

Hong Kong-dollar debt market development in 2007

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New debt issuance contracted in 2007, with overseas borrowers and local corporations cutting back on their debt issuance programmes amid the global credit market turmoil. Nevertheless, the total amount of outstanding Hong Kong-dollar debt continued to grow. Fixed-rate debt, which accounted for a greater share of total debt issued, declined relative to floating-rate debt amid growing expectations of falling interest rates.

In promoting the Hong Kong-dollar debt market during the year, the HKMA improved the Exchange Fund Bills and Notes Programme, completed the second phase of the debt market development review and conducted a study on developing an Islamic finance platform.

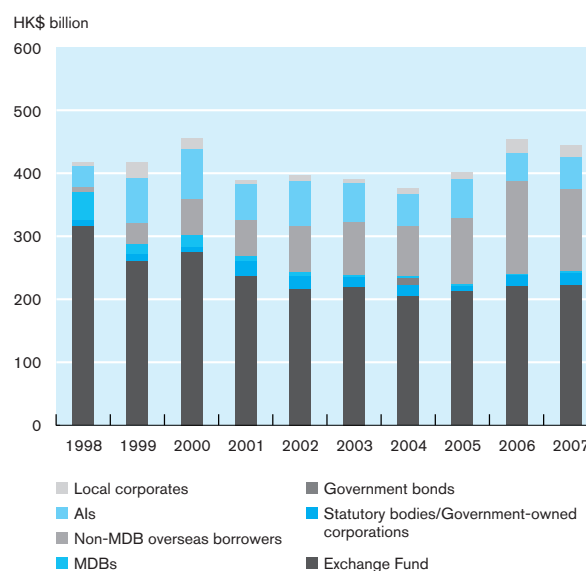
Market overview

Total gross issuance of Hong Kong-dollar debt declined by 2.0% to HK\$444.8 billion in 2007 (Chart 1), reflecting the spillover effects of the turmoil in global credit market triggered by the US sub-prime crisis. While authorized institutions (AIs)¹ increased Hong Kong-dollar debt issuance by 13.0% to HK\$50.8 billion in 2007 (after a reduction in 2006), and borrowing by the Exchange Fund, and statutory bodies and government-owned corporations² rose, this growth was more than offset by a combined 11.8% drop in issuance by overseas borrowers and the local corporate sector.

The amount of Exchange Fund Bills and Notes (EFBNs) issued in 2007 increased to HK\$223.5 billion from HK\$220.4 billion the previous year. Reflecting strong demand, the over-subscription rate for EFBNs averaged around three times, exerting downward pressure on yields. The yield on the

10-year paper declined by 29 basis points to 3.44% at the end of 2007, 59 basis points below the yield of comparable US Treasury notes.

CHART 1
New issues of Hong Kong-dollar debt instruments



¹ AIs include licensed banks, restricted licence banks, and deposit-taking companies.

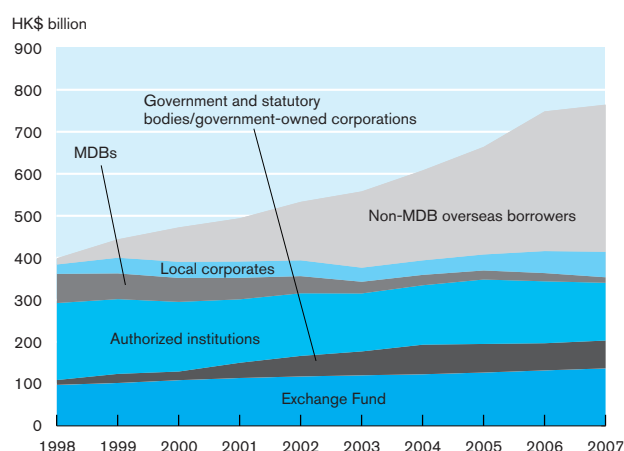
² Statutory bodies and government-owned corporations include Bauhinia Mortgage-backed Securities Limited, the Hong Kong Mortgage Corporation, the Hong Kong Airport Authority, the Hong Kong Housing Authority, Hong Kong Link 2004 Limited, the Kowloon-Canton Railway Corporation, and the MTR Corporation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

Total outstanding Hong Kong-dollar debt increased by 2.1% to HK\$764.2 billion at the end of 2007, as new issues exceeded maturing securities (Chart 2). Outstanding debt of the Government remained unchanged, while that of multilateral development banks (MDBs)³ and AIs declined. Outstanding debt in other sectors grew, with the local corporate sector registering a growth of 15.7%. Non-MDB overseas borrowers remained the single largest group, with outstanding debt totalling HK\$350.1 billion, representing a 5.3% increase from the previous year. A detailed breakdown of issuance activities and outstanding debt instruments is at Appendix A.

Despite the strong performance of the local stock market and competition from the introduction of renminbi-denominated bonds in 2007, Hong Kong-dollar bonds as an alternative investible asset still proved attractive at the retail level. Under the retail Exchange Fund Note (EFN) programme, three retail issues of the two-year EFN, totalling \$587 million, were launched. The Hong Kong Mortgage Corporation (HKMC) also issued HK\$613 million worth of two-year Hong Kong-dollar notes and HK\$33.5 million worth of one-year HIBOR-linked Hong Kong-dollar notes to retail investors.⁴ These HKMA and HKMC issues were generally well received.

CHART 2

Outstanding amount of Hong Kong-dollar debt instruments



Fixed-rate versus floating-rate debt⁵

Fixed-rate debt continued to dominate new issuance in 2007, while floating-rate debt gradually gained popularity amid increased expectations of falling interest rates. The dominance of fixed-rate debt may be due to Hong Kong's low interest rate environment. Gross issuance of fixed-rate debt amounted to HK\$165.7 billion. However, its share in total gross issuance declined from 77.6% in 2006 to 74.9% in

TABLE 1

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

Issuer	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Government bonds	–	–	–	–	–	–	5.5	–	–	–
Statutory bodies/Government-owned corporations	2.9	2.0	2.0	3.6	2.9	6.7	4.5	6.6	3.3	3.5
MDBs	2.0	3.4	4.0	4.8	5.6	7.5	8.2	7.0	2.8	4.8
Non-MDB overseas borrowers	2.1	1.6	2.2	2.9	3.7	3.1	4.0	4.5	3.0	3.9
AIs	3.5	2.0	2.1	2.4	2.4	3.0	3.0	2.4	1.7	2.2
Local corporates	0.2	2.4	3.3	2.6	4.3	4.5	5.6	6.9	5.3	5.0
Total	2.3	2.2	2.5	3.0	3.3	3.6	4.1	4.2	3.1	3.6

³ 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 debt securities issued by the MDBs is exempt from profits tax.

⁴ The one-year issue is extendable semi-annually until 2011.

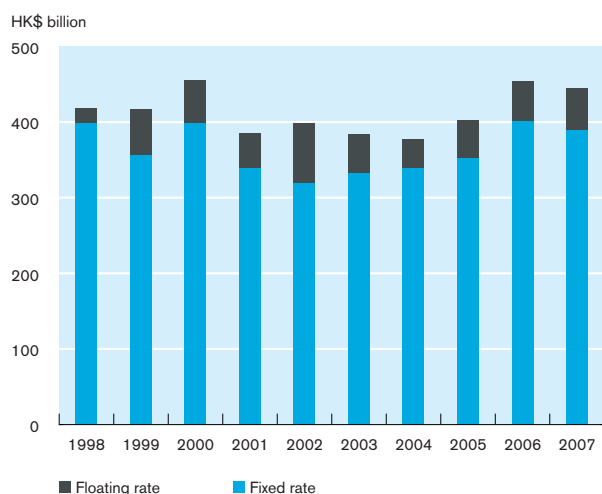
⁵ EFBNs are excluded in the calculation of fixed rate debt in this section.

2007. The total amount of outstanding fixed-rate debt grew by 1.8% to HK\$467.5 billion at the end of the year. The overall average maturity of new fixed-rate issues lengthened from 3.1 years in 2006 to 3.6 years in 2007, indicating that most issuers tended to increase the tenor of their debt issues (Table 1).

The significant increase in floating-rate debt issuance in 2007 was seen both in absolute terms and relative to fixed-rate debt. Total floating-rate debt issued grew by 6.3% to HK\$55.5 billion in 2007 (Chart 3), accounting for 25.1% of gross issuance of Hong Kong-dollar debt. With new issues exceeding maturing debt, the total amount of outstanding floating-rate debt rose by 2.0% to HK\$160.0 billion at the end of 2007.

CHART 3

New issues of fixed-rate and floating-rate Hong Kong-dollar debt (including EFBNs)



Measures to promote debt market development in Hong Kong

EFBN programme

After a review of the programme in 2006 (as part of Phase 1 review of debt market development), the HKMA implemented improvements, including extending the benchmark yield curve with the

inaugural issue of the 15-year EFN in August 2007. At the same time, the seven-year EFN was discontinued to streamline the issuance programme. Refinements were also made to the market-making system by publishing (from December 2006), half-yearly league tables of top-performing market makers for Exchange Fund Bills (EFBs) and EFNs as an incentive to encourage them to trade the Exchange Fund papers. From July 2007, exclusive tender rights on EFBs and EFNs were granted to market makers in the league tables. In addition, an Electronic Trading Platform was launched in December 2007 for the trading of bonds in Hong Kong, primarily for the Exchange Fund papers, to help improve price transparency among market players and streamline the trading process.

The HKMA will continue to develop the EFBN programme and fine-tune the maturity mix of the EFBN portfolio to increase liquidity at the longer end. This will help develop the local debt market and the pricing of private and public sector debt products when the maturity structure of the benchmark yield curve becomes progressively more-balanced.

Phase 2 review

The second phase of the review of debt market development was completed in 2007. It focused on a broad set of issues, ranging from investor and issuer bases, regulation, taxation, and market infrastructure. In particular, the study made a number of recommendations associated with the regulatory process, investment benchmarks and guidelines, and tax treatment, with the aim of attracting issuers and broadening the investor base. The findings and recommendations have been submitted to the Government for consideration.

During the year, the HKMA initiated a study on developing an Islamic finance platform in Hong Kong drawing on the expertise of the Treasury Markets Association. A report containing policy recommendations was submitted to the Government in late 2007.

Conclusion

The Hong Kong-dollar debt market continued to expand in 2007 despite the difficult external environment. Although new issuance declined, total outstanding debt grew moderately. Retail bonds issued by the HKMA and the HKMC were again well received. On the market development front, significant progress was made in enhancing the EFBN programme through extending the yield curve, refining the market-making system and launching an electronic trading platform. And, recommendations are now with the Government on ways to further stimulate the Hong Kong debt market and create an Islamic finance hub.

APPENDIX A

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

	Exchange fund	Statutory bodies*	Government	MDBs	Non-MDB overseas borrowers	Als	Local corporates	Total
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	237,009	24,316	0	7,462	56,865	57,807	5,600	389,059
2002	216,228	21,557	0	5,200	73,065	71,406	8,854	396,312
2003	219,648	16,002	0	2,641	85,509	60,850	5,470	390,120
2004	205,986	17,799	10,250	3,530	79,387	50,802	9,071	376,825
2005	213,761	8,560	0	1,800	105,383	62,542	9,951	401,997
2006	220,415	17,419	0	2,950	147,009	44,930	21,371	454,094
2007	223,521	19,368	0	1,700	130,745	50,775	18,678	444,787

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

	Exchange fund	Statutory bodies*	Government	MDBs	Non-MDB overseas borrowers	Als	Local corporates	Total
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	214,088	141,458	34,607	607,903
2005	126,709	57,712	10,250	21,535	255,999	153,385	38,138	663,728
2006	131,788	56,876	7,700	19,555	332,396	147,428	52,398	748,141
2007	136,646	58,476	7,700	13,155	350,133	137,482	60,628	764,220

* Includes government-owned corporations
Source: HKMA.