The Hong Kong dollar debt market in 2004

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The Hong Kong dollar debt market continued to grow in 2004. For the first time since 1984, the Government issued bonds to help develop the local bond market and to provide capital for infrastructure projects. New issues of fixed-rate debt continued to dominate the market as issuers took advantage of the low interest rate environment.

The growth partly reflected the HKMA's continued efforts to improve market infrastructure and to educate individual investors by establishing debt securities settlement between the Mainland and Hong Kong, introducing a new Hong Kong dollar repo settlement platform, offering Exchange Fund Notes to retail investors, and facilitating media coverage of the pricing of Exchange Fund Notes.

The successful sales of government securitisation bonds and the Hong Kong Mortgage Corporation mortgage-backed notes to retail investors suggest that securitisation is gathering momentum in Hong Kong. Securitised debts provide firms with an efficient financing channel and cater for investors with various risk preferences. Also, a liquid and well-functioning securitisation market can help strengthen Hong Kong's financial system.

Market overview

The Hong Kong dollar debt market grew during the year with total outstanding debt rising by 9% to HK$608 billion at the end of 2004 (Chart 1). Apart from multilateral development banks (MDBs),[1] all other issuers–the Exchange Fund, the Government, statutory bodies/government-owned corporations,[2] authorized institutions (AIs),[3] local corporations, and non-MDB overseas borrowers–increased their debt stocks. After reaching a peak of HK$69 billion in 1998, MDBs' outstanding Hong Kong dollar debt fell continuously to HK$25 billion at the end of 2004.

Gross issuance of Hong Kong dollar debt declined slightly by HK$7 billion in 2004 to HK$377 billion (Chart 2). Debt issuance activity by the Exchange Fund moderated by a similar amount, but it remained the largest issuer in the year, accounting for 55% of all new issues. Demand for these Exchange Fund

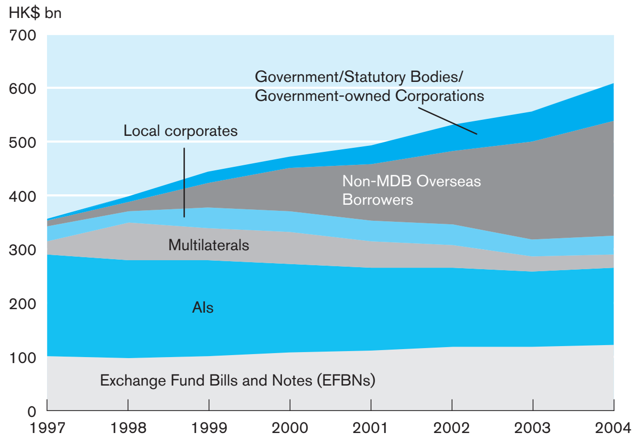
[1] MDBs refer to the Asian Development Bank (ADB), the Council of Europe Social Development Fund (CEF), the European Company for the Financing of Railroad Rolling Stock (Eurofima), the European Investment Bank (EIB), the European Bank for Reconstruction and Development (EBRD), the Inter-American Development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

[2] Statutory bodies or government-owned corporations include Bauhinia Mortgage-backed Securities Limited, the Hong Kong Mortgage Corporation, the Hong Kong Airport Authority, the Hong Kong Housing Authority, Hong Kong Link 2004 Limited, the Kowloon-Canton Railway Corporation, and the MTR Corporation Limited.

[3] AIs include licensed banks, restricted license banks, and deposit-taking companies.

CHART 1

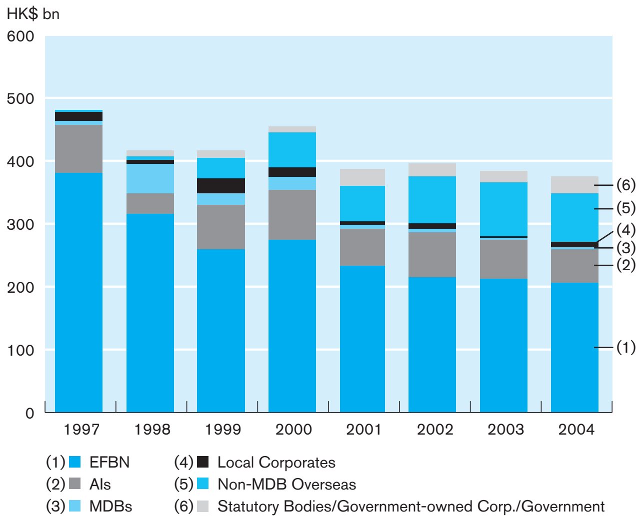
Outstanding amount of Hong Kong dollar debt instruments



Source: HKMA.

CHART 2

New issues of Hong Kong dollar debt instruments



Source: HKMA.

Bills and Notes (EFBNs) was strong with an average over-subscription rate of three times. Strong demand, together with ample liquidity in the banking system,[4] helped keep yields on EFBNs down. The yield on 10-year EFBNs decreased by 74 basis points to 3.63% at the end of 2004, some 58 basis points lower than the yield of comparable US Treasury notes.

Excluding the Exchange Fund paper, new issuance of Hong Kong dollar debt was stable at HK$171 billion in 2004. Decreases in new issues by AIs and non-MDB overseas borrowers were broadly offset by increases in new local corporate, government/ statutory bodies and government-owned corporate issues (see Appendix A for a detailed breakdown of issuance activities and outstanding debt instruments).

The Government launched a global bond issue in 2004, its first since 1984, to provide funding for capital works projects and greater flexibility in the management of government liquidity, as well as to promote the development of the Hong Kong bond market. The offering totalled HK$20 billion of which a domestic tranche of HK$10.25 billion was sold to retail and institutional investors, and an international tranche of US$1.25 billion 10-year notes was allocated to 147 institutional investors.

The overall market continued to deepen with more structured products and securitised instruments being offered during the year (see Appendix B). In May, Hong Kong Link 2004 Limited, a wholly government-owned corporation, sold HK$6 billion of securitisation bonds, backed by toll revenues from five government-owned tunnels and one bridge to finance infrastructure projects. In late 2004, the HKMC launched the first-ever retail mortgage-backed securities in Hong Kong.

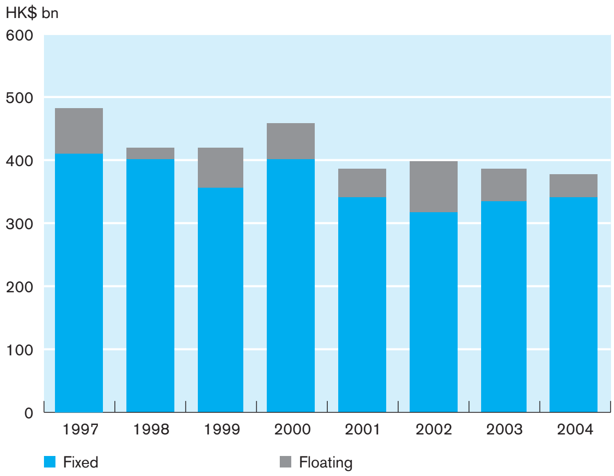
[4] The Aggregate Balance, a measure of interbank liquidity, rose sharply to a daily average of HK$30 billion in 2004 from HK$3 billion in 2003.

Fixed-rate debt market

New issues of fixed-rate debt, excluding Exchange Fund paper, continued to grow strongly in 2004.[5] After rising by 16% in 2003, new fixed-rate debt issued increased by another 12% to HK$134 billion. The expansion was largely driven by the Government's global bond and securitisation issues. New issues of fixed-rate debt by private issuers such as non-MDB overseas borrowers, AIs, and local corporates were broadly stable. Many of the issuers extended their average maturity profiles of new fixed-rate debt issues in 2004 to lock in the current low borrowing costs (Table 1), perhaps reflecting the general market expectations of a rise in interest rates in Hong Kong in 2005.

CHART 3

New fixed-rate and floating-rate debt issued in Hong Kong



Source: HKMA.

Floating-rate debt market

Gross floating-rate debt issuance declined by 27% in 2004 to HK$37 billion, after falling 36% in the previous year (Chart 3). With fixed-rate debt becoming more popular among investors, the share of floating-rate securities in total new issues (excluding Exchange Fund paper), fell to 22% in 2004 from 29% a year earlier. As more floating-rate debt matured during the year than newly issued debt, outstanding floating-rate debt fell slightly to HK$144 billion at the end of 2004.

Measures to promote debt market development in Hong Kong

The HKMA continued its efforts to foster the development of the Hong Kong debt market in 2004. The measures included establishing a direct linkage with the China Government Securities Depository Trust & Clearing Co. Ltd., introducing a new Hong Kong dollar repo settlement platform, offering Exchange Fund Notes to retail investors, and facilitating the media's coverage of the pricing of Exchange Fund Notes.

TABLE 1

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

Issuer	1997	1998	1999	2000	2001	2002	2003	2004
Government bonds	–	–	–	–	–	–	–	5.5
Statutory bodies/ government-owned corporations	–	2.9	2.0	2.0	3.6	2.9	6.7	4.5
MDBs	5.2	2.0	3.4	4.0	4.8	5.6	7.5	8.2
Non-MDB overseas borrowers	4.3	2.1	1.6	2.2	2.9	3.7	3.1	4.0
AIs	2.5	3.5	2.0	2.1	2.4	2.4	3.0	3.0
Local corporates	0.1	0.2	2.4	3.3	2.6	4.3	4.5	5.6
Total	3.2	2.3	2.2	2.5	3.0	3.3	3.6	4.1

Source: HKMA.

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

Direct linkage with the Mainland Government Securities Book-Entry System

The Central Moneymarkets Unit (CMU) provides an efficient clearing, settlement and depository service for both Hong Kong and other international debt securities. To foster cross-border debt securities settlement between Mainland China and Hong Kong, the CMU established a direct link with the Government Securities Book-Entry System (GSBS) of the China Government Securities Depository Trust & Clearing Co. Ltd. (CDC) in April. This new GSBS/CMU one-way link provides an efficient access for Mainland investors to debt securities outside the Mainland in a safe and cost-effective manner. CDC members that are authorised to invest in foreign debt securities can now settle and hold Hong Kong and foreign debt securities through the CDC's account with the CMU.

Hong Kong dollar repo settlement platform

In December 2004, the CMU improved its system to facilitate the settlement of interbank Hong Kong dollar repo transactions, using eligible securities lodged with the CMU as collateral. Direct clearing members of the Hong Kong dollar interbank payment system can set their own repo limits and the system will automatically select for them the repo securities for an agreed transaction. The pool of eligible securities and haircut ratio are predefined in the system. All the borrower and lender need to do is to agree on the lending amount, repo rate and the value dates of a transaction.

Offering Exchange Fund Notes to retail investors

Using the HKMA pilot scheme to facilitate retail investment in Exchange Fund Notes (EFN), selected issues of 2-year and 3-year EFN were sold to retail investors through three designated Retail EFN Distributors–the Bank of East Asia, DBS Bank (Hong Kong) and Wing Lung Bank. The distributors adhere to a number of unified standards in the distribution of EFN to retail investors in the secondary market to increase pricing transparency and expedite comparison by retail investors. Under the pilot scheme, which was completed in August 2004, HK$330 million of EFN was sold to retail investors. The HKMA reviewed the scheme and introduced certain refinements to improve marketing and other features. The scheme will continue to be implemented when market conditions are suitable.

Media coverage of the pricing of Exchange Fund Notes

Improving the transparency of EFN prices and yields to the public has been a goal of the HKMA. With support from the Hong Kong Capital Markets Association, the HKMA has helped strengthen the media's coverage of the prices and yields of EFN. Starting from late-December 2004, the benchmark yields of EFN have been reported on morning television news. Discussions with other TV channels and newspapers are in progress. Further media coverage of EFN pricing is expected in 2005.

Conclusion

The size of the Hong Kong dollar debt market grew further in 2004, supported by the first issuance of Government bonds in two decades and further improvements in market infrastructure. The overall market deepened with more structured products being sold and securitisation bonds starting to gain public acceptance. Nevertheless, the local bond market remains small when compared with other financing channels such as equities and bank lending. Given that a well-functioning bond market can help strengthen the financial system, the authorities remain committed to support further development through improvements to the market infrastructure and regulatory framework.

APPENDIX A

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

	Exchange Fund	Statutory bodies*	Govern-ment bonds	MDBs	Non-MDB overseas borrowers	AIs	Local corporates	Total
1997	379,900	0	0	8,650	2,540	76,902	12,778	**480,770**
1998	316,850	9,171	0	44,502	7,728	33,307	6,180	**417,738**
1999	261,443	10,386	0	15,920	34,417	70,290	24,098	**416,553**
2000	275,036	8,325	0	19,330	57,110	79,753	16,107	**455,661**
2001	233,960	24,316	0	7,462	56,865	57,807	5,600	**386,011**
2002	216,228	21,557	0	5,200	73,065	71,406	8,854	**396,312**
2003	213,255	16,002	0	2,641	85,509	60,850	5,470	**383,727**
2004	205,986	17,799	10,250	3,530	76,546	53,642	9,071	**376,825**
Increase/ (decrease) over 2003	(7,269)	1,797	10,250	889	(8,963)	(7,208)	3,601	**(6,903)**

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

	Exchange Fund	Statutory bodies*	Govern-ment bonds	MDBs	Non-MDB overseas borrowers	AIs	Local corporates	Total
1997	101,650	2,295	0	26,150	10,032	188,387	26,183	**354,698**
1998	97,450	11,366	0	69,402	14,777	183,300	22,378	**398,673**
1999	101,874	21,572	0	61,287	43,767	177,915	37,331	**443,745**
2000	108,602	20,509	0	57,062	81,840	165,680	38,405	**472,098**
2001	113,750	36,227	0	51,104	102,897	150,960	38,880	**493,818**
2002	117,476	48,828	0	40,834	139,145	149,013	37,567	**532,863**
2003	120,152	56,780	0	27,855	181,522	137,988	33,466	**557,764**
2004	122,579	60,186	10,250	24,735	211,247	144,299	34,608	**607,904**
Increase/ (decrease) over 2003	2,427	3,406	10,250	(3,120)	29,725	6,311	1,142	**50,140**

* Includes government-owned corporations.
Source: HKMA.

APPENDIX B

Securitisation and bond market developments in Hong Kong

Sales of government securitisation bonds and HKMC mortgage-backed notes to retail investors in 2004 have increased public awareness of securitised instruments. One of the Government's objectives in issuing securitisation debt is to foster development of the domestic bond market. But how can securitisation help achieve this goal? Who benefits from securitisation? This box discusses these questions and the future prospects for securitisation in Hong Kong.

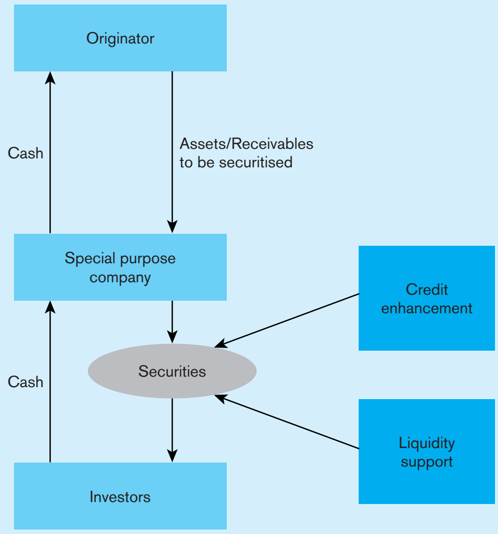
What is securitisation

Securitised debts date back to the early 1970s when US federal agencies first issued securitised debts that were backed by mortgage pools. Following the success of these mortgage-backed securities, assets such as credit cards, automobile loans, and home equity loans have been packaged by other public and private entities as collateral for securities issued in the public markets or as private placements.[6] By 2004, the total outstanding issuance of these mortgage-backed and asset-backed securities in the US is estimated to have reached nearly seven trillion US dollars.

Chart 4 shows a typical securitisation transaction, in which a company or the government (the originator) sells receivables (such as toll revenues) to a special purpose company

CHART 4

A typical securitised transaction



established for issuing the securitisation bonds to investors. The SPC is normally structured as a bankruptcy-remote entity in the sense that it is unlikely to become insolvent as a result of its own activities and is adequately insulated from the consequences of the insolvency of any related party, including the originator.[7] The securitised instruments are quite often equipped with credit enhancement (for example, third-party guarantees, over-collateralisation, senior-subordination, or reserve fund) and liquidity support (usually provided by a financial institution) to ensure a higher credit rating and stronger demand for the securities. Credit enhancement is especially common when private institutions aim to obtain a higher than their own credit rating for their securitised debts.

[6] Securitised instruments can take a variety of forms, but this note focuses only on traditional securitisation bonds to illustrate the essential market structure. Another popular form - synthetic securitisation - which refers to transactions when credit risk is transferred through the use of funded and unfunded credit derivatives or guarantees that serve to hedge the credit risk of the portfolio will not be discussed here.

[7] This can be achieved by, for example, limiting the scope of the business of the SPC to just the acquisition and financing of specific assets and restricting other liabilities that it may incur.

Potential benefits of securitisation

Securitisation offers several benefits to both the originator and investors. A clear benefit of securitisation to the originator is lower borrowing costs. As mentioned above, securitised debts are often designed to carry a higher credit rating than the originator would otherwise have obtained for unsecured instruments. The higher credit rating then translates into a lower interest rate for the originator as investors demand a smaller risk premium. In addition, securitisation reduces the originator's funding risk by diversifying its funding sources. Financial institutions, in particular, can use securitisation to reduce the risk of interest rate mismatches. For example, through mortgage-backed securities, banks can pass the interest rate and other market risk associated with long-term fixed rate mortgage loans to investors seeking similar term fixed-rate assets. In such a case, the systemic risk to the financial system as a whole also reduces as the risk level of an individual institution declines.

Securitisation can also help improve the balance-sheet structure of the originator. By transferring its asset to a special purpose company, the originator can remove such an item from its balance sheet. On the other hand, the originator (normally in its capacity as servicer) receives ongoing fee income from the SPC.

Investors benefit from securitisation because it provides additional investment opportunities to suit different investors' risk preferences. In principal, issuers can tailor the coupon and maturity of a security according to particular investor's needs.[8] This flexibility not only boosts investor's interest in securitised debts, but also contributes to more efficient capital markets by ensuring investors have access to a more diversified portfolio. Meanwhile, investors also benefit from the legal segregation of the securitised assets, with the payment stream on the securitised debts being protected from the bankruptcy of the originator.

Future prospect

The popularity of the Government's securitisation bonds launched in 2004 reflects that retail investors have a strong appetite for such products in Hong Kong. The large mortgage portfolios of Hong Kong banks suggest that a well-functioning mortgage-backed securities market has great potential in improving overall financial stability by allowing banks to reduce their exposures to residential real estate and the associated interest and liquidity risks. At this stage, the size of the securitised bond market remains relatively small and illiquid.[9] As the experience of other industrialised economies has shown, for the market to prosper, a range of practical issues needs to be addressed, [10] such as the accurate evaluation of securitised products, and the efficient transfer of the legal ownership of the assets from the originator to the SPC. However, given the dynamism of the legal, accounting and finance communities, and the commitment of the authorities to capital market development, Hong Kong has all the right elements for the securitised bond market to prosper in the future.

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[8] For example, a securitised debt can comprise several tranches with different maturities and carrying different coupon rates.

[9] For a general survey of asset securitisation activity in the Hong Kong banking sector, see *HKMA Quarterly Bulletin* (June 2004), "Result of the 2003 survey on credit derivatives and asset securitisation activity".

[10] See, for example, Bank of Japan (2004), "Report on the workshop on securitisation".