, no such investment shall be made without the prior approval of the Financial Secretary."

2.1.2 The approving authority is usually the Financial Secretary, Secretary for Financial Services and the Treasury, Director of Bureau, Permanent Secretary or Head of Department. It normally :-

- sets direction for investment objectives,
- approves/selects investment vehicles & counterparties,
- monitors funds performance, and
- approves any change in investment strategy.

2.1.3 The approving authority may be assisted by an independent Investment Advisory Board/Committee to perform regular supervision on the investment activities.

2.2 <u>Investment Objectives</u>

2.2.1 The following factors should be considered in setting investment objectives for a fund :

a) ***Specific directions or requirements, if any, laid down in the relevant statutory provisions***

b) ***Target Return required*** **-** it may be

- to earn a better than cash rate of return,
- to protect principal/capital against inflation,
- to earn a return relative to the market indices e.g. return not lower than the Hang Seng Stock Index, or
- to earn a specific strategic level of return e.g. 10% of the capital per annum.

c) ***Risk level involved*** - Inevitably, investing involves a degree of risk. Risk is broadly defined here as the uncertainty of future net returns and includes :-

- credit risk - risk of loss because of inability of counterparty to meet its obligations. In a mark to market context, credit risk refers to the uncertainty or volatility of value as a result of changes in the credit quality of an investment.

- market risk - risk that prices of securities fluctuate in value due to changes in market conditions e.g. interest rate environment (interest rate risk), currency fluctuations (currency risk).

d) ***Cashflow requirements*** **-** It is a common requirement for funds to maintain a reasonable level of liquidity so as to have sufficient available fund in meeting expenditure on capital projects and for operational needs.

e) ***Time horizon*** **-** This would provide investors with a clearer definition of the investment horizon in accordance with the investment objectives.

2.2.2 If more than one objective is identified after considering all relevant factors, departments may need to assign the relative priority and decide the prime objective. It should be recognized that **risk normally correlates positively with return**. Investments producing the highest returns are usually those which are the most risky. If there are tight & immediate fund requirements from time to time, the prime investment objective may be to generate sufficient return to meet operational needs and risk avoidance would be the main criterion while only a reasonably good yield could be expected. Therefore, in setting the financial objectives, **departments may need to strike a balance between return, liquidity & the tolerable risk level** that best fit the financial & legal requirements of the funds.

2.2.3 For example, after considering all relevant factors, the investment objective for the Schools Provident Funds managed by the Treasury is defined as to provide contributors with a target return equal to C.P.I. + x% subject to the following risk constraints :

- to minimize a chance of requiring a Government loan, and
- to minimize a chance of achieving a return less than 5 % over any 2 years or a negative return in any one year.

Another example is the Beat Drugs Fund. Its long-term investment objective is to achieve a target return equal to C.P.I. + x% in order to maintain the real value of the fund and generate recurrent income to finance anti-drug projects.

2.3 Investment Strategy

2.3.1 Formulation of Strategy

Having defined the investment objectives, departments may formulate the investment strategy by considering :-

- the appropriate types of investment vehicle/instrument and currency that meet the objectives,

- the appropriate asset allocation model if more than one type of investment instrument is selected, and

- whether to manage the funds by in-house or external fund managers.

2.3.2 Investment Vehicle/Instrument

The investment objectives generally dictate the choice of investment vehicles/instruments. Some common types of investment vehicles and the risk associated are described briefly in the following table :-

	Particulars	***Reward***	***Risk level***	***Risk associated***
Bank deposit	• the most common type of investment	• low	• low	• default by bank
Negotiable certificate of deposit (CD)	• purchase from secondary market or direct issue from bank	• low	• low	• default by CD Issuer (Bank)
Exchange Fund bills or notes	• bills with a minimum denomination of HK$500,000 and a life of up to a year, • notes can be bought in unit of HK$50,000 with maturity ranging from 1 to 10 years • normal dealing size: HK$1m to 2m	• low	• low	• fall in market value on sale before maturity

	Particulars	***Reward***	***Risk level***	***Risk associated***
Placement with the Exchange Fund	• normal dealing size : HK$100m • maturity normally not shorter than 1 month • interest rates based upon the prevailing interbank rates	• low	• low	• nil
Other Debt instrument	• purchase from market or direct placement from the institution • coupon rate: the periodic interest payment • yield to maturity: the IRR • minimum dealing size: HK$500,000 usually	• low to medium	• low to medium	• fall in market value on sale before maturity • default by bond issuer
Equities	• primary market: direct placement of the shares from the company to the public • secondary market: trading of shares in the Stock Exchange	• high	• medium to high	• fall in market value • reduction in dividend payment • collapse of company
Unit Trust / Mutual funds	• investment in Funds that holds securities • diversification	• high	• medium to high	• fall in market value
All the above investments in foreign currencies	• should be in currencies freely convertible to HK$ • hedging need to be considered to protect against currency loss	• can be better or worse than HK$ investment	• slightly higher than equiv. HK$ investment	• same as HK$ investments above • fall in currency exchange

2.3.3 Diversification & Hedging

In general, the risks in investments can be properly reduced by ways of diversification and hedging :-

a) As markets do not all normally move in tandem, and there are periods when one investment will perform better than another, therefore, diversification by investment, by maturity, by counterparty, and/or by geographical location will help to spread the risk.

b) Hedging is a strategy designed to reduce investment risk using certain financial instruments. A hedge can help lock in existing profits. Its purpose is to reduce the volatility of a portfolio, by reducing the risk of loss. For example, financial instruments that could be held to manage interest rate and foreign currencies exposures for hedging purposes include interest rate swap agreements, forward exchange contracts, foreign currency swap agreements and options.

2.3.4 Asset Allocation

A key area of risk management is asset allocation, which involves defining the proportions of the fund to be placed in different types of investment vehicles, such as equities, bonds, deposits, etc., and/or different currencies in order to balance risk & return and to meet the overall investment objective of the fund.

a) In general,

- the portfolio of a long term growth and risk-taking fund, which can tolerate volatility of returns, may include a large percentage of equities and mutual funds and a relatively small portion of bonds and cash deposits, and

- for a short term fund with high cash flow requirement, equities will likely be excluded and the portfolio may consist of bonds, certificates of deposit and cash deposits only.

However, if the fund managed by a department is small, diversification by investment type to reduce risk may not be practicable and the choice of investment is likely limited to fixed income instruments only.

b) **Four typical asset allocation models** and the types of fund for which these models could be assigned are illustrated below. The 4 models, which are not exhaustive, could be used for different types of fund and of course could be used with some modifications:-

- Model A ("Growth") :-

Investment Types	***Target Weighting***	***Tactical Range***
Equities, Mutual Funds	60%	45% to 75%
<u>Long term : one year or over</u> Bonds, CDs, Deposits	30%	22% to 38%
<u>Short term : less than one year</u> Bonds, CDs, Deposits, Cash	10%	Any

It would be suitable for a fund which has long term objectives, and which uses investment income to supplement other forms of income, or for one reason or another does not need immediate return from the investments. Where investment is successful, the fund could perhaps improve its activities in quantity or quality at some time in the future. The investment approach here may be considered more 'risk-taking'.

- Model B ("Growth and Income") :-

Investment Types	***Target Weighting***	***Tactical Range***
Equities, Mutual Funds	40%	30% to 50%
<u>Long term : one year or over</u> Bonds, CDs, Deposits	40%	30% to 50%
<u>Short term : less than one year</u> Bonds, CDs, Deposits, Cash	20%	Any

It would be suitable for a fund which has similar long term objectives, but which is likely to be more dependent on investment income. The fund needs some income in the early years to fulfil its primary purpose. This demands an investment approach which generates some growth in the value of the fund to ensure it can perform in the long term whilst producing some current income as well. Obviously, this income yield cannot be very high.

- Model C ("Income") :-

Investment Types	***Target Weighting***	***Tactical Range***
Equities, Mutual Funds	20%	15% to 25%
<u>Long term : one year or over</u> Bonds, CDs, Deposits	40%	30% to 50%
<u>Short term : less than one year</u> Bonds, CDs, Deposits, Cash	40%	25% to 55%

It would suit a fund whose activities are shorter term, say, seven to ten years. Here, inflation is of less concern, and maximizing current yield is the important investment criterion. A small amount of the fund is allocated for growth.

- Model D ("Cash") :-

Investment Types	***Target Weighting***	***Tactical Range***
<u>Long term : one year or over</u> Bonds, CDs, Deposits	40%	30% to 50%
<u>Short term : less than one year</u> Bonds, CDs, Deposits, Cash	60%	50% to 70%

It would suit a short-term fund, say up to seven years. Risk avoidance is the main criterion and a reasonably good yield is required.

c) Departments should note that asset allocation may change, either accidentally due to changing market values, or deliberately to reflect changing circumstances. Models need to be reviewed on a yearly basis.

d) The **currency exposure** should also be considered carefully. As a guideline, no more than 30% of the fund assets should be exposed to currencies other than HK$/US$. Exposure to any individual currency other than HK$/US$ should not exceed 5% of the fund assets and exposure to currencies not freely convertible should be zero.

2.3.5 General Guidance on Management of Risk

To reduce risk relating to over-exposure and over-concentration, the then **Secretary for Financial Services (SFS) has given a general guidance on the choice of bank counterparties** (Appendix A), which will be discussed in more detail in para. 2.4.3. In addition**, the Second Schedule of the Trustee Ordinance on 'Authorized Investments'** (Appendix B) lays down restrictions for selecting certificates of deposit, bonds, equities, etc. for trust funds. For example, it is stipulated that equities should be listed on a recognized stock market or specified stock exchange as defined in section 1 of Part 1 of Schedule 1 to the Securities and Futures Ordinance, with a 5 year dividend history and a minimum market capitalization of HK$10 billion or equivalent in foreign currency. The Second Schedule could also serve as a good reference for non-trust funds managed by departments. As a general guideline, fund managers should avoid investing in companies and mutual funds that invest in derivatives and/or deal in currency speculations.

2.3.6 In-house vs. External Fund Managers

If the funds to be managed are considerable, departments may consider appointing external fund managers for portfolio management if internal expertise or resources, i.e. professional staff with expertise in funds management, are not available. However, this does not affect the responsibilities of the department to the approving authority. The benefits and costs of appointing external fund managers include :-

a) the benefits :-

- they are professionals in the investment industry with experience and technical back-up in selecting the most appropriate investment and risk diversification,

- they have access to market information more readily and would likely be able to capitalize on the growth opportunities in overseas investment,

- they can provide research support and training for in-house managers, and

- the performance of external managed portfolio can be served as a meaningful comparison for investment being managed in-house.

b) the costs :-

- annual management fee which is usually expressed as a percentage of the fund size, and

- internal resources deployed and/or cost of appointing independent party for monitoring the compliance and performance of external fund managers.

Owing to the relatively high costs involved, usually only funds with large size (say, greater than HK$100m) and frequent trading activities would be considered suitable for appointing external fund manager. In any event, the Investment Division of Financial Services and the Treasury Bureau should be consulted when a department is faced with the choice of using the "Growth" or "Growth and Income" models. Advice will be given as to whether it may be appropriate to manage the funds internally or appoint external fund manager.

2.4 <u>Counterparties</u>

2.4.1 Counterparties are defined in this Guide as persons, agents or organizations with which departments deal in the management of funds. They include :-

- **Banks/financial institutions** - the most common investment counterparties of departments as most funds managed by departments are invested in bank deposits.

- **Brokers/Investment bankers -** for securities trading or investment in bonds.

- **Fund managers -** invest and manage funds for departments if departments decide to use them.

- **Custodians -** safekeeping of investment assets such as documents of title and of certificates evidencing title to investments under the fund for departments/fund managers. The custodian may sometimes be assigned the responsibility for coordinating/consolidating the performance of fund managers. Custodians facilitate trade settlement and should be independent from the fund manager. Custodians could be custodian banks or trust companies capable of providing asset custody services. For funds managed either by an in-house or external fund manager, it is advisable for the custodian to be an organization separated from the fund manager in order to segregate the investment function from custodian function. A global custodian can be appointed for all assets or different custodians for different type of assets.

- **Settlement agents -** usually appointed to undertake the settlement process for department to ensure that investment transactions involving exchange of moneys and investment assets are properly and successfully conducted before payments are effected.

2.4.2 Departments are advised to consider the selection criteria for building up an authorized list of investment counterparties, and the appropriate exposure limits.

2.4.3 <u>Selection of Counterparties</u>

In general, credit ratings from approved credit rating agencies (which, at present, include Standard & Poor’s, Moody’s Investors Service, Rating & Investment Information, Inc., Fitch Ratings, and the list may be expanded from time to time), total assets and shareholder’s equity, and/or other information about the capability, stability and performance of a counterparty would form the basis of selection criteria. In particular, departments may note the following guidance :-

a) ***Selection of bank counterparties***

(i) The circular memo from the then SFS dated 12 February 2001 (Ref. : G6/33C II) gives a general guidance on the choice of bank counterparties. (Please see Appendix A for details). The key points include :-

- Departments should not conduct financial business of a banking nature with an institution which has not been granted Authorized Institution status by the Hong Kong Monetary Authority (HKMA).

- Maximum exposure to any one institution should be kept within set limits, preferably in the region of
  - ◊ 1% of the overall deposit base of that institution, and
  - ◊ 10% of the capital base of that institution.

- Funds with any one institution should be subject to a maximum exposure equivalent to 20% of the total funds under management. For fund under HK$100m in size, the exposure to any one institution could be limited to 50% of the total fund.

- Departments transacting HK$ debt securities business are advised to consider institutions designated as Recognized Dealers and Market Makers in Exchange Fund Paper by the HKMA.

- As an alternative, funds may be placed either in Exchange Fund Paper or directly with the Exchange Fund.

(ii) Information on capital base or deposit base of individual banks is public information and departments, as the customers, can ask for copies from individual banks.

(iii) In addition, departments should note the Accounting Circular No. 3/96 which stipulates that departments should obtain the approval of the Director of Accounting Services before any banking, security or safe custody accounts are opened for the purposes of S25 of the Public Finance Ordinance (PFO). (See also para. 3.4). Departments dealing with non-PFO funds may also consult the Treasury on the placement of deposits with banks.

b) ***Selection of fund managers*** **-** If an external fund manager is appointed, the selection should be carried out through a competitive process. The following areas may need to be considered :-

- type of mandate (balanced or specialist),
- complementary of investment styles with investment objectives,
- past performance and experience in fund management,
- the investment process,
- regular reporting of the investment transactions, and
- support services provided (such as performance evaluation, market commentary, training).

If no in-house resources/expertise is available for the above assessment, departments may consider hiring consultants.

c) ***Selection of asset custodians*** **-** Similar to fund managers, custodians, if appointed, should be selected through a competitive process. The following aspects may need to be considered :

- credit rating and financial position,
- insurance coverage and indemnity available,
- sub-custodian network (global custodian only),
- reporting requirements,
- segregation of the fund’s and the custodian’s asset,
- internal controls, and
- availability of other support service such as performance analysis.

CHAPTER 3 - NECESSARY CONTROLS IN INVESTMENT OPERATIONS

3.1 <u>Investment Guidelines and Operational Manual</u>

3.1.1 To maintain effective control over fund management, departments are advised to develop comprehensive investment guidelines and an operational manual for the benefit of all levels of staff who are responsible for investment operations. The manual/guidelines generally include :-

- the investment objectives, strategies and policies approved by the Authority,
- a list of approved investment vehicles/instruments,
- a framework of risk management e.g. policy of diversification, asset allocation model adopted,
- a list of approved counterparties and related exposure limits, including the criteria for selecting or evaluating counterparties,
- the organizational chart setting out clearly the responsibility of each party concerned and the reporting lines,
- operational procedures for cash forecast, investment dealing, settlement and reconciliation,
- benchmarking or standards for measuring investment performance,
- accounting procedures and policies, and
- scope and approach of internal audit.

3.1.2 In preparing guidelines/manuals to meet the specific needs of the funds, departments may also wish to refer to the Guidelines for Corruption Prevention on "Investment of Surplus Funds in Fixed Income Instruments" issued by the ICAC in 2001.

3.2 <u>Segregation of Duties</u>

Adequate segregation of duties will provide a high level of protection against malpractice. Typical functions which are normally performed by different parties include :-

- setting of investment objectives, strategies and policies,
- maintenance and evaluation of the approved list of counterparties,
- investment dealing,
- settlement, confirmation and reconciliation,
- safe custody,
- evaluation of investment performance, and
- internal audit.

3.3 <u>Conflict of Interest</u>

Conflict of interest may arise when officers who have the responsibility for approving/assessing the offers or choosing the counterparties in dealing have any personal or related financial interest which might affect the objectivity of their actions and decisions. Departments should remind all officers concerned to declare their own investments regularly or report any investments which may give rise to conflict of interest between their investments and official duties in accordance with the Civil Service Regulations (CSRs) 461-466 and Civil Service Bureau Circular No. 9/2001.

3.4 <u>Operation of Bank Accounts</u>

3.4.1 Effective controls over the operation of bank accounts will reduce the risk of misappropriation.

3.4.2 As promulgated in Accounting Circular No. 3/96, the approval of the Director of Accounting Services must be obtained before any banking, security or safe custody accounts are opened for the purposes of S 25 of the Public Finance Ordinance.

3.4.3 Instructions on the operation of bank accounts are laid down in Standing Accounting Instructions 1610-1690. In particular, payment from a bank account should be effected only by cheques, which must be signed by 2 authorized signatories.

3.4.4 In addition, departments may consider the following in operating bank accounts :-

- open separate investment accounts which are independent of operational accounts,

- set appropriate financial limits for different levels of authorized signatories to effect transfer of funds,

- instruct banks to accept instructions to transfer funds only when they are made to other bank accounts in the same name as the account holder and the instructions are properly signed by 2 authorized signatories, and

- arrange to check the accounting and bank accounts independently by senior staff.

3.5 Quotations

3.5.1 The seeking of quotations for investments such as deposits and fixed interest securities is normally done by telephone and the quotations are subject to change until the deals are confirmed. To enhance control over the quotation procedures, departments may consider obtaining quotations from all approved investment counterparties. However, if it is not practicable, departments should formulate a rotation system and decide the minimum number of quotations to be obtained each time in advance. The selection can be done on a random, sequential or other basis. For example, in placing a bank deposit a department may get quotations from the 2 banks which gave the best rates last time, and select another 2 from the approved list in sequence. The formulated basis should be clearly laid down and followed consistently by the staff concerned.

3.5.2 To ensure that the quotations are fairly obtained, departments may consider the following :-

- assign at least 2 staff to call different counterparties for quotations,

- use telephones with recording system to get quotations if the volume justifies, or use conference calls to enable 2 staff to listen to telephone calls simultaneously during the quotation process, and/or

- random check the quotations against other sources and confirm the best rate by a separate officer.

3.5.3 Details of quotations (including the rates and officer-in-charge) should be properly documented to facilitate subsequent verification and checking.

3.6 Settlement, Recording and Accounting

3.6.1 Departments are advised to devise appropriate procedures for the settlement arrangements to ensure proper segregation of duties and authorization of transactions. For example, banking instructions for fund transfers and/or confirmation letters should be checked by appropriate level of officers to ensure that the details match with the data contained in the approved quotation sheets and comply with the laid down departmental guidelines. Instructions/confirmation letters should be delivered to the counterparties concerned promptly before deadline. Any discrepancy or late delivery should be followed up by senior officers.

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3.6.2 There should be procedures for reconciling the confirmation notes and bank statements received from counterparties. Procedures for proper follow-up of any outstanding confirmation notes and monthly statements not received within a specified period must be laid down. The reconciliation should be reviewed by management on a timely basis to ensure that any differences are adequately resolved or appropriate action is being taken.

3.6.3 The investment transactions should be properly recorded onto the general ledger on a timely basis. The accounting policies for investment will be discussed in Chapter 4.

3.7 Controls on External Fund Managers

To maintain effective control over fund managers and to prevent possible abuse, departments may consider the following precautions:

- setting financial limits on the aggregate level of funds placed with each fund manager,

- clear documentation of the investment objectives, policies and strategies on investments for the compliance of the fund managers and regular review of such guidelines,

- use of a separate custodian to safekeep assets managed by the manager,

- close monitoring of fund managers' performance and regular review of their performance against pre-defined benchmarks and criteria, and

- appointment or re-appointment of fund managers subject to regular review based on performance. There should be provision in the Fund Manager Agreement for termination in the event of poor performance and a mechanism to ensure the consideration of new fund managers.

3.8 Controls on Custodians

To maintain effective control, departments may consider the following prudent steps :-

- setting financial limits on the aggregate level of assets placed with each custodian,

- stipulating clearly the duties and responsibilities in the custodian agreement,

- regular reporting by custodians in respect of the investment transactions,

- obtaining evidence/information of the operation of specific internal controls in relation to safeguarding of assets and recording of transactions by the custodians,

- reconciliating custodians' records with fund managers' records and/or internal records at periodic intervals, and

- making provisions for regular review and termination in the event of poor performance in the custodian agreement. There should also be a mechanism to ensure the consideration of new custodians.

3.9 Internal Audit

3.9.1 Internal audit is a vital part of the overall control system. It is an independent appraisal service provided to the management by measuring and evaluating the effectiveness, efficiency and economy of the internal control system.

3.9.2 The internal audit functions must be carried out by officers independent from the investment functions. If the fund exceeds $100 million, the head of the internal audit should be a qualified accountant.

3.9.3 The scope of services generally include :-

- ongoing evaluation of management and operational controls to ensure that they are appropriate and effective to the level of operations,

- compliance testing to ensure that all controls are operating in accordance with the established procedures and guidelines,

- physical and substantive checks of individual transactions to ensure that all funds are safeguarded and the accounts are properly recorded, and

- investigations of non-compliance or other odd situations, and reporting to independent senior management on a timely basis.

3.9.4 The internal audit work may cover investment operations conducted by both in-house and external fund managers.

CHAPTER 4 - ACCOUNTING, MONITORING & REVIEW

4.1 Accounting

4.1.1 Departments are advised to :-

- maintain proper books of accounts and supporting documents for each fund under their management in order to provide audit trails for subsequent reviews and audits,

- select proper accounting policies for accounting and disclosure of investments, in particular, for reporting the carrying value of investments and for recognition of investment income and expenditures of their funds. For example :-

  ◊ investments may be carried in the balance sheet at :-
    ⇒ historical cost, or
    ⇒ market value, or
    ⇒ the lower of cost and market value

  ◊ investment income and expenditure may be recognized on :-
    ⇒ a cash basis, or
    ⇒ an accrual basis

- prepare annual financial statements reporting the financial position and the performance of the funds to the relevant committee and/or approving authority.

- comply with the disclosure requirements promulgated in the Statement(s) of Standard Accounting Practice issued from time to time by the Hong Kong Society of Accountants.

4.1.2 In considering the accounting policies, departments may refer to the Hong Kong Society of Accountants' Statement of Standard Accounting Practice No. 24 on 'Accounting for Investments in Securities', International Accounting Standard No. 32 on 'Financial Instruments: Disclosure and Presentation' and International Accounting Standard No. 39 on 'Financial Instruments: Recognition and Measurement'.

4.2 Performance Measurement

4.2.1 Departments are advised to evaluate the performance of the investment portfolio to determine whether the investment objectives are met on a regular basis. The performance can be measured against some benchmarks that can reflect the investment objectives of the fund. Common benchmarks include :-

- a fixed rate of return,
- a three-month Hong Kong Interbank Offer Rate,
- an inflation related index, and
- an equity/bond index related measure.

4.2.2. In particular, the investment performance in mutual funds should be reviewed against the performance of similar funds in the industry.

4.3 Reports to Management

4.3.1 Regular management reports should be submitted to the department head, Investment Advisory Committee, and/or approving authority from time to time. The frequency and details may be specified by the approving authority or its delegates as appropriate. The reports generally include :-

- the consolidated funds position,
- the investment results for the period,
- comparison of the current performance with the targets or benchmarks already set, and explanations/comments on significant differences,
- projections and/or market outlook, and
- highlight of exceptions or confirmation of full compliance to the approved Investment Guidelines.

4.4 Audit

4.4.1 Departments should appoint an external auditor, who may be the Director of Audit or other auditors as appropriate, to carry out audit of the annual financial statements. The audit will enable the department to :-

- comply with the requirements laid down by the approving authority or the relevant statutory provisions, and

- enhance the credibility of the financial statements.

4.4.2 The auditor would, based on the audit conducted, express an independent opinion on whether the financial statements, in all material respects, are properly presented and whether they have been prepared in accordance with the provisions laid down in relevant ordinance or by the approving authority.

4.4.3 Subject to the requirements laid down in the relevant ordinances or by the approving authority, departments are usually required to submit the audited financial statements, together with a report by the Director on the administration of the fund during the period.

4.5 Review & Feedback

4.5.1 To better monitor the investment operations and provide feedback, departments are advised to carry out :-

- reviews on the investment objectives and strategies when there are changes in statutory provisions, fund flow requirements, and/or the investment environment,

- reviews on the current status of counterparties on the approved list on a regular basis to ensure that the established selection criteria are being met and the exposure limits, if applicable, are still appropriate, and

- continuous assessment of the internal controls built in the operational procedures to ensure that they are effective and relevant to the changing circumstances.

4.5.2 Departments are advised to take immediate action to update the investment strategies and/or improve the operational procedures whenever appropriate.

Appendix A

Circular Memorandum

From	Secretary for Financial Services	*To*	Bureau Secretaries Heads of Departments
Ref.	in G6/33C II	*(Attn. :*	*)*
Tel. No.	2527 3974	*Your Ref.*	in
Fax No.	2527 0790	*Dated*	*Fax No.*
Date	12 February 2001	*Total Pages*	8

The Choice of Bank Counterparties
In the Investment of Public Assets

I refer to this Bureau's circular memorandum dated 2 April 1996 (copy without attachment at Annex A).

2. I enclose at Annex B the HKMA Guidance on the choice of bank counterparties in the investment of public assets updated as at February 2001. Updates have been made to the contact details and technical terms therein. The Guidance remains the same in substance.

(Edward Mak)
for Secretary for Financial Services

Annex A

Circular Memorandum

From	Secretary for Financial Services	To	Branch Secretaries Heads of Departments
Ref.	in G6/33C (96)·II	(Attn. :	)
Tel. No.	2528 9076	Your Ref.	in
Fax No.	2528 3345	Dated	Fax No.
Date	2 April 1996	Total Pages	

The choice of bank counterparties in the investment of public assets

Branches and departments are from time to time required to open bank accounts in the course of discharging their official duties. This involves credit exposure, and the choice of the bank with which to do business is an important decision. The Hong Kong Monetary Authority (HKMA) has prepared a general guidance on the choice of banks for use by branches and departments when the need to operate bank accounts arises. A copy of the guidance is attached.

2. Enquiries concerning the guidance should be referred to the HKMA direct (see section 7 for telephone numbers). Enquiries on new applications for the opening of bank accounts should be directed to the Director of Accounting Services who has been designated the authority to approve the opening of bank accounts under section 25 of the Public Finance Ordinance with effect from 29 March 1996. Financial Circular No. 7/96 of 29 March 1996 refers.

3. This memorandum supersedes the circular memorandum of 1 October 1991 by the Secretary for Monetary Affairs on the placement of bank deposits.

(David Leung)
for Secretary for Financial Services

THE CHOICE OF BANK COUNTERPARTIES IN THE INVESTMENT OF PUBLIC ASSETS: GUIDANCE FROM THE HONG KONG MONETARY AUTHORITY

1. *Introduction*

1.1 Those responsible for the management of public money are also responsible for the choice of suitable bank counterparties for the conduct of their management of public assets. There are two areas where this is particularly important: first the opening of current accounts for the handling of transactions, and secondly the choice of banks for fixed term deposits and other financial investments. Both of these involve credit exposure, and the choice of the bank with which to do business is therefore an important one.

1.2 The Hong Kong Monetary Authority (HKMA), as the supervisor of all banks and other authorised institutions in Hong Kong, is in receipt of privileged information on those institutions the disclosure of which is prohibited in law save in certain specified circumstances. The HKMA will therefore never be in a position to comment on any particular institution by name, or answer any direct request on the suitability of a particular institution. This includes requests from other areas of the Government and public sector. The advice that follows is therefore necessarily of a more general nature.

1.3 As an alternative to investments with or through bank counterparties, the HKMA continues to offer managers of public assets the option of placing money direct with the Exchange Fund. This guidance note therefore concludes with a section setting out some of the terms and conditions under which such placements can be made (see section 6).

2. *The status of Authorised Institutions*

2.1 The HKMA supervises three types of financial institutions in Hong Kong. These are licensed banks, restricted licence banks and deposit-taking companies. Taken together the institutions are known as Authorised Institutions (AIs). The status of AI indicates that the institution has been authorised to conduct banking or deposit-taking business in Hong Kong and is supervised by the HKMA. **It does not imply any statement or guarantee from the HKMA as to the institution's solvency or financial health.**

2.2 Despite the limited nature of the assurances that can be drawn from an institution's status as an AI, the HKMA advises that in general, and unless there are very sound overriding reasons, **Government and public sector bodies should not conduct financial business of a banking nature with an institution which has not been granted AI status.** A full list of AIs can be obtained from the Public Registry of the HKMA (for contact telephone number see section 7 below).

3. ***Over-exposure to an institution***

3.1 In managing banking relationships, it is unwise for any creditor to become too large a part of its banking counterparties' business. Such a position carries with it two risks. The first is **liquidity risk**. This is the risk that, when the creditor requests repayment of its deposit or call balance, the institution cannot supply the cash due to a lack of liquidity. The second is **insolvency risk**, which is the risk that the institution becomes insolvent and cannot repay the creditor in full or even at all.

3.2 These risks apply to all depositors, both large and small and both private and institutional/professional. Managers of public assets should be aware that in any liquidation of a bank or deposit taking company, they will be treated the same way as other depositors, and will not be given special treatment because of their public status. They would be treated equally with other "professional investors", who are deemed able to control their own exposure themselves to the two risks outlined above. It is important that the investment guidelines that managers of public assets operate under address these two risks.

3.3 This is best achieved by ensuring that exposures are in general spread amongst several counterparties, with the exposure to any one institution kept within set limits. In the case of liquidity risk, such a limit will refer most commonly to the size of the institution's overall deposit base. In the case of credit risk, it is more appropriate to refer the limit to the institution's capital base, out of which, ultimately, losses are funded and depositors repaid in times of stress.

3.4 There is no one correct answer as to what figure is appropriate in each case, but the HKMA would feel comfortable with guideline limits for managers of public assets that were in the region of :

(a) **a maximum exposure to an institution of 1% of the overall deposit base of that institution;**

(b) **a maximum exposure to an institution of 10% of the capital base of that institution.**

Both the deposit base and the capital base of AIs are publicly available data.

4. *Concentration of exposures*

4.1 Because of the risk of a delay in receiving good value for one's assets, or even an outright default, it is equally unwise for an investment manager in charge of significant assets to concentrate all of his deposit business with too small a number of banks. To do so exposes him to **concentration risk**, and just as a manager will not wish to be a large part of any one bank's business, he will not wish any one bank to dominate his deposit placement activities, for then a failure by the bank will have very damaging consequences for the investment fund that he is responsible for.

4.2 Concentration of bank exposures via e.g. deposits should be controlled by making each exposure subject to an overall limit which refers to the size of the fund of assets under management. For small funds, it may be inappropriate to divide up the assets under management into too many very small parcels, and for funds under $100 million in size, it may be sufficient merely to ensure that deposit exposures are split between two or three banks, with the exposure to any one bank not exceeding say 50% of the assets in the fund. For larger funds the HKMA would draw more comfort from a wider distribution of banking deposit risk, and managers of large funds may wish therefore to establish guidelines that specify a smaller maximum percentage for deposits with any one bank. A suitable guideline would be that **funds with any one institution should be subject to a maximum exposure equivalent to 20% of the total funds under management.**

4.3 This figure should be used in conjunction with the two figures referred to in section 3 above (i.e. limits derived as a percentage of a bank's deposit base and capital base). In the first place they should be used to ensure that the institution being considered is suitable for the level and magnitude of business being proposed. If the implied limits derived from the formulae in section 3 for a certain institution are very much smaller than that derived from paragraph 4.2 above, managers should consider whether it is either appropriate or administratively worthwhile to conduct business with that institution. Secondly, after the accounts have been opened or deposits have been entered into, the three limits in sections 3 and 4 form ongoing credit limits to ensure the level of exposures stay appropriate as circumstances change (both the size of the funds under management and the size of the bank counterparties).

5. *The suitability of the AI chosen*

5.1 Adequate size to handle the proposed business is not the only criterion that managers should use in assessing the suitability of an AI counterparty. Not all AIs will be active in every sphere, and those managing public assets also have the responsibility of ensuring that the counterparties selected are competent to carry out the business offered to them. It can be assumed that all banks will offer current or call account facilities, and that all AIs will take deposits at market-related rates (though it should be noted that restricted licence banks and deposit-taking companies have restrictions on their deposit taking activities in terms of size and maturity of deposits). But for other transactions, such as loans, foreign exchange (spot and forward), securities settlements etc, it is necessary to ensure not just that the institution chosen *can* perform the tasks requested, but that it is sufficiently familiar with them to do so to a high degree of accuracy and competence in all instances.

5.2 A particular area where this is relevant is investment in securities. In such investments, it is important to ensure that the counterparty with whom the business is conducted is fully competent in the required fields. In the particular field of debt securities, managers of public assets will be able to draw comfort from a proven capability in handling Exchange Fund paper. This has the advantage that those banks which are active participants in the Exchange Fund bills and notes markets can by using their holdings of Exchange Fund paper have access to the HKMA's Discount Window, thus offering them an extra guaranteed source of liquidity. This in turn will enable those institutions to be in a position to offer the finest terms and tightest bid-offer spreads to large professional investors.

5.3 For these reasons, **Government and public sector bodies wishing to transact HK$ debt securities business would be advised to consider the merits of doing so through those institutions designated as Recognised Dealers and Market Makers in Exchange Fund paper by the HKMA.** Such institutions are regularly supervised by the HKMA to ensure that they maintain the appropriate commitment to the markets (including for market makers the commitment to making two-way prices in securities), and that they operate in a suitable and appropriate manner to preserve the integrity and stability of the market. A list of these institutions can be obtained from Mr Francis Chu, Head of Monetary Operations Division at the HKMA (for contact telephone number see section 7 below).

6. *Investments with the Exchange Fund*

6.1 Managers of public assets can as an alternative way of investing monies place funds either in Exchange Fund paper or directly with the Exchange Fund. Both methods are particularly suitable for those managers of public assets of reasonable size who wish to diversify their portfolio by investing a proportion of it in lower risk assets.

6.2 The market for Exchange Fund Bills and Notes is the premier debt market in Hong Kong dollars. As overseer of the market, the HKMA welcomes the participation of Government and public sector bodies as investors in these instruments, provided that those managing the assets can demonstrate that the fund under their control is authorised to hold these instruments; that they understand the risks inherent in the instruments; and that they are satisfied that the risks are appropriate for the fund in question.

6.3 Exchange Fund paper is available as either Bills, which have a minimum denomination of $500,000 and a life of up to a year, or Notes, which can be bought in units of $50,000 and carry maturities ranging up to 10 years. They are issued by the HKMA on behalf of the Government for the account of the Exchange Fund, and as they carry the credit risk of the Government's Exchange Fund, their fields will tend to be slightly below that of the corresponding wholesale interbank rates and yields of other HK$ debt securities. However, there is an active and liquid market for Exchange Fund paper which can be sold easily at any time before their maturity. Exchange Fund paper can be purchased at the regular tenders or in the secondary market through Recognised Dealers or Market Makers who would normally provide custodian/nominee service to hold such paper on behalf of investors. As mentioned in section 5 above, a full list of such institutions is available on request from Mr Francis Chu, Head of Monetary Operations Division (for contact telephone number see section 7 below). As from 16 August 1999 Exchange Fund Notes have been listed on The Stock Exchange of Hong Kong.

6.4 The second option open to managers of public assets is the Scheme of Placements direct with the Exchange Fund. Under this scheme, managers of public assets may place funds amounting to $100 mn or more with the Exchange Fund. The placements may be for any maturity of not shorter than one month, and the Exchange Fund will offer interest rates based upon the prevailing interbank rates. In some circumstances smaller sums or placements for shorter periods may be accepted, subject to different conditions and to the availability of HKMA staff resources. Further information on the Scheme, and the necessary arrangements for participating in it, can be obtained from the HKMA from Mr Francis Chu, Head of Monetary Operations Division, or

Mr Barry Yip, Senior Manager (Monetary Operations) (for contact telephone numbers see section 7 below).

7. *__Contact telephone numbers at the HKMA__*

HKMA Public Registry :	
Mr Jimmy Ko	2878 1641
Advice on Exchange Fund paper and Market Makers/Recognised Dealers :	
Mr Francis Chu, Head (Monetary Operations)	2878 8169
Advice on the Scheme of Placements with the Exchange Fund :	
Mr Francis Chu, Head (Monetary Operations)	2878 8169
Mr Barry Yip, Senior Manager (Monetary Operations)	2878 8104

Hong Kong Monetary Authority
February 2001

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Section of Enactment

Chapter:	29	Title:	TRUSTEE ORDINANCE	Gazette Number:	L.N. 12 of 2003
Schedule:	2	Heading:	**AUTHORIZED INVESTMENTS**	Version Date:	01/04/2003

[section 4]

1. Any shares or debentures which are issued or allotted by a company and which satisfy the following conditions at the date the investment is made-
(a) in the case of shares-

(i) the shares are listed on a recognized stock market or specified stock exchange as these terms are defined in section 1 of Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap 571); (Replaced 5 of 2002 s. 407(2))
(ii) the market capitalization of the company issuing the shares is not less than $10 billion ($10000000000) or its equivalent in foreign currency; and
(iii) the company has paid, in each of the 5 years immediately preceding the calendar year in which the investment is made, a dividend wholly in cash (except to the extent that any shareholder may have opted to accept it other than wholly in cash) on all the shares issued by the company, excluding any shares issued after the dividend was declared and any shares which by their terms of issue did not rank for the dividend in that year; (b) in the case of debentures, the security meets the credit rating as specified in the Table.

For the purposes of subparagraph (a)(iii) a company formed-

(i) to take over the business of another company or other companies; or
(ii) to acquire the securities of, or control of, another company or other companies,

or for either of those purposes and for other purposes shall be deemed to have paid a dividend as mentioned in that subparagraph in any year in which such a dividend has been paid by the other company or all the other companies, as the case may be.
2. Any debt security which is issued by, or the payment of principal and interest on which is guaranteed by-

(a) in Hong Kong, the Government of Hong Kong, the Exchange Fund established by the Exchange Fund Ordinance (Cap 66) or a company 100% of the shares in which are owned beneficially by the Government of Hong Kong; or
(b) outside Hong Kong, the government, the central bank or an equivalent agency of a country which qualifies for the credit rating specified in the Table; or

(c) any multilateral agency specified in Part 4 of Schedule 1 to the Securities and Futures Ordinance (Cap 571) which qualifies for the credit rating specified in the Table. (Amended 5 of 2002 s. 407(2))

3. Any unit trust or mutual fund authorized as a collective investment scheme under section 104 of the Securities and Futures Ordinance (Cap 571). (Replaced 5 of 2002 s. 407(2))
4. Any deposit (as defined in section 2 of the Banking Ordinance (Cap 55)) with an authorized institution.
5. Certificates of deposit, bills of exchange, promissory notes or short-term (i.e. less than 1 year) debt securities issued or guaranteed by an authorized institution or by an exempted body.
6. First legal mortgages of any property, including an undivided share in property, which is situated in Hong Kong and held under a Government lease of which the unexpired term at the time of investment is not less than 50 years, excluding any term for which the lease can be renewed. (Amended 29 of 1998 s. 105)
7. Any derivatives which are traded on a recognized stock market, specified stock exchange, recognized futures market or specified futures exchange as these terms are defined in section 1 of Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap 571); except that an investment under this paragraph- (Amended 5 of 2002 s. 407(2))

(a) shall be made for hedging purposes only, that is to say, the derivatives acquired shall be of a type and specification suitable for reducing the impact on the trust fund of a diminution in the value of specific assets already held by the trust fund or which are to be acquired at the same time as the derivatives; and
(b) shall not be made except in accordance with the written advice of a corporation licensed to carry on, or an authorized financial institution registered for carrying on, a business in advising on securities, advising on futures contracts, advising on corporate finance or asset management under Part V of the Securities and Futures Ordinance (Cap 571) expressly obtained as to- (Amended 5 of 2002 s. 407(2))

(i) the nature and extent of the risk of diminution in the value of the assets in question, the type and specification of the derivatives suitable to reduce the impact of such diminution in value, and generally the strategy to be adopted in acquiring, holding and disposing of the derivatives;
(ii) the potential loss that could result from acquiring and holding the derivatives and the risk of such occurring; and
(iii) the nature and extent of the various risks of diminution in the value of the trust fund and the suitability of using derivatives to protect against those risks.

8. In this Schedule-
"authorized institution" (認可機構) has the meaning assigned to it in section 2 of the Banking Ordinance (Cap 155);
"bill of exchange" (匯票) and "promissory note" (承付票) have the same meanings as in the Bills of Exchange Ordinance (Cap 19);
"certificate of deposit" (存款證) means a document relating to money, in any currency, which has been deposited with the issuer or some other person, being a document-

(a) which recognizes an obligation to pay a stated amount to bearer or to order, with or without interest; and
(b) by the delivery of which, with or without endorsement, the right to receive that stated amount, with or without interest, is transferable;

"company" (公司) means a body corporate-

(a) incorporated under the Companies Ordinance (Cap 32);
(b) incorporated under any other enactment; or
(c) incorporated or established outside Hong Kong;

"debentures" (債權證) includes debenture stock, bonds and any other securities of a company whether or not constituting a charge on the assets of the company;
"debt security" (債務證券) means-

(a) debenture or loan stock;
(b) debentures, bonds, notes and other securities or instruments acknowledging, evidencing or creating indebtedness, whether secured or unsecured;
(c) options, warrants or similar rights to subscribe to or purchase any of the foregoing; and
(d) convertible loan stock;

"derivative" (衍生工具) means any right in or to a financial contract or financial instrument the value of which is determined by reference to the value of or any fluctuation in the value of a share, index, rate of exchange or rate of interest either individually or in the aggregate;
"exempted body" (豁免團體) means a body specified in Part 3 of Schedule 4 to the Securities and Futures Ordinance (Cap 571) but does not include a body referred to in item 11 of that Part; (Replaced 5 of 2002 s. 407(2))
"shares" (股份) means shares in the capital of a company and includes the stock or any part of the stock of a company;

(Amended 5 of 2002 s. 407(2))

TABLE

CREDIT RATINGS

(a)	For long-term debt (one year or over)- Given by Moody's Investors Service Inc. Standard & Poor's Corporation or an equivalent rating given by any recognized credit rating agency approved by the Secretary for Financial Services and the Treasury. (Amended L.N. 106 of 2002)	A3 A-
(b)	For short-term debt (less than one year)- Given by Moody's Investors Service Inc. Standard & Poor's Corporation or an equivalent rating given by any recognized credit rating agency approved by the Secretary for Financial Services and the Treasury. (Amended L.N. 106 of 2002)	Prime-1 A-1

(Second Schedule replaced L.N. 177 of 1995)

Previous section of enactment **Next section of enactment** **Switch language** **Back to the List of Laws**

Appendix C

Some Other Useful References :-

- Accounting Circular No. 3/96 on 'Opening & Operation of Bank Accounts' (3 May 1996)

- Civil Service Bureau Circular No. 9/2001 on 'Declaration of Investments by Civil Servants' (15 May 2001)

- Guidelines for Corruption Prevention issued by the ICAC -- Investment of Surplus Funds in Fixed Income Instruments (2001)

- Hong Kong Society of Accountants' Statement of Standard Accounting Practice No. 24 -- Accounting for Investments in Securities (April 1999)

- International Accounting Standard No. 32 – Financial Instruments: Disclosure and Presentation

- International Accounting Standard No. 39 – Financial Instruments: Recognition and Measurement

- List of Licensed Banks, Restricted Licence Banks, Deposit-taking companies, etc from the Web Site of the Hong Kong Monetary Authority (HKMA) (http://www.info.gov.hk/hkma)

- SFC Publications and Advice to Investors, etc. from the Web Site of the Hong Kong Securities and Futures Commission (http://www.hksfc.org.hk)

- "Ratings Definitions", etc. from the Web Site of Standard & Poor's (http://www.standardpoors.com)

- "Rating Definitions", etc. from the Web Site of Moody's Investors Service (http://www.moodys.com); Moody's Global Ratings Guide by Moody's Investors Service