

Press release

LCQ13: The issuance of inflation-linked retail bonds Wednesday, May 23, 2012

Following is a question by the Hon Mrs Regina Ip Lau Suk-yea and a written reply by the Secretary for Financial Services and the Treasury, Professor K C Chan, in the Legislative Council today (May 23):

Question:

In presenting his 2012-2013 Budget, the Financial Secretary announced that the Government plans to launch through the Hong Kong Monetary Authority (HKMA) a further issuance of inflation-linked retail bonds (iBond) worth not more than HK\$10 billion. Calculated on the basis of the average year-on-year change of the Composite Consumer Price Index from June to November 2011, the interest rate of the first interest payment for the first batch of iBond is 6.08%. As indicated by the authorities, iBond's interest payments are made from the Bond Fund. The Bond Fund is placed with the Exchange Fund for investment purposes, and the investment income received by the Bond Fund from the Exchange Fund is based on the "fixed rate" sharing arrangement. However, the rates of return of the Exchange Fund managed by HKMA in the past few years were lower than Hong Kong's inflation rate in the second half of last year, which stood at 6.08%. According to HKMA's Annual Report 2010, for the three years from 2008 to 2010, the average rate of return of the Exchange Fund was only 1.2%, and even in the 10-year period from 2001 to 2010, the average rate of return was only 4.9%. In this connection, will the Government inform this Council, given that despite the low rate of return of the Exchange Fund, HKMA is still required to make iBond's interest payments at a rate corresponding to the inflation rate of a specified period from the investment income received by the Bond Fund from the Exchange Fund, whether it knows the amount of money, calculated in terms of the size of the first batch of iBond issued, which HKMA needs to subsidise iBond's interest payments after deducting the investment

income generated from an equivalent amount of the Bond Fund over the same period of time?

Reply:

President,

Pursuant to a Resolution passed by Legislative Council under the Public Finance Ordinance on July 8, 2009, "Bond Fund" was established in connection with the implementation of the Government Bond Programme (GBP), which is aimed to promote further and sustainable development of Hong Kong's bond market. GBP offers more diversified investment products and financing avenues, which in turn attract more overseas capitals and reinforce Hong Kong's position as an international financial centre.

GBP comprises two parts, namely institutional and retail bond issuances. As the low-interest rate environment in recent years has made conventional fixed-rate retail bonds less attractive to investors, the Government has issued inflation-linked retail bonds (iBond) to initiate the retail part of GBP and enhance retail investors' awareness of and interest in bond investments. The inaugural iBond issuance last year has laid a good foundation to deepen the local retail bond market and enhance the investing public's understanding of the trading process of bond investments. This helps proactively foster development of a retail bond market in Hong Kong.

Regarding receipts and payments of iBond, according to the aforementioned Resolution, sums borrowed under GBP are required to be credited to the "Bond Fund", as they will be used for principal redemptions and interest payments, to meet financial obligations and liabilities associated with the Programme, and to invest in a manner the Financial Secretary considers appropriate for prudent management of the "Bond Fund". The borrowed sums credited to the "Bond Fund" are placed with the Exchange Fund for investment purposes, and attracts investment income on the basis of a "fixed rate" sharing arrangement from the Exchange Fund. In other words, the rate of investment return for the "Bond Fund" for a year will be calculated on the basis of the average investment return of "Investment Portfolio" of the Exchange Fund over the past six years. According to the relevant investment arrangement, since the

implementation of GBP, the rates of investment return for the "Bond Fund" in 2009, 2010 and 2011 were 6.8%, 6.3% and 6.0% respectively.

As at end March 2012, iBond accounted for around 20% of the total bonds outstanding under GBP, with the remaining 80% being institutional bonds. So far, iBond made its first semi-annual interest payment with a per annum rate of 6.08% in January 2012 (for the period from July 2011 to January 2012). This rate was similar to the rate of investment return in which the "Bond Fund" shared from the Exchange Fund last year. For GBP as a whole (including both institutional and retail bonds), the average rate of interest payments is estimated at around 3%, even after taking into consideration another proposed iBond offering this year. Thus, the investment return of the "Bond Fund" can sufficiently cover the relevant interest payments. The interest payments of iBond do not significantly affect the ability of GBP in making interest payments and principal redemptions. The Government does not need to subsidise the interest payments of iBond.

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