

財經事務及庫務局  
(庫務科)

香港下亞厘畢道  
中區政府合署



FINANCIAL SERVICES AND THE  
TREASURY BUREAU  
(The Treasury Branch)

Central Government Offices,  
Lower Albert Road,  
Hong Kong

傳真號碼 Fax No. : 2801 7135  
電話號碼 Tel. No. : 2810 2971  
本函檔號 Our Ref. : FIN 150/7/1 Pt.1  
來函檔號 Your Ref. : CB(3)/PAC/R42

香港中區  
昃臣道8號  
立法會大樓  
立法會政府帳目委員會秘書  
(經辦人：徐偉誠先生)

徐先生：

審計署署長衡工量值式審計結果報告書  
(第四十二號報告書)  
第 2 章：對應用研究基金投資項目的撥款

二零零四年五月十一日來函收悉。庫務署曾於一九九九年三月發出投資指南(只備英文版)，並於二零零四年一月予以更新。該指南旨在為需要成立和管理基金的政府部門提供有用的參考資料，其內概述部門進行投資策劃的重要步驟，以及進行投資買賣活動，包括將剩餘資金投資所需採取的監管措施。有關指南現隨函附上。

財經事務及庫務局局長  
(尤桂莊代行)

副本送： 工商及科技局局長  
創新科技署署長  
審計署署長  
內部  
財經事務及庫務局局長政務助理

二零零四年五月十七日

# *Investment Guide*



The Treasury  
Hong Kong

March 1999  
*[updated January 2004]*

**TABLE OF CONTENTS**

	<u>Page</u>
<b>1. Introduction and Overview</b>	
<b>1.1 Purpose of the Guide</b>	<b>1</b>
<b>1.2 Basic Steps in Funds Management</b>	<b>2</b>
<b>2. Key Areas for Investment Planning</b>	
<b>2.1 Authority to Invest</b>	<b>3</b>
<b>2.2 Investment Objectives</b>	<b>4</b>
<b>2.3 Investment Strategy</b>	
<b>2.3.1 Formulation of Strategy</b>	<b>6</b>
<b>2.3.2 Investment Vehicle/Instrument</b>	<b>6</b>
<b>2.3.3 Diversification &amp; Hedging</b>	<b>8</b>
<b>2.3.4 Asset Allocation</b>	<b>8</b>
<b>2.3.5 General Guidance on Management of Risk</b>	<b>11</b>
<b>2.3.6 In-house vs. External Fund Managers</b>	<b>11</b>
<b>2.4 Counterparties</b>	<b>12</b>
<b>3. Necessary Controls in Investment Operations</b>	
<b>3.1 Investment Guidelines and Operational Manual</b>	<b>16</b>
<b>3.2 Segregation of Duties</b>	<b>17</b>
<b>3.3 Conflict of Interest</b>	<b>17</b>
<b>3.4 Operation of Bank Accounts</b>	<b>17</b>
<b>3.5 Quotations</b>	<b>18</b>
<b>3.6 Settlement, Recording and Accounting</b>	<b>19</b>
<b>3.7 Controls on External Fund Managers</b>	<b>20</b>
<b>3.8 Controls on Custodians</b>	<b>20</b>
<b>3.9 Internal Audit</b>	<b>21</b>
<b>4. Accounting, Monitoring &amp; Review</b>	
<b>4.1 Accounting</b>	<b>22</b>
<b>4.2 Performance Measurement</b>	<b>23</b>
<b>4.3 Reports to Management</b>	<b>23</b>
<b>4.4 Audit</b>	<b>24</b>
<b>4.5 Review &amp; Feedback</b>	<b>24</b>

**LIST OF APPENDICES**

- A. Circular memorandum from the then Secretary for Financial Services of 12 February 2001 on “The Choice of Bank Counterparties In the Investment of Public Assets”
- B. Second Schedule of the Trustee Ordinance on “Authorized Investments”
- C. Some Other Useful References

*\*委員會秘書附註：各附錄並無在此隨附。*

## **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 :-

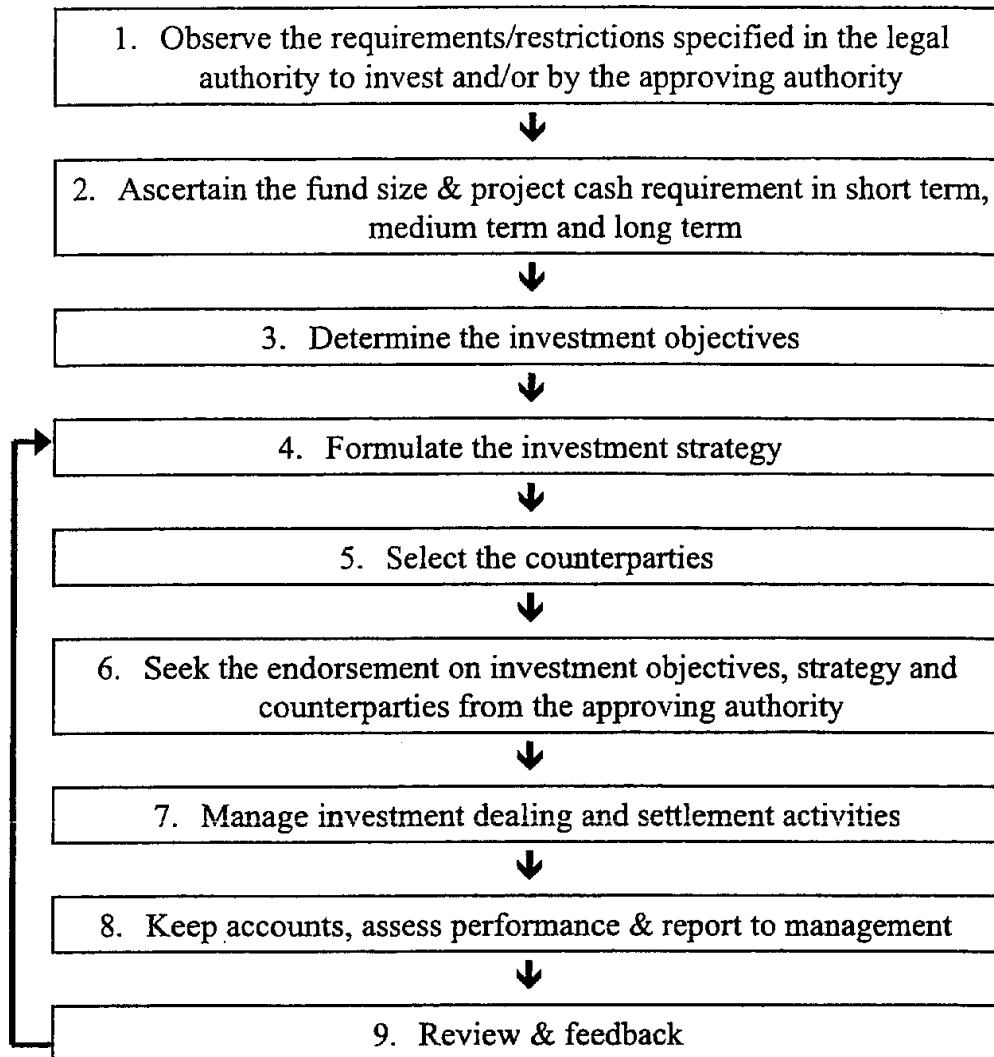
- donations,
- funds set up for schemes of special/designated purposes,
- money of general public held for administrative or legal proceeding purposes, or
- operating surplus of trading funds or financially autonomous bodies.

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.



## CHAPTER 2 - KEY AREAS FOR INVESTMENT PLANNING

2.1 Authority to Invest

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,

<i>Types of funds</i>	<i>Examples</i>	<i>Related statutory provisions on investment of funds</i>
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 Investment Objectives**

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 :-

	<i><b>Particulars</b></i>	<i><b>Reward</b></i>	<i><b>Risk level</b></i>	<i><b>Risk associated</b></i>
<b>Bank deposit</b>	<ul style="list-style-type: none"> <li>• the most common type of investment</li> </ul>	• low	• low	• default by bank
<b>Negotiable certificate of deposit (CD)</b>	<ul style="list-style-type: none"> <li>• purchase from secondary market or direct issue from bank</li> </ul>	• low	• low	• default by CD Issuer (Bank)
<b>Exchange Fund bills or notes</b>	<ul style="list-style-type: none"> <li>• bills with a minimum denomination of HK\$500,000 and a life of up to a year,</li> <li>• notes can be bought in unit of HK\$50,000 with maturity ranging from 1 to 10 years</li> <li>• normal dealing size: HK\$1m to 2m</li> </ul>	• low	• low	• fall in market value on sale before maturity

**Investment Guide**

	<i>Particulars</i>	<i>Reward</i>	<i>Risk level</i>	<i>Risk associated</i>
<b>Placement with the Exchange Fund</b>	<ul style="list-style-type: none"> <li>• normal dealing size : HK\$100m</li> <li>• maturity normally not shorter than 1 month</li> <li>• interest rates based upon the prevailing interbank rates</li> </ul>	• low	• low	• nil
<b>Other Debt instrument</b>	<ul style="list-style-type: none"> <li>• purchase from market or direct placement from the institution</li> <li>• coupon rate: the periodic interest payment</li> <li>• yield to maturity: the IRR</li> <li>• minimum dealing size: HK\$500,000 usually</li> </ul>	• low to medium	• low to medium	<ul style="list-style-type: none"> <li>• fall in market value on sale before maturity</li> <li>• default by bond issuer</li> </ul>
<b>Equities</b>	<ul style="list-style-type: none"> <li>• primary market: direct placement of the shares from the company to the public</li> <li>• secondary market: trading of shares in the Stock Exchange</li> </ul>	• high	• medium to high	<ul style="list-style-type: none"> <li>• fall in market value</li> <li>• reduction in dividend payment</li> <li>• collapse of company</li> </ul>
<b>Unit Trust / Mutual funds</b>	<ul style="list-style-type: none"> <li>• investment in Funds that holds securities</li> <li>• diversification</li> </ul>	• high	• medium to high	• fall in market value
<b>All the above investments in foreign currencies</b>	<ul style="list-style-type: none"> <li>• should be in currencies freely convertible to HK\$</li> <li>• hedging need to be considered to protect against currency loss</li> </ul>	• can be better or worse than HK\$ investment	• slightly higher than equiv. HK\$ investment	<ul style="list-style-type: none"> <li>• same as HK\$ investments above</li> <li>• fall in currency exchange</li> </ul>

### 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”) :-

<i>Investment Types</i>	<i>Target Weighting</i>	<i>Tactical Range</i>
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”) :-

<i>Investment Types</i>	<i>Target Weighting</i>	<i>Tactical Range</i>
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”) :-

<i>Investment Types</i>	<i>Target Weighting</i>	<i>Tactical Range</i>
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”) :-

<i>Investment Types</i>	<i>Target Weighting</i>	<i>Tactical Range</i>
<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 Counterparties

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 Selection of Counterparties

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 Investment Guidelines and Operational Manual

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 Segregation of Duties**

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 Conflict of Interest**

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 Operation of Bank Accounts**

- 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.

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,



- reconciling 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.