FEATURE ARTICLE

The Hong Kong debt market in 2011

by Monetary Management Department

The Hong Kong dollar debt market presented a mixed picture against the volatile global backdrop, with tightening liquidity pushing up the cost of funds for banks, while bond yields appeared to be falling. Contrasting this was a robust increase in debt issuance activities and the launch of the first retail investor issuance under the Government Bond Programme. The Hong Kong offshore renminbi debt market also continued to grow with increased support from Mainland China.

Global background

The global debt market remained under substantial stress and volatility in 2011. In the US, the amount of outstanding public debt in summer approached the ceiling permissible under the prevailing legislation, and the debate over the passage of new legislation to raise the ceiling almost ended in a default. While the default was avoided after the relevant legislation was passed, the US sovereign credit rating was downgraded from AAA to AA+ by Standard & Poor's (S&P) in August because of "weakening effectiveness, stability, and predictability of American policymaking and political institutions at a time of ongoing fiscal and economic challenges". To provide further monetary accommodation to support recovery in the real economy, the US Federal Open Market Committee announced in September the purchase of US$400 billion worth of longer-term US Treasuries by the end of June 2012 through selling an equal amount of short-term US Treasuries, a strategy commonly referred to as "Operation Twist".

In Europe, the market became increasingly alarmed by the growing number of debt-laden euro zone countries unable to manage their public debt burden without resorting to external assistance, including Greece, Italy, Spain and Portugal. Their credit ratings were downgraded over the course of the year (Table 1). Investors reduced their exposures to these sovereign debt papers and increased their holdings of higher-quality euro papers, such as German Bunds, thus driving the yield spreads of these countries against the Bund to an historic high since joining the euro zone (see Chart 1).

TABLE 1

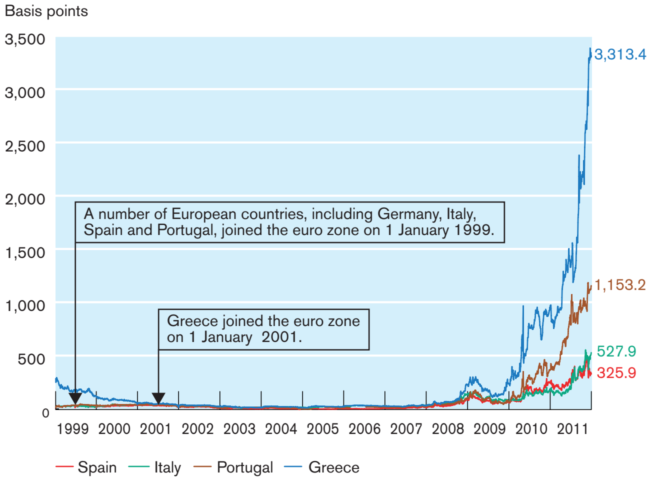
Local currency long-term credit ratings assigned by the three international credit rating agencies

	As at the end of 2010			As at the end of 2011		
	Fitch	Moody's	S&P	Fitch	Moody's	S&P
Greece	BBB-	Ba1	BB+	CCC	Ca	CC
Italy	AA-	Aa2	A+	A+	A2	A
Spain	AA+	Aa1	AA	AA-	A1	AA-
Portugal	A+	A1	A-	BB+	Ba2	BBB-

Source: Bloomberg.

CHART 1

Yield spreads of 10-year government bond yields of selected European countries versus Germany



Source: Bloomberg.

Against this backdrop, many European banks gradually became more reluctant to lend to one another, as they needed to mitigate the potential risks that the counterparty would not be able to repay their loan due to significant exposures to the debt-laden sovereigns. As a result, interbank liquidity dried up. Many banks were then forced to de-leverage to preserve capital, resulting in a vicious cycle that caused further deterioration in the liquidity condition.

Hong Kong debt market overview

Hong Kong dollar debt issuance activities recovered to pre-2008 level

Despite this volatile backdrop, the Hong Kong dollar debt market displayed a mixed picture. While tightening liquidity caused a rising cost of funds for banks in general, bond yields declined over 2011 (Charts 2 and 3). Meanwhile, debt issuance activities became more active. In particular, the non-public segment issued over HK$200 billion worth of Hong Kong dollar debt instruments, up 26% from 2010 (see Appendix). It was the first time issuance activities exceeded HK$200 billion since the outbreak of the global financial crisis in 2008.

It is worth noting that the growth was mostly driven by increased issuances made by authorized institutions (AIs) (i.e. banks) and local corporates. AIs' issuances increased by over 31%, while local corporate debt issuances doubled to a record level of over HK$27.5 billion. And, this growth took place against a global backdrop of tightened bank liquidity. Some banks reportedly became more active outside the interbank market, for instance, by issuing Certificates of Deposits, to obtain funding.

Similar situations were also found in corporate borrowers, who traditionally relied on loan facilities from banks to support funding. As liquidity tightened, banks' funding costs rose, causing an upward pressure on corporates' borrowing costs as well. Market reports suggested that some Hong Kong blue-chip borrowers were in talks with relationship banks on pricing of over 200 basis points above HIBOR for multi-year loans at the end of 2011,

CHART 2

Average cost of funds for banks in Hong Kong, proxy by the Composite Interest Rate

Note: The composite interest rate is a weighted average interest rate of all Hong Kong dollar interest bearing liabilities, which include deposits from customers, amounts due to banks, negotiable certificates of deposit and other debt instruments, and Hong Kong dollar non-interest bearing demand deposits on the books of banks, hence a measure of the average cost of funding for banks in Hong Kong.

Source: HKMA.

CHART 3

Average borrowing cost in the Hong Kong dollar bond market, proxy by the daily average yield of the non-government sub-index of HSBC Hong Kong Dollar Bond Index

Note: The non-government sub-index of the HSBC Hong Kong Dollar Bond Index tracks the performance of high quality Hong Kong dollar bonds with credit rating of Single-A or equivalent. Its daily average yield would therefore be a proxy of the average borrowing cost by such non-public issuers in the Hong Kong dollar market.

Source: Bloomberg.

up from around 50 basis points above HIBOR at the beginning of the year. Such a high pricing margin had not been seen since February 2000. At the same time, however, borrowing costs in the debt capital market appeared to be falling. Against this scenario, local corporates, especially the better names with existing and established access to the debt capital markets, might have switched from banks to such markets for raising funds, thus contributing to the sharp increase in issuance activities.

The Hong Kong offshore renminbi debt market continued to grow

Another key development in the Hong Kong debt market in 2011 was a further expansion of the renminbi segment. In the public segment, the Central Government's Ministry of Finance issued a total of RMB20 billion sovereign bonds in Hong Kong in August, up from RMB8 billion in 2010, of which RMB15 billion were for institutional investors and RMB5 billion for retail investors. For the non-public segment, around RMB88 billion worth of renminbi bonds were issued in 2011, a 217% growth over 2010.

The non-public issuer base also became more diversified during the year. In 2010 a significant portion of the renminbi bond issuances was made by Mainland financial institutions and local corporations, while corporations incorporated outside Hong Kong and the Mainland accounted for less than 10% of the amount issued. However, in 2011 these corporations issued over 30% of the renminbi bonds in Hong Kong. In addition, Mainland non-finance-related enterprises were allowed to issue renminbi-denominated bonds in Hong Kong for the first time, with Baosteel Group Limited raising a total of RMB3.6 billion in December 2011.

The development of the offshore renminbi debt market picked up further during the year and attracted a more diversified investor base. For example, over 50% of the issuance of the renminbi bond offering by a European retailer in August was bought by overseas investors, most of whom were reportedly institutional investors, such as investment funds. As the market continues to grow, greater participation from these institutional investors will help increase the diversity and sophistication of the market and assist with its sustainable development.

The Central Government also announced in August measures to stimulate the development of the offshore renminbi bond market, including a commitment that the issuance of renminbi sovereign bonds in Hong Kong would be a long-term institutional arrangement. As the offshore renminbi bond market is still at an early stage of development, the regular issuance of sovereign bonds will help build up an offshore renminbi sovereign benchmark yield curve in Hong Kong, which could facilitate the pricing of other renminbi-denominated debt papers in the offshore market. Such a long-term arrangement will also secure an important source of supply of high quality renminbi papers, which will help attract more investors to the market.

Apart from the above, the Central Government stated its support for the use of renminbi for foreign direct investments (FDI) on the Mainland. The administrative rules for conducting FDI in renminbi were promulgated in October. As Mainland China is one of the world's biggest FDI recipients, and a significant portion of the FDIs is processed through Hong Kong, the opening up of FDI in renminbi will attract a greater number of corporations to raise their funds for FDI through tapping the renminbi pool in Hong Kong. This will be useful in attracting a greater diversity of corporations to issue renminbi-denominated debts in Hong Kong.

Strengthening the Hong Kong debt market platform

A number of initiatives were implemented in 2011 to strengthen both the institutional and retail segments of the Hong Kong debt market.

Changes to the debt securities listing regime

Like other debt markets, the Hong Kong investor base is largely made up of institutional investors.

While on-exchange trading of debt securities by these institutional investors is rare, many of them can only invest in listed debt securities for reasons of investment compliance and mandated requirements.

In order to align the Hong Kong debt securities listing platform with other leading markets and enable it to offer processing times comparable with those markets, the Stock Exchange of Hong Kong (SEHK) made a number of amendments to its Listing Rules in 2011. In essence, for debt securities sold to professional investors[1], the listing regime has been simplified (see Box 1 for details). As a result, according to the SEHK, the appropriate listing application can be completed within 48 hours after all requisite documents are submitted under the new simplified regime, much the same as other leading markets.

Continued implementation of the Government Bond Programme to develop both the institutional and retail investor base of debt securities in Hong Kong

The Government continues to implement the Government Bond (GB) Programme to promote the non-bank investor base in Hong Kong. During 2011 HK$17.5 billion worth of GBs were issued to institutional investors under the Programme, bringing the outstanding size of bonds issued under this part of the GB Programme to HK$38 billion (Table 2). The HKMA will continue to look at necessary enhancements to assist the institutional GB market to better enable the Programme to achieve its market development objective.

The GB Programme is also aimed at developing Hong Kong's retail investor base. However, given the low interest rate environment in the past few years, issuance of conventional retail bonds with fixed coupon rates is not an attractive way to appeal to a sufficient mass of retail investors to participate. With this background, a HK$10 billion three-year inflation-linked bond, or the iBond, was issued to Hong Kong residents in July to initiate the retail part of the GB Programme. The iBond pays interest semi-annually, and the interest rate is linked to the average of the annual inflation in the previous six months. The parameters of the HK$10 billion iBond issuance completed in July are set out in Box 2.

The first iBond was aimed at improving retail investors' awareness and interest in investing in bonds, and providing Hong Kong residents with

TABLE 2

Outstanding Government Bonds issued under the Institutional Programme as at the end of 2011

Expected maturity date		Original maturity	Issue code	Coupon rate (% p.a.)	Outstanding size (HK$ billion)
2012	5 March	2-year	02GB1203	0.70	3.5
	3 September	2-year	02GB1209	0.48	3.5
2013	4 March	2-year	02GB1303	0.85	3.5
	9 September	2-year	02GB1309	0.32	3.5
2014	3 November	5-year	05GB1411	2.07	6.5
2015	2 December	5-year	05GB1512	1.43	5.0
2016	8 December	5-year	05GB1612	0.97	2.5
2020	13 January	10-year	10GB2001	2.93	7.5
2021	4 August	10-year	10GB2108	2.46	2.5
Total					**38**

Source: HKMA.

[1] A large majority of institutional investors who invest in debt securities actually fall under the definition of "professional investors" under the Securities and Futures Ordinance of Hong Kong. Hence, the SEHK currently uses the term "professional investors" as defined under the Ordinance.

another investment option for coping with inflation. It was over-subscribed and well-received by investors. Over 155,000 valid applications were received for a total of about HK$13.16 billion in principal amount. By subscribing to the iBond and participating in the investment process, investors with no previous experience in this field have the opportunity to better understand the whole bond investment process. It also helps broaden the investor base for the local bond market and foster the development of the local retail bond market and secondary market for bond trading.

In his 2012-13 Budget, the Financial Secretary announced that another iBond of up to HK$10 billion would be issued under the GB Programme. The HKMA is co-ordinating the issuance and hopes to complete it in the first half of 2012.

Looking ahead

The HKMA is considering further measures to help promote the attractiveness of the Hong Kong debt market, including ways to facilitate the secondary market, and broaden the investor base for Hong Kong dollar debts. The HKMA will also increase its marketing and outreach efforts to overseas investors to better understand their investment appetite and promote their interest in the market.

APPENDIX

Issuances of Hong Kong dollar debt instruments (in HK$ million)

	(A) Exchange Fund	(B) Government	(A) + (B) Public segment (year-on-year rate of change)	(C) Authorized Institutions	(D) Local corporates	(E) MDBs	(F) Non-MDB overseas issuers	(G) Statutory bodies & government-owned corporations	(C) to (G) Non-public segment (year-on-year rate of change)	Total (year-on-year rate of change)
1998	316,850	0	316,850	34,029	6,180	44,502	7,006	9,171	100,888	**417,738**
1999	261,443	0	261,443 (-17.5%)	83,410	24,098	15,920	21,197	8,931	153,556 (52.2%)	**414,999 (-0.7%)**
2000	275,036	0	275,036 (5.2%)	99,694	16,157	19,330	37,404	8,325	180,910 (17.8%)	**455,946 (9.9%)**
2001	237,009	0	237,009 (-13.8%)	72,634	5,175	7,462	42,464	24,075	151,809 (-16.1%)	**388,818 (-14.7%)**
2002	216,228	0	216,228 (-8.8%)	94,813	8,804	5,200	50,746	20,760	180,323 (18.8%)	**396,551 (2.0%)**
2003	219,648	0	219,648 (1.6%)	94,373	5,470	2,641	51,955	15,724	170,162 (-5.6%)	**389,810 (-1.7%)**
2004	205,986	10,250	216,236 (-1.6%)	74,289	9,171	3,530	55,799	17,799	160,588 (-5.6%)	**376,824 (-3.3%)**
2005	213,761	0	213,761 (-1.1%)	98,911	9,951	1,800	69,014	8,560	188,236 (17.2%)	**401,997 (6.7%)**
2006	220,415	0	220,415 (3.1%)	82,642	21,371	2,950	109,297	17,419	233,679 (24.1%)	**454,094 (13.0%)**
2007	223,521	0	223,521 (1.4%)	100,543	18,678	1,700	80,977	19,368	221,266 (-5.3%)	**444,787 (-2.0%)**
2008	285,875	0	285,875 (27.9%)	67,997	14,292	3,000	28,889	24,308	138,485 (-37.4%)	**424,360 (-4.6%)**
2009	1,047,728	5,500	1,053,228 (268.4%)	74,779	19,539	13,145	51,530	29,852	188,845 (36.4%)	**1,242,073 (192.7%)**
2010	1,816,752	18,500	1,835,252 (74.3%)	104,160	13,383	315	31,674	11,187	160,720 (-14.9%)	**1,995,972 (60.7%)**
2011	1,841,278	27,500	1,868,778 (1.8%)	136,768	27,522	0	19,082	19,195	202,567 (26.0%)	**2,071,345 (3.8%)**

Outstanding size of Hong Kong dollar debt instruments (in HK$ million)

	(A) Exchange Fund	(B) Government	(A) + (B) Public segment (year-on-year rate of change)	(C) Authorized Institutions	(D) Local corporates	(E) MDBs	(F) Non-MDB overseas issuers	(G) Statutory bodies & government-owned corporations	(C) to (G) Non-public segment (year-on-year rate of change)	Total (year-on-year rate of change)
1998	97,450	0	97,450	169,896	19,450	69,402	25,579	11,366	295,693	**393,143**
1999	101,874	0	101,874 (4.5%)	184,358	34,248	61,287	37,309	20,117	337,318 (14.1%)	**439,192 (11.7%)**
2000	108,602	0	108,602 (6.6%)	193,102	37,955	57,062	55,153	20,047	363,319 (7.7%)	**471,921 (7.5%)**
2001	113,750	0	113,750 (4.7%)	181,986	38,455	51,104	72,401	35,873	379,818 (4.5%)	**493,568 (4.6%)**
2002	117,476	0	117,476 (3.3%)	187,964	37,017	40,834	99,514	48,212	413,542 (8.9%)	**531,018 (7.6%)**
2003	120,152	0	120,152 (2.3%)	198,524	32,966	27,855	121,486	56,441	437,273 (5.7%)	**557,425 (5.0%)**
2004	122,579	10,250	132,829 (10.6%)	208,217	34,208	24,735	147,729	60,186	475,075 (8.6%)	**607,904 (9.1%)**
2005	126,709	10,250	136,959 (3.1%)	235,486	37,638	21,535	174,397	57,712	526,769 (10.9%)	**663,728 (9.2%)**
2006	131,788	7,700	139,488 (1.8%)	242,366	52,398	19,555	237,458	56,876	608,653 (15.5%)	**748,141 (12.7%)**
2007	136,646	7,700	144,346 (3.5%)	252,983	60,628	13,155	234,632	58,476	619,874 (1.8%)	**764,220 (2.1%)**
2008	157,653	5,000	162,653 (12.7%)	207,645	67,015	14,253	200,425	64,618	553,955 (-10.6%)	**716,608 (-6.2%)**
2009	534,062	7,000	541,062 (232.6%)	195,042	79,462	24,348	201,490	66,643	566,985 (2.4%)	**1,108,047 (54.6%)**
2010	653,138	25,500	678,638 (25.4%)	219,280	84,875	15,513	186,755	60,592	567,016 (0.0%)	**1,245,654 (12.4%)**
2011	655,413	49,500	704,913 (3.9%)	228,920	95,824	14,731	166,506	50,034	556,016 (-1.9%)	**1,260,929 (1.2%)**

Notes:

1. Authorized institutions include licensed banks, restricted licence banks and deposit-taking companies.
2. Multilateral Development Banks (MDBs) refer to the Asian Development Bank, the Council of Europe Social Development Fund, the European Company for the Financing of Railroad Rolling Stock, the European Investment Bank, the European Bank for Reconstruction and Development, the Inter-American Development Bank, the International Bank for Reconstruction and Development, the International Finance Corporation, the African Development Bank, and the Nordic Investment Bank. Income earned on Hong Kong dollar debt securities issued by the MDBs is exempt from profits tax.
3. Statutory bodies and government-owned corporations include Bauhinia Mortgage-backed Securities Limited, The Hong Kong Mortgage Corporation, Airport Authority Hong Kong, Hong Kong Housing Authority, Hong Kong Link 2004 Limited, Kowloon-Canton Railway Corporation and MTR Corporation Limited. It should be noted that while the issuers are public bodies in the legal sense, they are typically considered as non-public issuers by the market. Hence, they are categorised under the "non-public" segment in the tables above.
4. Figures between 1998 and 2010 have been revised.
5. Figures may not add up to total because of rounding.

Source: HKMA.

BOX 1

The Stock Exchange of Hong Kong's listing regime for debt securities issued to professional investors

In Hong Kong, the listing status of debt issuances can be sought from the Stock Exchange of Hong Kong (SEHK) in accordance with the Listing Rules, which set out the detailed methods, qualifications, procedures and document requirements for such listing applications. Recognising that many debt instruments are actually sold to institutional investors, the SEHK had a "selectively marketed securities" regime, whereby issuers selling their debt securities to a selective group of institutional investors could seek to list their issuances in a simplified regime under the Listing Rules.

The SEHK conducted a public consultation exercise in December 2010 with the aim of revising the regime. A number of amendments were proposed, including renaming the regime to one for "professional investors" to unify the definition used under the Securities and Futures Ordinance. Following the announcement of the public consultation conclusions in October 2011[2], a number of changes took effect on 11 November, which are summarised as follows:

1. Adoption of an "approval-in-principle" approach

Under the new regime for professional investors, the SEHK will issue a "Listing Eligibility Letter" to confirm that an issuer and issue are eligible for listing. It also confirms that the SEHK will not exercise authority to require a listing document to include additional information (or sets out details of information to be included) in relation to the listing status. Such an approach, which market participants commonly refer to as "approval-in-principle", is adopted in other markets, such as Singapore. Under this new approach, the issuer will be subject to a shorter time frame between listing application and issuance, hence more flexibility for them to finalise the issuance parameters. The "Listing Eligibility Letter" will be issued within five business days after it receives the application, and will be valid for three months from its date of issue.

2. Replacing the previous prescribed disclosures for listing documents with a requirement to include information that is customary for offers of debt securities to professionals

Under the old "selectively marketed securities" regime, listing documents prepared for a listing were required to comply with a prescribed checklist of information, as set out under the Listing Rules. Under the new "professional investor" regime, the issuers are only required to submit information that is *customary* for offers of debt securities to professionals. This new approach is also very similar to that practised in other regional stock exchanges. Hence, the change is expected to make it easier for issuers who are not familiar with the listing arrangements of the SEHK, such as the overseas issuers, to seek a listing status on the SEHK for debt securities sold to our professional investors.

[2] The document is available on: http://www.hkex.com.hk/eng/newsconsul/mktconsul/Documents/cp2010122cc.pdf.

3. Removing continuing obligations on issuers to report under the "professional investors" regime

Since the "professional investors" are expected to be more knowledgeable in relevant investment matters, they are not expected to be subject to the same level of investor protection as retail investors. Therefore, a number of disclosure requirements originally contained in the Listing Rules, which are directed at protecting retail investors' interests, no longer apply under the "professional investors" regime. This will reduce the reporting costs for debt issuers, hence increasing the attractiveness of the SEHK debt listing platform.

BOX 2

Key parameters of the HK$10 billion iBond series due 2014 issued under the retail part of the Government Bond Programme

Issue number	03GB1407R
Stock code	4208
Tenor	3-year
Issue size	HK$10 billion
Issue date	28 July 2011
Maturity date	28 July 2014
Application and subscription price	100%
Minimum denomination	HK$10,000
Interest rate (i.e. coupon rate)	The interest rate for each interest payment date will be determined and announced on the relevant interest determination date as the higher of : (i) the floating rate, being the arithmetic average of the year-on-year rates of change in the 2009/10-based Composite Consumer Price Index for the six most recent preceding months, rounded to the nearest two decimal places; and (ii) the fixed rate of 1.00%, per annum, payable every six months in arrears.
Method of offering	Application via one of the Placing Intermediaries: • Placing banks • Hong Kong Securities Clearing Company Limited • Securities brokers
Application requirement	Holders of valid Hong Kong Identity Card
Listing status	On the Stock Exchange of Hong Kong