

HKD Bond Market, From a Trader's Perspective

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HKD trading instruments

	<u>Liquidity*</u>	<u>Market makers#</u>	<u>Turnover^</u>
TT forwards	3	3	3
Money market	2	3	2
Spot TT	2	2	3
Exchange fund bills (EFB)	2	2	3
Interest rate swaps (IRS)	2	2	2
Forward rate agreement (FRA)	2	1	2
HIBOR/LIBOR swaps	2	1	1
Exchange fund notes (EFN)	2	1	1
CDs and corporate bonds	1	1	1
FX / interest rate options	1	1	1
EFN / HIBOR futures	1	1	1

*, #, ^ refer to definitions stated next page

Definitions

Liquidity

1. Poor – any big trades would easily move the market, and be spotted out
2. Average
3. Ample – easy to enter and exit from market

Market makers

1. Less than 10 players
2. Approx 10 to 20 players
3. More than 20 players

Turnover

1. Poor
2. Average
3. Good

What makes the HKD market the most active interest rate market in Asia (ex-Japan)?

Out of the many factors, below are the ones that differentiate HKD market from other Asian markets:

- No control over capital flows
- Rare intervention from the central bank, i.e. the HKMA
- Lead to the use of HKD as proxy hedge for other Asian currencies

What makes TT forwards outperform?

- Broader client base (local and overseas), for hedging and speculation purposes. This motivates banks to trade this product more actively
- Best liquidity
- Considerable volatilities
- Not easy for any players to dominate the market on broader client base, including hedge funds

Other than TT forwards, which interest rate instrument shall be used?

For trading purposes:

1. Exchange fund bills and notes
2. Derivatives
3. CDs and bonds

Exchange fund bills and notes (EFBN)

- Little balance sheet usage
- Minimum credit risk
- Eligible to be pledged to the HKMA for funding as last resort
- Little concern over counterparty risks compare with IRS or TT forwards
- Reasonable bid-offer spreads
- Tax benefits to most local entities
- Most G7 countries use their government securities to construct the benchmark yield curves

That being said...

- Lack of market participants:
 - Despite EFBNs are listed in the stock market, retail participation is less than that of retail bonds
 - Lack of commitments from market makers (MMs), particularly on EFNs. MMs can be graded (and are equally divided) into the following three status: *Active, Dormant and Coma*
- EFN yields trade at sub HIBOR due to tax benefits. Fund managers are seen willing to forego better credit, better liquidity for other CDs and bonds
- Lack of media coverage
 - 95% of HK people cannot even reckon a rough level for 10y EFN, but only 5% cannot state the correct Hang Seng Index

How about CDs and bonds?

- More than 20 banks actively participate in arranging new HKD issues for league table purposes, but only less than 5 banks are willing to make markets on secondary issues at reasonable levels
- Banks often treat investors better when they buy the bonds, and worse when they sell
- Lack of a repo market
- Wide bid-offer spreads

HK Capital Market

- Do not get over-excited on recent large size of new HKD issuance, which is mainly driven by:
 - MPF demands
 - Bullish interest rate environment (contrast to equity)
 - With financial institutions as the major buyers, negotiable securities have now replaced the conventional loan portfolios
 - At the end of the day, has the investor base been broadened?

Real life case study

- On behalf of a Church fund of US\$ 2mio, a Sister is looking for investment opportunities in fixed income market. Having been approached by a few banks, she was very upset to find:
 1. Prices vary a lot between different banks on the same bond
 2. Expensive custodian & bank charges
 3. Banks are not professional
- Case 1 – she wanted to buy EFN 5409 at a yield of 2.41% (price 108.30 for value T+3)
 - So as to match her cashflow, she asked for a price for value T+1mth. Bank told her the price would remain at 108.30, however, she realised the yield had in fact dropped by 19bp to **ONLY 2.22%**!
- Case 2 – bank approached her with a USD 4y callable CD at a rate which was 30bp! below the 4y USD rate (not to mention the missing premium gained by selling the options to the bank). Banks kept on comparing the saving deposit rate of 0.125%

How can we help to develop the market

- Broaden investor base particularly on retail level by:
 - Increase media coverage – publish the EFN yield curve through TV, radio and newspaper
 - Show commitment by forming good secondary retail markets
 - Current custody arrangements proved as a major hurdle
 - Lack of incentives for banks to promote EFBNs given they compete against banks' deposits, and less profits margins compare with other retail bonds and CDs. Banks often treat investors better when they buy bonds, and worse when they sell bonds
 - Consider to replace banks' role by a third party, e.g. Treasury Dept or Post Office on marketing EFBNs for retails
 - Upgrade retail investors' knowledge on fixed income products

Not to forget...

- Banks also play a very important role in developing the HKD market
 - Commitment
 - Appropriate risk management
 - Appropriate risk appetite
 - Cross product trading
 - Right people in the right place
 - Funny but a true story: During a Treasury division review, a working group was formed to look for ways to improve revenue in Q4. The market making trader for EFN proudly suggested that by giving excuses to market not to quote and stopped trading until year end, the revenue would go up by HKD 1mio as the bank had budgeted a loss of HKD 4mio on EFN trading for the year

HKMA and EFBN Market makers

- MMs' privileges should only be awarded to those that fulfills their duties
- Given 1/3 in coma, and 1/3 are dormant, should consider reducing number of MMs
- Banks to re-apply the MM status
- League table seems to work well in new HKD issuance market, should consider introducing 'league table' on secondary EFBN trading
- Given the growing complaints on unfair tax treatments on corporate bonds, is it time to consider abolishing the preferential tax benefits

As investors...

- Ample complaints on the lack of secondary liquidity on CDs and bonds
- A matter of 'give and take'
- Given better liquidity on EFNs, should consider increasing the portions of EFNs in their portfolios