Hong Kong dollar debt market development in 2003

by Michael Chui, Ada Lee and Eve Law of the Research Department and
Colin Pou and Frances Lee of the Monetary Management and Infrastructure Department

New issues of Hong Kong dollar debt declined slightly in 2003. Increased borrowing by overseas borrowers other than Multilateral Development Banks was offset by falling issues by authorized institutions and local corporations. Nevertheless, total outstanding debt continued to grow, as issuers took advantage of low borrowing costs to refinance their existing debts.

A number of initiatives were introduced in 2003 to promote the further development of the local debt market. The Euro Clearing system, introduced in April, enables euro-denominated debt securities to be settled on a Delivery versus Payment (DvP) basis. The Government also implemented, under a three-phased approach, measures to streamline regulations and procedures for issuing and listing debt securities.

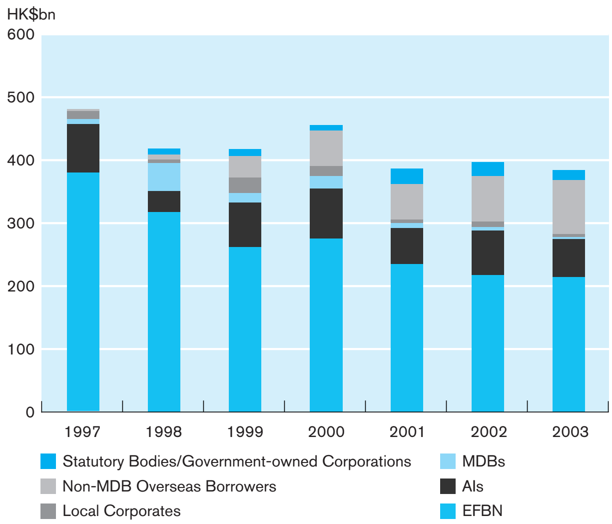
Growth in the retail bond market consolidated in 2003 after expanding sharply in 2002. Looking ahead, the promotion of investor education, together with supportive government policies, should further facilitate development of the local retail bond market.

MARKET OVERVIEW

Gross issuance of Hong Kong dollar debt declined by 3% in 2003 to HK$384 billion (Chart 1). Following a sharp increase of 28% in 2002, debt issuance by overseas borrowers other than Multilateral Development Banks (MDBs) rose by 17% in 2003 to HK$86 billion.[1] However, this was more than offset by the strong decline in domestic private-sector debt issuance, with that of authorized institutions (AIs) and local corporates falling by 15% and 38% respectively.[2] Debt issuance activity by the Exchange Fund, Statutory Bodies/Government-owned Corporations and MDBs also moderated.

CHART 1

New issues of Hong Kong dollar debt instruments



Source: HKMA.

[1] MDBs refer to Asian Development Bank (ADB), Council of Europe Social Development Fund (CEF), European Company for the Financing of Railroad Rolling Stock (Eurofima), European Investment Bank (EIB), European Bank for Reconstruction and Development (EBRD), Inter-American Development Bank (IADB), International Bank for Reconstruction and Development (IBRD), International Finance Corporation (IFC), African Development Bank (AfDB), and Nordic Investment Bank (NIB). Income earned on debt securities issued by the MDBs is exempted from profits tax.

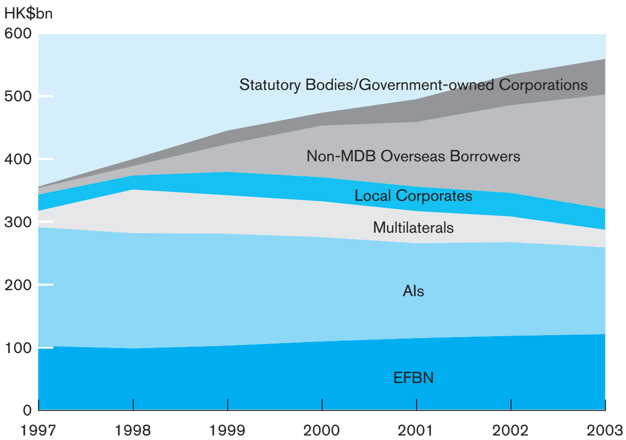
[2] AIs include licensed banks, restricted licence banks (RLBs), and deposit-taking companies (DTCs).

In 2003 the overall market continued to deepen with more structured products bearing yield enhancement features and longer-term debt securities being sold. However, the demand for retail bonds weakened, in part due to the rebound of the local stock and property markets in the second half of 2003 (see Appendix A).

Despite the fall in gross issuance, outstanding Hong Kong dollar debt rose to HK$558 billion at the end of 2003 as total new issues during the year exceeded maturing securities by HK$25 billion (Chart 2). Net issuance (gross issuance minus debt matured) by non-MDB overseas borrowers reached HK$42 billion in 2003, replacing AIs as the largest debtor, accounting for almost one-third of total outstanding Hong Kong dollar debt. At the same time, possibly reflecting the ample liquidity in the banking sector and hence little need for external funds, AIs reduced their total outstanding debt by HK$11 billion to HK$138 billion. A detailed breakdown of issuance activities and outstanding debt instruments is in Appendix B.

CHART 2

Outstanding amount of Hong Kong dollar debt instruments (HK$ billion)



Source: HKMA.

FIXED-RATE DEBT MARKET

New issues of fixed-rate debt, excluding Exchange Fund paper, continued to grow strongly in 2003, rising by 18% to HK$120 billion.[3] The low interest rate environment in Hong Kong appeared to be particularly attractive to foreign corporates as non-MDB overseas borrowers issued a net HK$34 billion of fixed-rate debt, bringing the total outstanding amount to HK$123 billion. Net issues of fixed-rate instruments by AIs and other local companies were flat, while that of statutory bodies and MDBs fell slightly. These issuers extended their average maturity profiles of new fixed-rate debt issues in 2003 to lock in the current low borrowing costs (Table 1).

FLOATING-RATE DEBT MARKET

Gross floating-rate debt issuance fell substantially by 36% to HK$51 billion in 2003, after growing strongly

TABLE 1

Average maturity of new fixed-rate debt excluding Exchange Fund Bills and Notes

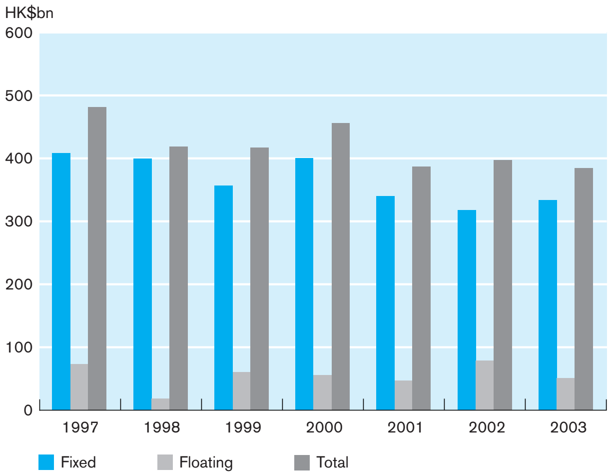
Issuer	1997	1998	1999	2000	2001	2002	2003
Statutory Bodies/Government-owned Corporations	—	2.9	2.0	2.0	3.6	2.9	6.7
MDBs	5.2	2.0	3.4	4.0	4.8	5.6	7.5
Non-MDB Overseas Borrowers	4.3	2.1	1.6	2.2	2.9	3.7	3.1
AIs	2.5	3.5	2.0	2.1	2.4	2.4	3.0
Local Corporates	0.1	0.2	2.4	3.3	2.6	4.3	4.5
Total	**3.2**	**2.3**	**2.2**	**2.5**	**3.0**	**3.3**	**3.6**

Source: HKMA.

[3] All Exchange Fund Bills and Notes are fixed-rate debt.

CHART 3

New fixed-rate and floating-rate debt issued in Hong Kong (HK$ billion)



Source: HKMA.

in the previous year (Chart 3). With fixed-rate debt becoming more popular among investors, the share of new issuance of floating-rate securities, excluding Exchange Fund paper, fell to 30% in 2003 from 44% a year ago. The slowdown was largely due to a reduction in issues by AIs and non-MDB overseas borrowers, which increased their fixed-rate issuance on uncertain US growth and interest rate outlook. At the end of 2003, outstanding floating-rate debt amounted to HK$147 billion, down 6% from 2002.

MEASURES TO PROMOTE DEBT MARKET DEVELOPMENT IN HONG KONG

Over the past year, the authorities have introduced a number of new measures to foster the development of the local debt market. These included improving the debt securities clearing infrastructure, promoting Exchange Fund Notes in the retail market, expanding the profits tax concession scheme, and streamlining regulations on issuing and listing debt securities.

Enhancing debt securities clearing systems

Ever since the HKMA began implementing out-bound links from the Central Moneymarkets Unit (CMU) to other regional and international central securities depositories in 1997, the CMU has evolved as a one-stop debt securities clearing, settlement and custody platform for Asian investors. Through the CMU, Asian investors can settle and hold domestic debt securities in Australia, Hong Kong, Korea and New Zealand, as well as international debt securities lodged with Clearstream and Euroclear in a safe and efficient environment. With the implementation of the Euro Clearing system in Hong Kong in April 2003, the CMU provides its members an option to settle, in addition to Hong Kong dollar and US dollar, euro-denominated debt securities on a Delivery versus Payment (DvP) basis. This real-time DvP facility has further enhanced settlement efficiency and eliminated settlement risk of euro-denominated debt securities transactions settled through the CMU.

Promoting Exchange Fund Notes in the retail market

The HKMA launched, on 1 August 2003, a one-year pilot scheme to facilitate retail investment in Exchange Fund Notes. Under the scheme, a portion of the 2-year and 3-year Exchange Fund Notes issued each quarter is made available for non-competitive tender by retail investors through three designated Retail Exchange Fund Notes Distributors — the Bank of East Asia, DBS Bank (HK) and Wing Lung Bank. In addition to providing the non-competitive tender service, the distributors agreed to adhere to a number of unified standards in the distribution of Exchange Fund Notes to retail investors in the secondary market to enhance pricing transparency and facilitate comparison by retail investors. The first three non-competitive tenders conducted in August, October and November 2003 saw a total of HK$241 million of Exchange Fund Notes sold to retail investors.

Educating retail investors

While welcoming progress in the retail bond market, the HKMA is also concerned that the public might not be aware of the risks associated with fixed income product investment. In this regard, the HKMA added a new section, “Exchange Fund Notes: Information for Investors”, to its website to educate retail investors on bond investment. An updated pamphlet on Exchange Fund Notes was also issued for distribution to the public to promote awareness of the retail Exchange Fund Notes programme.

Tax concession

The Government expanded some tax concessions to stimulate demand for debt securities. In his Budget Speech on 5 March 2003, the Financial Secretary announced that trading profits from Qualified Debt Instruments (QDI) with a maturity period of seven years or more, which previously were eligible for a 50% profits tax concession, would be exempted totally from profits tax.[4] In addition, the Government relaxed the minimum maturity requirement on the current 50% tax concession on QDI profits from five years to three years.

Streamlining regulations on issuing and listing debt securities

The Government implemented, under a three-phase approach, measures to streamline the regulations and procedures for issuing and listing debt securities. Measures under the first phase involved the issuance of various guidelines by the Securities and Futures Commission (SFC) in February 2003. These included permitting awareness advertisements, an alternative "dual prospectus" structure, and allowing faxed copies of expert consent letters and bulk print proofs of prospectuses for the purpose of registration. A two-class exemption by the SFC in relation to prospectuses for offers of debentures also came into operation in May 2003.[5] The second phase was the introduction of the Companies (Amendment) Bill 2003 into the Legislative Council in June 2003. It proposed to simplify procedures for registration and issue of prospectuses. In the third phase, the SFC will conduct a comprehensive review of the existing laws and procedures against international standards, with a view to facilitating the issuance and listing of securities. The SFC has started the review and aims to put forward proposals for public consultation by September 2004.

CONCLUSION

Gross issuance of Hong Kong dollar debt declined modestly in 2003. Despite reduced activity in this area by local corporates and banks, the market saw an increasing participation of foreign issuers. Looking ahead, fund-raising needs of both the public and private sectors should increase as the economy continues to recover. The enhancement of market infrastructure and the implementation of measures to streamline the regulations and procedures for issuing and listing debt securities should add further impetus to the development of the local bond market.

---

4 Qualified debt securities (QDSs) are debt paper (a) issued to the public in Hong Kong (b) with an original maturity of not less than five years (c) with a minimum denomination of HK$50,000 or its equivalent in a foreign currency (d) lodged with and cleared by the Central Moneymarkets Unit in its entirety and (e) for papers issued by non-statutory bodies or non-government owned corporations, they would need to have at all relevant times a credit rating from a recognised rating agency acceptable to the HKMA (e.g. currently BBB- or above from S&P's).

5 The two class exemption includes:

(a) prospectuses relating to offers of listed and unlisted debentures will be exempted, subject to certain conditions of the Third Schedule to the Companies Ordinance on the basis that the SFC considers they are irrelevant for the purposes of making an informed investment decision and/or unduly for companies to comply with; and

(b) prospectuses relating to offers of listed debentures will be exempted from those contents requirements that are the same as or similar to those under the applicable listing rules (provided no waiver, modification or other dispensation has been granted from such requirements).

APPENDIX A

RETAIL BOND MARKET DEVELOPMENT IN HONG KONG

The retail bond market in Hong Kong has grown considerably over the past two years, evolving into an alternative source of funding for both local and overseas corporations. From the point of view of individual investors, retail bonds provide an extra investment choice with relatively low risk and stable income. In addition, they can help enlarge the investor base and improve local debt market liquidity, which has now been generally accepted as a key policy to prevent and ameliorate financial crises. This box assesses recent trends in Hong Kong's retail bond market and discusses possible measures to enhance its future development.

Strong initial development

Since the Hong Kong Mortgage Corporation (HKMC) first introduced in October 2001 its arrangement of offering bonds to retail investors through placing banks, retail bonds have attracted growing local investor interest. Initially, issuance activities were dominated by statutory organisations such as the HKMC, the Airport Authority (AA), and the Mass Transit Railway Corporation. But in mid-2002, Wharf became the first private company to issue retail debt securities in Hong Kong. The first foreign company to tap Hong Kong's retail bond market was Ford Credit — a wholly owned subsidiary of the Ford Motor Company, specialising in automotive finance — which issued both Hong Kong dollar and US dollar denominated notes in late 2003.

From October 2001 to end-2003, 24 companies and banks had raised over HK$38 billion through 170 issues of retail bonds and retail certificates of deposits, accounting for around 10% of total Hong Kong dollar debt securities (excluding Exchange Fund Bills and Notes) issued during that period. With more companies and financial institutions exploring this channel of fund raising in Hong Kong, the range of products offered has expanded to include those with relatively high fixed coupon payments for an initial period and other yield enhancement features to compete for potential customers. The maturity profile of retail bonds has also been extended with the introduction of long-dated issues, such as the 7-year notes issued by the AA and the HKMC, as well as the 10-year issue by the Kowloon-Canton Railway Corporation in 2003.

Apart from the increasing number of issuers and continuous product innovation, favourable market conditions in 2001-02 also contributed to the rapid development of the retail bond market. The volatile stock market performance and depressed property prices, together with historically low nominal deposit rates, have spurred retail investors to look for alternative investment vehicles with lower risk and more stable income. The implementation of the Mandatory Provident Fund Scheme also helped stimulate retail demand for bonds by increasing the public's acquaintance with bond investment.

The recent slowdown

Entering the second half of 2003, issuance activity slowed with the dissipation of some favourable macroeconomic factors. In particular, demand for retail bonds was affected by the improved returns of alternative investment instruments. First, after an unusually long period of market downturn, equity prices around the world rose sharply in the second half of 2003. Secondly, property prices appeared to have passed their trough. On the supply side, some issuers might have taken advantage of the record low interest rates by pre-funding their investment projects in early 2003, contributing to the recent slowdown in fund-raising activities. It is estimated that a total of HK$14 billion of retail bonds and certificates of deposits was issued in Hong Kong in 2003, a decline of around 40% from the previous year.

Apart from the macroeconomic conditions, some microeconomic factors also contributed to the recent slowdown in the retail bond market. Market sources suggested that a majority of existing bondholders were fixed-term depositors who switched to retail bonds for the higher returns under the present low interest-rate environment. These investors, who regard retail bonds as direct substitutes for time deposits, are inclined to hold them until maturity. This is despite their having no problem trading retail bonds in the secondary market, since more than a dozen banks are committed to making markets for the retail bonds. Such buy-and-hold behaviour boosts the demand in the primary market, but does not contribute to active secondary market trading.

Over the past few years, authorized institutions (AIs) in Hong Kong have experienced a falling loan-to-deposit ratio, which affects their profitability. In agreeing to act as placing agents and market makers for the retail bond issuers, AIs could explore a new source of fee income and potentially reduce their cost of interest payments as depositors converted their excess deposits into bonds. However, some market sources reported that, after the initial period of rapid growth in 2002, some sales staff appear to be less enthusiastic to market such products due to the relatively low fee income involved and the regulations that prohibit unsolicited calls to those depositors that do not have securities dealings accounts.[6]

[6] If the customer concerned is not an "existing client" as defined in the Securities and Futures Ordinance, the staff of the registered institutions should not take any initiative to promote securities or futures products and services unless and until that customer takes the initiative to indicate an interest in taking up the relevant products or services. See "Supervisor's Memo: The Securities and Futures Ordinance and Banking (Amendment) Ordinance 2002", *HKMA Quarterly Bulletin*, June 2003 for details.

Long-term prospect

In the face of these difficulties, policymakers have already introduced a series of measures to foster further progress of the retail bond market. Key initiatives include investor education, streamlining regulations and procedures in issuing and listing debt securities and promoting Exchange Fund Notes in the retail market (see main text for details).

The long-term growth potential for the retail bond market in Hong Kong is considerable. On the demand side, the size of Hong Kong dollar time deposits in the banking system, which gives some indication of the amount the public is prepared to put into assets that produce a stable return, exceeded HK$750 billion at end-2003, more than 1.8 times the outstanding Hong Kong dollar denominated fixed rate bonds. A transfer of a modest 10% of the time deposits to the bond market would significantly increase its size by HK$75 billion or 18%. This together with the developed local banking network and the Government's supportive stance offer some favourable conditions for the retail bond market to prosper.

APPENDIX B

New issues of Hong Kong dollar debt instruments (HK$ million)

During	Exchange Fund	Statutory Bodies*	MDBs	Non-MDB Overseas Borrowers	AIs	Local Corporates	Total
1997	379,900	0	8,650	2,540	76,902	12,778	**480,770**
1998	316,850	9,171	44,502	7,728	33,307	6,180	**417,738**
1999	261,443	10,386	15,920	34,417	70,290	24,098	**416,553**
2000	275,036	8,325	19,330	57,110	79,753	16,107	**455,661**
2001	233,960	24,316	7,462	56,865	57,807	5,600	**386,011**
2002	216,228	21,557	5,200	73,065	71,406	8,854	**396,312**
2003	213,255	16,002	2,641	85,509	60,850	5,470	**383,727**
Increase/ Decrease over 2002	(2,973)	(5,555)	(2,559)	12,443	(10,556)	(3,384)	**(12,584)**

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

As at end of	Exchange Fund	Statutory Bodies*	MDBs	Non-MDB Overseas Borrowers	AIs	Local Corporates	Total
1997	101,650	2,295	26,150	10,032	188,387	26,183	**354,698**
1998	97,450	11,366	69,402	14,777	183,300	22,378	**398,673**
1999	101,874	21,572	61,287	43,767	177,915	37,331	**443,745**
2000	108,602	20,509	57,062	81,840	165,680	38,405	**472,098**
2001	113,750	36,227	51,104	102,897	150,960	38,880	**493,818**
2002	117,476	48,828	40,834	139,145	149,013	37,567	**532,863**
2003	120,152	56,780	27,855	181,522	137,988	33,466	**557,764**
Increase/ Decrease over 2002	2,676	7,952	(12,979)	42,377	(11,025)	(4,101)	**24,901**

*Include Government-owned Corporations
Source: HKMA.