Press release

LCQ17: Review of the issuance of inflation-linked bonds

Wednesday, October 26, 2011

Following is a question by the Hon Frederick Fung Kin-kee and a written reply by the Secretary for Financial Services and the Treasury, Professor K C Chan, in the Legislative Council today (October 26):

Question:

To promote the development of the local retail bond market, and to provide the public with an investment option for coping with inflation, the Government launched the inflation-linked retail bonds (iBond) which was officially listed on the Hong Kong Stock Exchange (HKSE) on July 29, 2011. In this connection, will the Government inform this Council:

(a) whether the Government has reviewed the criteria and process regarding the pricing, issuance, subscription and trading, etc of the iBond, as well as its issuance size; if it has, of the outcome; based on a preliminary assessment of the subscription and trading conditions, whether the iBond has achieved the purposes of promoting the development of the local retail bond market and helping the public to cope with inflation;

(b) given that it has been reported that members of the public who subscribe iBond through banks have to trade it "over-the-counter" through banks, and the trading prices in such "over-the-counter" transactions are less transparent, while the trading prices in direct transactions through HKSE are more transparent, thereby creating a situation of "one bond, two markets", whether the authorities have looked into such a situation; whether they have conducted analysis on the price differences in trading iBond through these two different channels, and looked into how much profit the banks have made from the price differences; whether this situation is what the authorities designed and anticipated when they formulated the iBond programme; whether they have assessed if such a situation will impede the flow of bonds and the development of the bond market; and

(c) whether the authorities will, in view of the inflation situation and the development of the bond market, issue iBond again, and initiate a comprehensive review of as well as improvements on the bond issuance programme (including enhancing promotion to the public, and rectifying the unfair situation of "one bond, two markets", etc); if they will, of the timetable and the details; if not, the reasons for that?

Reply:

President,

My reply to the question is as follows:

(a) The objective of the iBond issue by the Government is to promote the development of the retail bond market in Hong Kong. It can also provide another investment alternative to Hong Kong residents in the current high inflation environment. We have conducted a review, following the completion of the iBond offering. Overall speaking, we believe that this bond issue has achieved the aforementioned objectives.

First, the pricing, subscription and trading arrangements, etc of the iBond are simple and easy to understand. This enables the general public to gain a better understanding of bond investment through participating in the subscription and trading process of the iBond. A total of over 150,000 applications have been received for the iBond, with the total application amount exceeding HK$13 billion. Both figures are at very high levels when compared with those for recent retail bond offerings in the market. Second, according to our understanding, 10-15% of those investors who have subscribed the iBond through the two co-arranging banks (ie Bank of China (Hong Kong) Limited and The Hongkong and Shanghai Banking Corporation Limited) have specifically opened an investment account for the first time due to the iBond issue. This suggests that the iBond issue has successfully attracted a group of investors who did not have any previous experience in bond investment. This has a positive impact on fostering the development of the retail bond market in Hong Kong.

In addition, the interest rate determination mechanism of the iBond allows the bond holders to receive the principal in full at maturity and an investment return tied to the average year-on-year inflation rate of the most recent six months during the bond term, which would help the bond holders to preserve the purchasing power of their investment.

(b) While the trading platform of HKSE and the "over-the-counter" (OTC) market operated by banks are two different platforms, they are in fact interacting with and affecting each other. Any price differences in these two markets will eventually be narrowed as a result of market forces.

On the first trading day of the iBond, the price differences in these two markets were considered normal as it usually took some time for the price-discovery process to complete. Shortly thereafter, such price differences had already narrowed. According to our understanding, after taking into account the different transaction costs, the OTC bid prices quoted by some major banks to their customers were effectively very close to those bid prices quoted on the HKSE. This demonstrated that the two markets were interacting with each other and functioning properly.

Putting in place both the HKSE and OTC trading platforms for the iBond is aimed to meet the demand of various investors and can also enhance liquidity of the iBond, which is in the interest of investors. All along, bonds have not been actively traded on the HKSE. Their liquidity has not been high either. Securities firms are not obliged to quote bid prices to repurchase the bonds. Instead, they will only place sell orders regarding the bonds concerned on the HKSE on behalf of their customers. Therefore, those investors who hold bonds through the securities brokers and intend to sell their bond holdings via the HKSE may not be able to dispose of the full amount of the bonds at the desired price, and hence subject to certain degree of liquidity risk.

There is a market-making system in the OTC trading platform. Taking the iBond as an example, there are 18 banks acting as market-makers to provide investors with repurchase guarantee, under which they undertake that when their customers need to sell their bond holdings, they would quote bid prices to purchase the bonds. While the OTC prices quoted by banks may be somewhat different from those quoted on the HKSE, banks can offer repurchase guarantee to investors in the capacity of market makers. This can increase investors' confidence in bond investment and enhance liquidity of the bonds in the secondary market. Therefore, the OTC trading platform is the core part of the secondary bond market in some of the advanced markets overseas, as it is conducive to and necessary for the bond market development. This is also the case in Hong Kong.

(c) As mentioned above, the main objective of the launch of the iBond by the Government is to enhance retail investors' understanding of and interest in bond investment through participating in the subscription and trading process of the iBond, thereby fostering the development of the retail bond market in Hong Kong.

When considering whether to issue further retail bonds under the Government Bond Programme in future, we would, based on the overriding objective of promoting the further and sustainable development of the local bond market, take into account relevant factors including the prevailing market conditions (such as demand and supply, interest rates, inflation rate and the potential impact on other prospective retail bond issuers in Hong Kong) as well as the sustainability of the Bond Fund. In the process, we would not confine ourselves to issuing a particular kind of bonds.

At the same time, we recognise the importance of enhancing investor education. In this connection, we would maintain close liaison with the relevant regulators and continue to take forward the work on investor education with the aim of further enhancing retail investors' understanding of the bond market operation and investment.

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