Joseph Yam: Exchange fund notes

Opening remarks by Mr Joseph Yam, Chief Executive of the Hong Kong Monetary Authority, at the signing ceremony for the appointment of retail exchange fund notes distributors, Hong Kong, 3 May 2005.

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I have often emphasised the need for diversification in the financial intermediation channels to maximise the contribution of the financial system to economic growth and development. Diversification can also promote financial stability through reducing the over-dependence of financial intermediation upon one particular channel. Such diversification is therefore clearly in the public interest, to the extent, I think, of requiring the involvement of the public sector in its promotion, if the free market does not produce the desired results.

Indeed, Hong Kong's non-interventionist Government finally got around to this view back in 1989 and on 14 March 1990 the first weekly issue of 91-day Exchange Fund Bills, amounting to HK$300 million, was launched. Since then the Exchange Fund Bills and Notes Programme has become a central feature of Hong Kong's debt market. The total amount of Exchange Fund paper now outstanding is HK$125 billion. And it was not just a matter of bringing supply to the market to meet demand. We developed a benchmark yield curve, a market-making system and a sophisticated market infrastructure, including a paperless clearing and custodian system.

But more needs to be done. Although the debt market has, over the past 15 years, become a significant channel of financial intermediation, sizing it against GDP it is still a lot smaller than the banking and equity markets, and by quite a wide margin. Furthermore, retail interest, increasing as it may have been, is still lacking by the standards of the developed markets in the US, Europe and Japan. And the further promotion of retail interest, specifically in Exchange Fund Notes, is the focus of attention of our gathering today.

As you may be aware, over the past year or so, we made various experimental attempts to attract retail investors to the primary issues of Exchange Fund Notes. On the basis of the experience gained, and subject to three refinements to be introduced to the arrangements, we have decided to continue offering Exchange Fund Notes to retail investors.

The first refinement is the introduction of greater flexibility in the selection of specific issues of Exchange Fund Notes to be offered to retail investors in the primary market. Instead of indiscriminately opening up all the 2-year and 3-year Exchange Fund paper for subscription by retail investors, we intend to take account of market conditions and consult our Distributors in deciding on the timing and tenor for issues with a retail feature. Initially, one issue will be selected for non-competitive bids from retail investors in each quarter. The number of issues per quarter may be increased subsequently, subject to market response. This refinement may mean a reduction in the frequency of issues open to retail investors compared with the experimental period, but it will enable the allocation of a larger portion of the selected issues for allotment to them. It will also facilitate more focused retail marketing for the relevant issues.

The second refinement is the enhancement of price attractiveness for the retail investors. Exchange Fund Notes open to retail investors will be allotted to successful non-competitive bids at the lowest price, i.e. the highest yield, accepted at the competitive-bid tenders, rather than the average accepted price (or average accepted yield). In other words, the retail investors will be assured of getting the best price that institutional bidders are able to get. I am sure retail investors will welcome this.

The third refinement is the strengthening of the distribution network. The number of Retail Exchange Fund Notes Distributors will be increased from three to seven. The extensive branch networks of the Distributor Banks and their sophisticated telephone and Internet banking facilities will, I hope, make it much easier for retail investors to gain assess to the primary market for Exchange Fund Notes. The large retail banks have in the past been criticised for not supporting the development of the retail debt market for fear of losing their retail deposits. Just by looking at the names of the magnificent seven you will realise how wrong that criticism has been. In alphabetical order, the magnificent seven are: Bank of China (Hong Kong), DBS Bank (Hong Kong), Bank of East Asia, Hang Seng Bank, The Hongkong and Shanghai Banking Corporation, Standard Chartered Bank, and Wing Lung Bank. I thank them sincerely for their participation as Retail Exchange Fund Notes Distributors.

Access for retail investors to the primary market of debt, not necessarily restricted to Exchange Fund Notes, is, of course, only part of our continuing efforts. To increase and sustain retail investor interest in bond products in general, we need also to provide convenient access to the secondary market at low transaction costs and reliable market information. But this is a subject for another occasion, after ideas, just recently discussed and endorsed by the new Financial Infrastructure Sub-Committee of the Exchange Fund Advisory Committee, mature and arrangements put in place, in collaboration with the industry.

Allow me to conclude with a commercial targeted at retail investors.

The Exchange Fund Notes are a very safe investment – you are putting your money with the Exchange Fund, which is managed by the HKMA.

The Exchange Fund Notes provide you with a steady stream of fixed-interest income that is higher than interest on bank deposits.

The Exchange Fund Notes are highly liquid – you can sell them any time you want. There are 26 market-makers appointed by the HKMA to make a market in Exchange Fund paper.

The Exchange Fund Notes have a transparent and efficient price discovery system – up-to-date prices and yields can be easily found in newspapers and the financial media.

But we all should not forget, of course, that the prices of Exchange Fund Notes can go up as well as down, depending on the level of interest rates.

End of commercial.

Thank you.