[LCQ11: Investments and assets of Long Term Growth Portfolio of Exchange Fund]

Following is a question by the Hon James To and a written reply by the Secretary for Financial Services and the Treasury, Mr James Lau, in the Legislative Council today (October 31):

Question:

In reply to a question I raised in May this year about the investments made by the Hong Kong Monetary Authority (HKMA) in the infrastructure projects of the countries and regions along the Belt and Road (B&R), the Government indicated that HKMA had all along been actively sourcing investment opportunities globally, including B&R-related projects, and that infrastructure was a key asset class of the Long Term Growth Portfolio (LTGP) of the Exchange Fund. Besides, the Financial Secretary (FS) stated in September this year in his blog article on B&R development that "with the support of the State-owned Assets Supervision and Administration Commission of the State Council, the HKMA is exploring cooperation with some state-owned enterprises to jointly look for attractive overseas projects with stable returns, and to consider investing in these projects as equity investors." On the other hand, the authorities have capped the proportion of the market value of the LTGP in the accumulated surplus of the Exchange Fund at one-third. Also, 50% of the capital of the Future Fund, which was set up by the Government in 2016, has been placed in LTGP. In this connection, will the Government inform this Council:

(1) of the details of each of the B&R-related projects joint-investment into which the HKMA is exploring with state-owned enterprises (joint-investment projects), including the form, size, region and horizon of the investments; and the earliest time anticipated for investing in the first project;

(2) given that the average annual internal rate of return of the LTGP was 13.7% from 2009 to 2017, whether the authorities anticipate that the average internal rate of return of joint-investment projects will be higher than that figure; of the factors which the HKMA will consider in determining whether to invest in joint-investment projects and whether those factors include the said rate of return;

(3) of the approach currently adopted by the HKMA for exploring cooperation with state-owned enterprises and for performing due diligence in respect of joint-investment projects, so as to minimise investment risks; whether the HKMA will make the investments itself or through investment managers; should it be the latter, of the selection criteria (including their experience and track records) for investment managers;

(4) given that the risks involved in equity investment are generally higher than those associated with loans and other forms of investments, whether the

HKMA will invest in joint-investment projects in the form of loans or through other forms of investments; if so, of the respective numbers of projects to be invested in different forms in the coming three years, as anticipated by the HKMA;

(5) whether the HKMA will, in respect of joint-investment projects, (i) establish a mechanism to minimise investment risks, (ii) request that terms for protecting its investments be included in investment agreements, and (iii) contain potential losses (e.g. capping the investment amounts);

(6) as the Deputy Chief Executive of the HKMA has indicated that the HKMA will maintain the requisite governance rights in various types of investment projects under the LTGP, so as to ensure its ongoing right to monitor such investment projects, otherwise it will consider abandoning the relevant projects, whether such principle applies to joint-investment projects; if so, how the HKMA will manifest the requisite governance rights;

(7) whether there will be differences between joint-investment projects and other types of investment projects under LTGP in respect of matters relating to business strategy, personnel appointment powers, etc.;

(8) whether the HKMA has set ceilings in respect of (i) the amount of its investment in individual joint-investment projects, (ii) the total amount of investments in joint-investment projects, and (iii) the proportion of the total amount of investments in joint-investment projects in the LTGP or the Exchange Fund; if so, of the details; if not, the reasons for that;

(9) of the circumstances and mechanism under which the HKMA may revise the ceiling of the proportion of the market value of the LTGP in the accumulated surplus of the Exchange Fund; apart from the money that has been set aside for the Future Fund, whether there is a mechanism to enable the Government to invest additional amount of funds from fiscal reserves in the LTGP; and

(10) given that according to the Exchange Fund Ordinance (Cap. 66), the Exchange Fund is under the control of FS and in exercising such control, he is required to consult members of the Exchange Fund Advisory Committee who are appointed by the Chief Executive, how the authorities will resolve the differences in the event that members of that Committee, FS or the HKMA have diverse views on investments in B&R-related projects or joint-investment projects; whether FS is authorised by the law to make the final decision?

Reply:

President,

The Exchange Fund (EF) started investing in private equity and real estate (commonly known as "alternative investments") under the Long-Term Growth Portfolio (LTGP) in 2009, with an aim to diversify its portfolio, spread investment risks associated with traditional assets (primarily bonds and equities), and enhance long-term return. To further diversify the asset classes, the EF has started to invest in infrastructure projects under the

LTGP in recent years.

Infrastructure investments provide relatively stable cashflows with lower loss ratios. As infrastructure is an essential part of people's livelihood, returns on infrastructure investment are less affected by economic cycles and have lower correlation with those of traditional assets. The inclusion of infrastructure investments could enhance the portfolio's resilience to economic shocks and reduce volatility of the overall return. Owing to these considerations, many medium- and long-term institutional investors who seek to achieve stable long-term returns like the EF, such as sovereign wealth funds, pension funds and insurance companies, have increased their allocation to infrastructure investments in recent years.

To ensure the EF has sufficient liquidity for maintaining monetary and financial stability, investments under the LTGP were capped at one third of the Accumulated Surplus of the EF at its initial establishment. Subsequently, since part of the Future Fund's capital has been placed with the LTGP, the total amount of capital available for investment under the LTGP has increased accordingly. As at the end of 2017, the total market value of investments under the LTGP reached HK$235.6 billion, or about 5.9% of the total assets of the EF.

The EF observes the usual principle of prudence when investing in infrastructure projects. Appropriate risk management measures have been implemented having regard to the characteristics of individual projects in order to assess, mitigate and prevent potential risks. These measures include:

(a) Appropriate allocation: The EF's total infrastructure investments (including commitments) amount to about US$2.2 billion currently, accounting for only a small portion of the LTGP;

(b) Diversified portfolio: The EF seeks to build a diversified portfolio of infrastructure investments spanning across different regions, sectors, capital structures and partners to avoid undue concentration;

(c) Due diligence: Before committing to an investment, the EF must conduct rigorous due diligence to assess carefully its financial conditions, growth potential, exit mechanism, risks and other factors, to ensure the project is commercially viable. Priority is accorded to jurisdictions with proper governance and environmental protection framework;

(d) Selection of partners: The EF seeks to partner with reputable and experienced institutional investors and asset managers to capitalise on their broad and deep expertise. The EF will also ensure that its partners are those with good integrity and governance standards, and are trustworthy long-term partners of the EF;

(e) External advisors: The EF engages external advisors to provide independent and professional opinions on tax, legal, regulatory and environmental issues;

(f) Stress testing: The EF conducts stress testing on the financial assumptions and models to ensure investments remain resilient even when confronted with unfavourable market conditions;

(g) Risk mitigation: The EF assesses if appropriate risk mitigation measures should be adopted for investment projects. At the negotiation stage of legal documentation, the EF will also secure the requisite governance rights in the projects, including their funding arrangements, operating budgets, investment and operation strategies, senior personnel appointments, as well as the right to participate in devising asset disposal plans;

(h) Reference check: The EF conducts reference checks with peer investors to understand and validate the capability of partners and viability of projects; and

(i) Post-investment monitoring: Post-investment monitoring is as important as pre-deal due diligence. The EF maintains regular contact with its partners and closely monitors the progress of projects to identify any potential issues at an early stage.

The Belt and Road covers more than 80 countries including many with strong demand for infrastructure investments. The EF is open to infrastructure investment opportunities along the Belt and Road. As regards investment partners, whilst the EF has yet to partner with any state-owned enterprises in any infrastructure investment, enterprises with sound track records in investing, building and operating overseas infrastructure projects could be potential partners of the EF. As explained above, when considering investment in infrastructure projects, the EF will focus on whether an individual project is commercially viable, its investment return reasonable and the associated risks well-managed. All projects, regardless of location or nature of business partnership, must go through rigorous, professional and objective due diligence processes and risk management mechanisms to be considered for investment.

Under the Exchange Fund Ordinance, the Financial Secretary (FS) will consult the Exchange Fund Advisory Committee (EFAC), of which he is the ex-officio chairman, in exercise of his control of the EF. Currently, the EFAC consists of 16 non-official members with knowledge and experience in the financial and professional services sectors. They are appointed in their personal capacity to advise the FS on the investment policies and strategies of the EF.