Chapter 1 – Saving for the Future

(A) Need for a Savings Scheme

1.1 Hong Kong has enjoyed over ten successive years of budget surpluses. Our fiscal reserves are running at a high of over $700 billion. Do we really need a Future Fund?

1.2 The Working Group Report released in March 2014 highlighted the massive pressure that an ageing population would put on public finance. The anticipated challenges to our public finance call for resolute and early actions to manage our finances in a sustainable manner.

1.3 The Working Group urges the Government to take timely and effective measures to address the problem, failing which the healthy state of our public finance would deteriorate gradually. A structural deficit could surface within a decade should government expenditure grow in line with historical trends and exceed the rate of GDP or revenue growth on a long-term basis. To fund the shortfalls, fiscal reserves could be depleted within another decade after the onset of structural deficit.

1.4 The idea of a savings scheme is to set aside some funding for long-term investment and hopefully yield higher returns in the medium to long term. As a good fiscal discipline, the savings scheme should be clearly segregated from the more liquid “cash in hand” for meeting daily and short-term government needs.

1.5 According to the long-term projections set out in the Working Group Report, there will still be budget surpluses for the coming few years, but probably not for too long. The Working Group recommends that the Government should start planning early, when we can still afford to set aside part of our fiscal reserves for long-term investments with possibly higher returns. Setting up a Future Fund is not a total solution but would alleviate the pressure of future generations.
The fiscal health of Hong Kong is envy to many. As at end March 2014, the Government’s fiscal reserves stood at $756 billion (after rounding). The figure reflects the sum total of the cash balances of the Government held in various government account/funds, as broken down below –

* Funds with designated use include Capital Investment Fund, Capital Works Reserve Fund, Civil Service Pension Reserve Fund, Disaster Relief Fund, Innovation and Technology Fund, Loan Fund and Lotteries Fund. It does not include the Bond Fund, the balance of which is not part of the fiscal reserves.

1.7 Except for the $400 billion plus in the General Revenue Account, the rest or **about half** of the fiscal reserves is held in various Funds the ambit and use of which are governed by the legal instrument supporting their establishment in the first place.
Worth noting is that the Land Fund was established on 1 July 1997 by Resolution of the Provisional Legislative Council to receive and hold all of the assets, net of expenses, transferred from the Hong Kong Special Administrative Region Government Land Fund. According to the Resolution, the Land Fund can be used only for investment and not for the provision of any government services. The Resolution does not allow the Government to freely transfer resources from the Land Fund to the General Revenue Account or other government funds. Should the Financial Secretary decide to draw down on the Land Fund, he would need to seek the approval of the Legislative Council, as were the cases in 2003-04 and 2004-05 when $120 billion and $40 billion respectively was transferred to the General Revenue Account to meet the anticipated cash flow shortfalls following repeated budget deficits since 2000-01. In gist, the balance in the Land Fund cannot be readily deployed.

The $756 billion fiscal reserves as at end March 2014 is equivalent to around 21 months of gross government expenditure. Noting that there will probably still be budget surpluses for the coming few years, the Working Group considers that there is room for the Government to consider setting up a Future Fund by making use of the Land Fund.

**Existing Investment of Fiscal Reserves**

The Government has placed its fiscal reserves with the Exchange Fund since 1976, in return for investment income. This arrangement has allowed the fiscal reserves to be invested in a prudent manner and has enabled the Exchange Fund to perform more effectively its statutory functions under the Exchange Fund Ordinance (Cap. 66).

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1. See Annex B for background on the Land Fund.
1.11 Since April 2007, the Government and Hong Kong Monetary Authority (HKMA) have agreed that the investment income on the fiscal reserves (including the Land Fund) shall be calculated on the basis of the higher of—

(a) the average annual investment return of the Exchange Fund’s Investment Portfolio for the past six years, and

(b) the average annual yield of three-year Exchange Fund Notes for the previous year subject to a minimum of zero percent.

1.12 The 2007 agreement offers greater stability of investment income as a source of government revenue and greater predictability of the revenue stream for budgeting. It also preserves the long-term value of our assets by achieving a reasonable rate of investment return.

**Overseas Reference**

1.13 In considering what we would like to get out of a savings scheme, the Working Group has made reference to the practice of overseas sovereign wealth funds (SWFs). The number and total assets under the management of SWFs have been growing rapidly over the past few years. SWFs are often defined as special purpose investment funds or arrangements created to achieve financial objectives, which are often established either out of official foreign currency operations, the proceeds of privatisations, fiscal surpluses, and/or receipts from commodity exports.

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2 Reference on SWFs are drawn from the following publications of the International Monetary Fund (IMF) and the International Working Group of Sovereign Wealth Funds (IWG) –


(c) The IWG Secretariat in collaboration with the Members of the IWG, 2008, “Sovereign Wealth Funds Current Institutional and Operational Practices”.

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1.14 The types and policy objectives of SWFs much depend on country-specific circumstances and may evolve over time. A typical type of SWFs is saving fund, created when governments have budgetary surpluses and have little or no international debt. Excess surpluses are set aside to save and invest with a view to spreading wealth across generations (e.g. Abu Dhabi Investment Authority, Libyan Investment Authority). This may be done by setting up an endowment type fund that makes use of the surpluses to generate future stream of financial cash flows to benefit the present and future generations. The investment mandate of saving funds often emphasises longer-term and high risk-return profile.

1.15 Another common category of SWFs is pension fund, established to cover the projected higher liability related to sustaining pension needs in the future. Examples include Australia, Ireland, New Zealand and Chile. Some countries set up stabilisation funds to insulate their budget and economy from commodity price volatility and external shocks (e.g. Chile (Economic and Social Stabilisation Fund) and Russia (Oil Stabilisation Fund)).

1.16 Some SWFs are held by the central bank and assumed a significant role in fiscal management. Other funds are set up in the form of reserve or national investment corporations with high degree of autonomy, e.g. Korea Investment Corporation of South Korea, Government of Singapore Investment Corporation and Temasek of Singapore.

**Objectives of the Future Fund**

1.17 Having considered the strength of our fiscal reserves and the objectives of some overseas savings schemes, the Working Group believes that the main objectives of the Future Fund should be a combination of “saving and investing”, “for the benefit of future generations” and “enhancing fiscal sustainability”.

1.18 In practical terms, the Working Group **recommends** that the Future Fund should seek **higher returns through long-term investments** (as elaborated in paragraph 1.41 below). The Working Group appreciates that higher returns normally entail higher investment risks; a fine balancing is needed. Over time, it is hoped that the Future Fund can be robust enough so that the Government has the option in acute or prolonged downswings to either draw on the Fund to stimulate the economy with countercyclical measures or to use it to help secure better terms for borrowing.
(B) Institutional Arrangements for the Future Fund

1.19 According to the long-term projections of the Working Group, structural deficits would strike within a decade or so under the Base Case, No Service Enhancement scenario. The time frame within which the Government can afford to set aside a portion of the fiscal reserves for longer-term investment is clearly limited. The coming ten years would be critical. If the Government is serious about a savings scheme, speed is of the essence.

1.20 The Working Group believes that the Fund should be established by adopting the fastest and simplest route. The cost of setting up and administering the Future Fund should be contained.

1.21 The Working Group explored the following options –

(a) **Administrative Route.** Under this option, the Government would designate a portion of the fiscal reserves, say the Land Fund as endowment plus budget surpluses as periodic top-ups, as the “Future Fund”. The Future Fund would be a **notional account**, primarily held against the Land Fund (for the endowment and related investment returns) and the General Revenue Account (for the periodic top-ups). The investment of the Future Fund would still be governed by the Resolution on the Land Fund as well as the Public Finance Ordinance (Cap. 2) and determined by the Financial Secretary. In line with established practice, the Financial Secretary may direct the Chief Executive of the HKMA to manage the Future Fund.

(b) **Body Corporate.** This would involve establishing a statutory body corporate with independent board and governance structure, operating with full commercial discretion and flexibility. This investment corporation could be given a high degree of autonomy and its mode of operation could follow that of the Temasek of Singapore or the Korea Investment Corporation.
(c) **Trust Fund.** This would involve establishing a trust fund, either under an existing statute (e.g. Community Care Fund established under the Permanent Secretary for Home Affairs Incorporation Ordinance (Cap. 1044)) or through a non-statutory approach (e.g. Film Development Fund administered by the Commerce and Economic Development Bureau). As with the body corporate option, the trust fund will have its own board of governance as well as executive and investment committees.

1.22 The Working Group notes that both the body corporate and trust fund options require legislative backing, and may take well over a year for processing within the Government and the legislature, and extra time and costs for post-establishment formalities (like appointment of governing boards and investment managers).

1.23 With the administrative route, however, the need to set up a new statutory governance structure can be obviated. The management and utilisation of the Future Fund under this option may still rely on the legislative and governance framework provided under the Resolution on the Land Fund and the Public Finance Ordinance (Cap. 2).

1.24 To ensure that the Future Fund can be established as soon as practicable, the Working Group **recommends** adopting the **administrative route**, which is the most efficient and cost effective means of setting up the Fund.

**Relationship with the Fiscal Reserves**

1.25 The Working Group has carefully considered whether the Future Fund should remain part of the fiscal reserves. Segregating the Future Fund from the fiscal reserves may send a clearer signal to the community that the savings in the Future Fund are different and are **beyond** the usual reach of the Government.
1.26 However, the Working Group is mindful that netting off the Future Fund from the fiscal reserves may generate unwarranted concerns about a misconceived weakening of Hong Kong’s fiscal strength and macroeconomic fundamentals, which may impact on our credit worthiness. In addition, the balance of fiscal reserves is also an important component of the Exchange Fund. Its placements with the Exchange Fund help reinforce public confidence in the Hong Kong dollar and our monetary stability. As at end March 2014, the balance of fiscal reserves was around 25% of the total assets of the Exchange Fund.

1.27 After due consideration, the Working Group recommends that the Future Fund should stay as part of the fiscal reserves. The fiscal reserves will be made up of two parts –

(a) the Future Fund; and

(b) the Operating and Capital Reserves (OCR). This is essentially the balance of the fiscal reserves that is not set aside for the Future Fund. It comprises the fund balances of the General Revenue Account and designated funds other than the Land Fund. It is the more liquid part of the fiscal reserves.
1.28 An illustration of the composition of the fiscal reserves upon the establishment of the Future Fund is set out in Chart 1.2 –

* Chart 1.2 – Distribution of the Fiscal Reserves
(Illustration based on 31 March 2014 position)

* Funds with designated use include Capital Investment Fund, Capital Works Reserve Fund, Civil Service Pension Reserve Fund, Disaster Relief Fund, Innovation and Technology Fund, Loan Fund and Lotteries Fund. It does not include the Bond Fund, the balance of which is not part of the fiscal reserves.
1.29 Other than proposing a ready "endowment" of about $220 billion from the Land Fund, the Working Group deliberated on whether the Future Fund should have regular top-ups. As a fiscal discipline, the Working Group recommends that whenever affordable, the Government should consider transferring a designated percentage of the Government’s annual budget surplus to the Future Fund as regular top-ups.

1.30 The Working Group appreciates that there is a natural trade-off between long-term and near-term needs. The higher the percentage of the annual budget surpluses set aside for saving in the Future Fund, the less would be the balance left for the OCR. The Working Group has analysed the effects of transferring 25%, 33% or 50% of the annual surpluses to the Future Fund. From a practical perspective, the Working Group considers that 25% to 33% would appear to be an appropriate tactical range.

1.31 The Working Group considered the idea of adopting a progressive two-tier structure for budget surpluses to be transferred as top-ups for the Future Fund. For “normal” years, the top-up can be fixed at a lower percentage; but for “exceptionally good” years with “exceptionally high” surpluses, a higher top-up percentage would apply. Upon deliberation, the Working Group does not consider a two-tier structure justifiable since the projected amount of additional transfer is not expected to be significant in the coming years (given that both the number of years with surplus as well as the amounts of surplus are not expected to be large). It is also hard to define “exceptionally good” years or “exceptionally high” surpluses.

1.32 The Working Group recommends that about a quarter to a third of the budget surpluses every year should be transferred to the Future Fund as regular top-ups. The Government would need flexibility to adjust the transfer amount having regard to the prevailing fiscal situation and needs of the community.
(D) **Investment Strategy for the Future Fund**

1.33 The Working Group has considered whether the Future Fund should be managed by the HKMA or invested by external fund investment managers. The Working Group **recommends** that the Future Fund should continue to be placed with the Exchange Fund as this –

(a) would allow the Future Fund to benefit from the Exchange Fund’s established investment infrastructure and expertise. The Exchange Fund has accumulated experience and expertise in the investments in long-term assets which could complement the objective of the Future Fund;

(b) can lower costs because of the economies of scale of the Exchange Fund investments; and

(c) would be a quicker route. As explained in paragraph 1.19 above, the Future Fund is expected to have a limited life span. It is not worthwhile or economical to set up a separate institution and develop the investment framework afresh.

1.34 The Working Group also recognises that continued placement with the Exchange Fund can enhance the financial resources for the Exchange Fund to maintain the financial and monetary stability of Hong Kong and is desirable. The balance of the fiscal reserves stands at about 25% of the total assets of the Exchange Fund.

**The Investment Portfolio of the Exchange Fund**

1.35 At present, the Government’s fiscal reserves are placed with the Investment Portfolio of the Exchange Fund, which strives to preserve capital as well as liquidity. The Investment Portfolio mainly holds bonds, supplemented by some equities. Its investment performance may be seen as less attractive vis-à-vis most equity funds during an economic upturn or stock market boom, but can avoid major losses in the face of a market slump and dramatic economic swings.
The Long-Term Growth Portfolio of the Exchange Fund

1.36 Since 2008, the Exchange Fund has started to diversify its investment into new asset classes, which gradually developed as the Long-Term Growth Portfolio. At present, this portfolio mainly holds private equity investments and real estate assets, which are similar to those asset classes commonly held by some SWFs.

1.37 As compared with the traditional assets held under the Investment Portfolio which are of lower risk and liquid, certain new asset classes may help deliver higher return in the medium and long term despite their lower liquidity and higher risk. In line with the principle of prudence and keeping risks within controllable limits, the Exchange Fund has capped the size of the Long-Term Growth Portfolio at one-third of the accumulated surplus of the Exchange Fund³.

1.38 The performance of the Long-Term Growth Portfolio has been quite encouraging. The low asset valuation immediately after the global financial crisis in 2008-2009 presented a good timing for the Exchange Fund to enter the private equity and real estate markets. At the end of 2013, the annualised internal rate of return since the portfolio’s inception was around 16%. An overview of the Exchange Fund’s overall asset allocation as at end 2013 is set out in Chart 1.3 below⁴ –

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The Long-Term Growth Portfolio is managed by external private equities and real estate managers. Private equities investment is mainly made through funds and co-investment while real estate investment is mainly on high-quality commercial properties in major overseas cities. The asset classes and market value of the Long-Term Growth Portfolio as at end 2013 is as follows –

<table>
<thead>
<tr>
<th>New Asset Classes</th>
<th>Market Value $ billion</th>
<th>Annualised return from inception to end 2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private Equity</td>
<td>64.2</td>
<td>15.9% (Internal Rate of Return)</td>
</tr>
<tr>
<td>Real Estate</td>
<td>24.4</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>88.6</strong></td>
<td></td>
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</tbody>
</table>

Note
1. Outstanding investment commitments at the end of 2013 amounted to $80.2 billion.
2. Investment cap is 1/3 of the Accumulated Surplus, or $220 billion at the end of 2013.
Investment objective of the Future Fund

1.40 The Working Group has deliberated thoroughly on the investment objectives and investment approach for the Future Fund.

1.41 As explained in paragraph 1.18 above, the main practical function of the Future Fund is to seek higher returns through long-term investments. The Working Group appreciates that most long-term risk-bearing investment tools do not or cannot offer annualised guaranteed returns. It does not feel able to prescribe a specific target rate of return for the Future Fund. As a practical way forward, the Working Group recommends that the investment objective of the Future Fund may be set as –

“achieving within acceptable risks a return that is higher over the medium to long term than the return for the rest of the fiscal reserves under the 2007 agreement between the HKMA and the Government”.

Investment approach for the Future Fund

1.42 The Working Group is mindful that investment is about a balance between risk and return. Common investment risks include credit risk, market risk and liquidity risk. As a general rule, higher potential return involves greater risk.

1.43 With the OCR standing at $536 billion (as at end March 2014), which is equivalent to about 15 months of government expenditure, there is capacity for the Future Fund to be invested in assets with higher risks. But exactly how far the Future Fund can afford to bear risks is ultimately a matter of professional judgement and fine balancing depending on the prevailing market situation.

1.44 In consultation with HKMA, the Working Group explored the trade-off between return and risk under various investment combinations – with the Future Fund assigning 50% or more of its resources for investment in the Long-Term Growth Portfolio, and assigning the rest for placements with public equities, bonds, and
the Investment Portfolio. Relying on market data since 2004 (suitably adapted for the Long-Term Growth Portfolio which was developed only in 2008), the Working Group noted that the **annualised returns** in various combinations of long-term investments would typically **exceed** that achieved for the fiscal reserves under the 2007 agreement with the Exchange Fund. However, when **annualised volatility** is taken into account, the risk-adjusted performance of the various investment combinations\(^5\), varies considerably.

1.45 The Working Group appreciates that in addition to the risk-adjusted investment returns, the liquidity needs and other considerations are also important determinants of the desired investment approach. As far as the Future Fund is concerned, the following factors should also be taken into account when deciding on the investment mix –

(a) **Liquidity needs** for the Government. Within the coming few years, the OCR balances would remain healthy. The need for the Government to have to draw on the Future Fund should be low. Hence the investment of the Future Fund can theoretically be more aggressive. Ten years down the line, however, the risk of population ageing eating into the OCR balances would be material. The need for the Government to draw on the Future Fund would be more imminent. The asset allocation would have to be fine-tuned.

(b) **Investment tenure**. A longer-term investment horizon can ride out year-on-year volatility, including the possibility of less favourable returns in individual years, and hopefully can achieve an ultimately better return compared with the Investment Portfolio in the medium to long term. To allow more time for long-term investments to reap and realise better returns, the Working Group considers that there

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\(^5\) Risk-adjusted investment performance can be measured by tools such as the Sharpe Ratio, which is a ratio of excess return (portfolio return over risk-free rate) per unit of the variability of portfolio return. The higher the ratio, the better the risk-adjusted return of the portfolio.
should be a ten-year time bar before withdrawals can be made. The risk appetite at the start of the ten-year window should theoretically be higher than that towards the end.

(c) **Market dynamics.** Managing an investment portfolio requires very close monitoring of market changes including interest rate movements, geopolitical tensions, flow of funds, trends in the property market, threats of economic crisis, etc. While seeking a better investment return for the Future Fund, the Working Group appreciates that a prescriptive approach in setting the exact investment mix would not be practical. Much depends on prevailing economic and market conditions.

(d) **Product availability and risk diversification.** Investment in long-term assets cannot be blindly pushed through. The right kind of products with the right investment prospects have to be available for investment at the right time when funding can be released. To avoid vintage or product concentration, as well as to facilitate risk diversification and re-balancing, investments may need to be spread over different years or over different types of products through periodic adjustments to the allocation of assets within the Future Fund.

1.46 The annualised returns on the Long-Term Growth Portfolio are attractive. The Working Group has considered how far the Future Fund should invest in this Portfolio having regard to the size of its investment. The Exchange Fund’s current investment in the Long-Term Growth Portfolio is about $100 billion. Its cap is one third of the Accumulated Surplus of the Exchange Fund, i.e. about $220 billion. If 100% of the Future Fund were to be invested into the Long-Term Growth Portfolio in the coming few years, this would raise the Exchange Fund’s investment in that Portfolio from about $100 billion to $320 billion or $440 billion depending on whether the Exchange Fund were to increase its own investment in that Portfolio up to the investment cap during the same period. Even if the entire amount of investment would be spread over different years, the relatively large annual investment size would
pose substantial challenge in the sourcing of investment opportunities in the long-term assets market while maintaining the quality of investment.

1.47 On balance, given the need for product and vintage diversification, given the substantial sums involved, and given the need to kick-start the long-term investments of the Future Fund soonest possible within its anticipated short life span, the Working Group believes that it would be reasonable for only about **50% of the Future Fund** (i.e. about $100 billion) to be set aside for investment into the Long-Term Growth Portfolio. This would **already double** the Exchange Fund’s current investment in that Portfolio.

1.48 The Working Group would not want to rule out any long-term investment option at this stage. Nor does it feel right or able to prescribe a fixed or rigid asset allocation as the investment guide for the Future Fund. The Working Group recommends that –

(a) **Maximum flexibility** should be allowed for the investment strategy to be adjusted periodically, having regard to the trade-off between risk and return, the investment tenure, liquidity needs of the Government, etc.

(b) It would be reasonable for **about 50%** of the Future Fund to be set aside for placement with the Exchange Fund’s **Long-Term Growth Portfolio**. The rest may be placed with the Investment Portfolio, bonds, public equities or other long-term investment products.

(c) The Future Fund’s placements under the Long-Term Growth Portfolio would be **phased in** over a couple of years, to allow for product and vintage diversification and to build in flexibility to allow the Exchange Fund to invest and dispose of the right investments at the opportune time (instead of imposing a rigid deadline).
(d) The portion of the Future Fund which would continue to be invested in the Investment Portfolio (as with the fiscal reserves before the establishment of the Future Fund) should continue to earn an investment return calculated in accordance with the formula agreed in 2007 (as explained in paragraph 1.11 above).

(e) The Future Fund would be managed as part and parcel of the Exchange Fund and is therefore subject to the same investment management regime and oversight by the Exchange Fund Advisory Committee on such matters as investment guidelines, due process in investment decision-making, and control of risk and compliance. Separately, however, the HKMA should consult the Financial Secretary, the Secretary for Financial Services and the Treasury and such other persons as the Financial Secretary deems fit at least once a year on the investment strategy and asset allocation for the Future Fund, having regard to the investment objective of the Future Fund, liquidity needs of the Government, the target asset allocation, investment performance and investment environment, etc.
(E) *Withdrawals from and Designated Use of the Future Fund*

**Withdrawals from the Future Fund**

1.49 The Future Fund is meant to be set aside for long-term investments for at least a ten-year period. However, in the event of a sudden economic downturn with the OCR fast depleting, the Government would need to consider whether to—

(a) break the ten-year placement with the Exchange Fund and suffer a loss;

(b) arrange for debt financing or asset securitisation; or

(c) consider a combination of these.

1.50 The Working Group considers it prudent to develop an alert system to determine what the critical threshold for the OCR balance should be, below which the Government should be seriously concerned and should consider developing contingency plans. The Working Group believes that the threshold should be expressed as X-months equivalent of gross government expenditure or net government expenditure (i.e. anticipated expenditure minus anticipated revenue).

1.51 As shown in **Chart 1.4**, the Government usually has cash flow shortfall in the early months of a financial year as the majority of the revenue (e.g. profits and salaries tax) is received in the second half of the year. The analysis in **Chart 1.5** shows that the cash flow shortfall faced by the Government during a year could be as much as three to four months of gross government expenditure, or six months of net cash outflow (for nine years out of the 16 years since 1998-99).
**Chart 1.4 – Government’s Cash Flow Pattern (Illustration)**

Cumulative funding shortfall equivalent to 4 months of gross government expenditure or 7 months of net cash outflow

**Chart 1.5 – Maximum Amount of Cash Flow Shortfall (Past Trend)**

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1.52 The Working Group notes that the accuracy of projecting the amount of gross government expenditure is likely to be higher than that of projecting the amount of net cash outflow; the latter involves also the projection of future revenue, which is volatile in nature. The Working Group agrees to express the threshold in terms of months of gross (vs net) government expenditure.

1.53 Other than the three to four months of gross government expenditure required to cover in-year cash flow shortfalls, the OCR needs a reasonable buffer to support contingent requirements, e.g. additional welfare expenditure during an economic downturn. This may be set at two months’ equivalent of government spending. This buffer would also allow time for the Government to alert HKMA to prepare for possible withdrawals from the Future Fund (since the investments will be placed in longer-term investments and are less liquid). Thus, the Working Group recommends that the critical threshold should be set at six months’ equivalent of gross government expenditure, i.e. four months plus two months buffer.

1.54 The trigger is meant to facilitate tracking. If the OCR balance can only cover six months of government expenditure, there is a real cause for concern. But it does not necessarily or automatically justify a drawdown from the Future Fund. The Working Group recommends that other viable options including debt financing or securitisation of government assets have to be exhausted before deployment of the Future Fund, or breaking up the ten-year placement of the Future Fund, is to be considered.
Designated use of the Future Fund

1.55 For illustration, if the investment return on the Future Fund averaged at 5% per annum and there could be regular top-ups at 33% of the annual budget surpluses, the balance of the Future Fund would amount to **about six to nine months’ equivalent of gross government expenditure** (depending on the expenditure scenario) when the OCR balance hits the threshold of six months’ equivalent of gross government expenditure. This is not a lot.

1.56 If the investment return of the Future Fund were one to three percentage points higher than 5% per annum, the corresponding balance of the Future Fund could be as follows –

*Table 1.1 – Projected Future Fund balance when the OCR balance = 6 months of government expenditure*

<table>
<thead>
<tr>
<th>Assumed average return per annum</th>
<th>Projected Future Fund Balance (Months of government expenditure)</th>
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<tbody>
<tr>
<td></td>
<td><strong>No Service Enhancement</strong></td>
</tr>
<tr>
<td>5%</td>
<td>9</td>
</tr>
<tr>
<td>6%</td>
<td>10</td>
</tr>
<tr>
<td>7%</td>
<td>12</td>
</tr>
<tr>
<td>8%</td>
<td>13</td>
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# Base Case, No Service Enhancement Scenario assumes that expenditure would be adjusted to reflect demographic and price changes only, and that services in education, social welfare and health would freeze at prevailing levels from now to 2041-42.

* Base Case, Service Enhancement at Historical Trend Scenario further assumes that expenditure on education, social welfare and health services would grow @ 3% per annum.

1.57 It is hard to anticipate the Government’s and the community’s needs ten years down the road. The Working Group does not feel right to commit the Future Fund to very specific uses. In fact, when the Land Fund was drawn down in 2003 and 2004, the objective was supposedly meeting the Government’s operating shortfall, i.e. covering all purposes.
1.58 If the OCR balance is as low as six months of gross government expenditure and if, having exhausted all other viable contingency options including debt financing or securitisation of government assets, there remains a need to draw down from the Future Fund, the Working Group believes that the Future Fund should logically be confined to **absolutely essential** expenditure items. Whether these items are technically classified as capital, recurrent or one off might not be material – provided they are all badly needed.

1.59 There is a well understood tension between immediate needs and longer-term more sustainable needs for the community. The Working Group believes that even in such dire circumstances when the Future Fund has to be drawn down, due consideration should also be given to **investments in countercyclical measures to revive and stimulate economic growth**, not just payouts to fill immediate cash flow gaps and to offer immediate relief for the community. These pro-growth measures include investments in strategic infrastructure projects and other countercyclical measures. Naturally, as the Future Fund is not a recurrent stream of funding, it should not be relied upon to fund recurrent expenditure unless all other viable fund-raising options have been exhausted.
(F) Views on the Future Fund

1.60 Since the release of the Working Group Report in March 2014, the proposition of setting up a Future Fund for Hong Kong has aroused considerable public interest and discussion. Some doubt the need to set up a Future Fund because they do not believe Hong Kong would really have a structural deficit problem. They fail to see why resources should be locked up to tackle future problems when problems of the day are deemed to be more pressing.

1.61 Some sectors are keen to have funds to serve their preferred objectives. Some consider it meaningful to create the Future Fund only if it could generate higher returns, but are concerned that this would be constrained by the investment vehicles available to the Government and its risk appetite, which tends to be prudent.

1.62 The Working Group appreciates the feedback and suggestions and hopes that this Report can assure the public that the Future Fund is a mere long-term investment option that can be made to work. It seeks to foster a stronger sense of fiscal discipline and allow long-term interests to be protected against short-term pressures which are often felt as more pressing. As its name suggests, the Future Fund serves the future. The Future Fund, though not the total solution for the anticipated fiscal problems, would help alleviate the pressure of future generations and mitigate the adverse impact a structural deficit may bequeath on the economy in the not-too-distant future.
(G) Recommendations

1.63 The Working Group reiterates that in the face of our coming fiscal challenges, the Government must continue to identify growth opportunities, exercise strict control over expenditure growth and stabilise as well as broaden the revenue base. Establishing the Future Fund as soon as practicable and placing it with longer-term and higher-yield investments is a constructive measure. But it is not the total solution for our fiscal challenges.

1.64 The Working Group recommends the following –

(a) The Future Fund should seek to achieve within acceptable risks a return that is higher over the medium to long term than the return for the rest of the fiscal reserves under the 2007 agreement between the HKMA and the Government.

(b) The Future Fund should remain an integral part of the fiscal reserves, held only in the form of a notional account through administrative means. The part of the fiscal reserves outside the Future Fund will be referred to as "Operating and Capital Reserves" (OCR).

(c) The Future Fund should be placed with the Exchange Fund for a ten-year investment period (at least for the initial endowment). Maximum flexibility should be allowed for the investment strategy to be adjusted periodically, having regard to the trade-off between risk and return, investment tenure, liquidity needs of the Government, market dynamics, product availability, etc.

(d) The Future Fund would have an “initial endowment” notionally held against the Land Fund, and regular “top-ups” pitched at about 25% to 33% of the annual budget surpluses, notionally funded by the General Revenue Account.
(e) About 50% of the Future Fund may be set aside for incremental placement with the Exchange Fund’s Long-Term Growth Portfolio. The rest may be placed with bonds, public equities, other long-term investment products or the Investment Portfolio.

(f) The Future Fund placed with the Exchange Fund would be subject to the same investment management regime and oversight by the Exchange Fund Advisory Committee. Separately, the HKMA should consult the Financial Secretary, the Secretary for Financial Services and the Treasury and such other persons as the Financial Secretary deems fit at least once a year on the investment strategy and asset allocation for the Future Fund, having regard to the investment objective of the Future Fund, liquidity needs of the Government, the target asset allocation, investment performance and investment environment, etc.

(g) The Future Fund should not be deployed unless the OCR falls below a certain threshold and unless the Government has exhausted all other viable contingency options like debt financing or securitisation. Conceptually, the threshold can be the point when the OCR is left with about six months’ equivalent of gross government expenditure.

(h) There is a well understood tension between immediate needs and longer-term more sustainable needs for the community. The Working Group recommends that even in such dire circumstances when the Future Fund has to be drawn down, investments in countercyclical measures to revive and stimulate economic growth should not be overlooked or substantially held back at the expense of payouts to fill immediate cash flow gaps and to offer immediate relief for the community.