FEATURE ARTICLE

Hong Kong-dollar debt-market development in 2009

by Monetary Management Department

The Hong Kong-dollar debt market rebounded strongly in 2009 amid ample liquidity, lower funding costs and reduced risk aversion. The rebound was broad-based, with debt issuance in both the public and private sectors registering vibrant growth. The implementation of the Government Bond Programme last year was also a milestone in furthering the development of the local debt market.

Global market overview

The collapse of Lehman Brothers in September 2008 turned the US sub-prime mortgage crisis into global financial turmoil, causing extreme market volatility. Credit markets almost stopped functioning, as risk aversion escalated on investor concerns over the creditworthiness of their counterparties. This severely undermined investor demand for debt securities and led to a huge surge in credit-risk premiums.

In early 2009 initial signs of stabilisation and recovery began to emerge. Credit spreads were falling from their previous highs and money markets were gradually returning to normal. A clearer turning point came in around March - April after a series of better-than-expected economic news and bank earnings results, easing market concerns of a deep global recession. Expansionary fiscal policies, monetary easing and debt guarantee programmes in major overseas markets also helped restore investor confidence and renew demand for debt securities, leading to a pick-up in issuance activities in global debt markets.

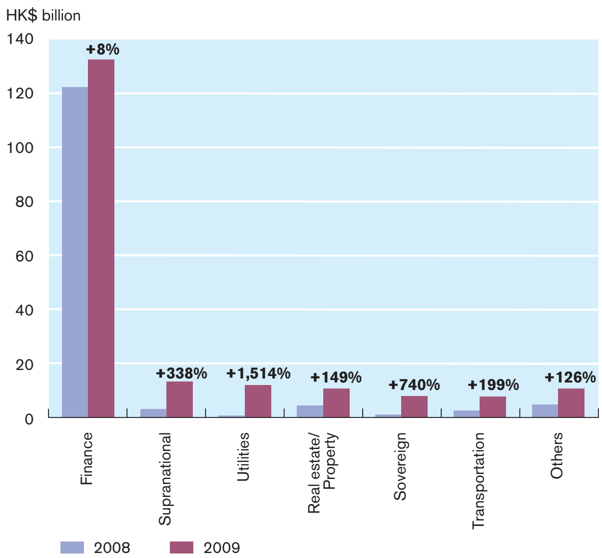
Hong Kong-dollar debt-market overview

The broad-based recovery in the Hong Kong-dollar debt market was marked by strong growth in the issuance of Hong Kong-dollar debt securities in both the public and private sectors in 2009 (Appendix). The majority of public sector issuance came from the increased supply of short-term Exchange Fund paper to meet the strong demand from banks for liquidity management purposes (see Box 1 for details). Government Bonds were also issued during the year under the new Government Bond Programme.

Financial institutions remained the major issuers in the private sector in 2009, but the increase in issuance was most notable among the non-financial sector (Chart 1). In particular, utilities companies became much more active in tapping the local debt market. This was mainly driven by the demand for Hong Kong-dollar assets from institutional investors such as

CHART 1

Issuance of Hong Kong-dollar debt instruments excluding Exchange Fund paper (by industry of issuer)



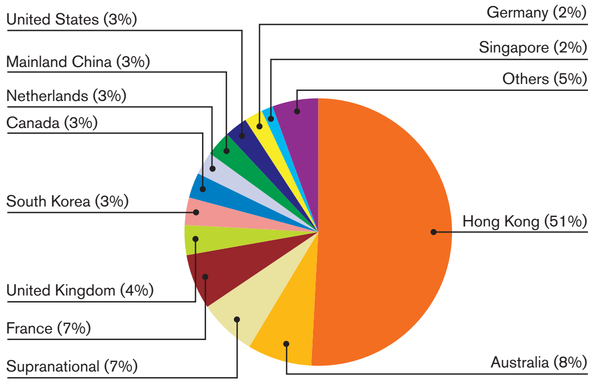
Source: HKMA.

insurance companies and bond funds amid the strong capital flows into Hong Kong. The solid credit ratings of the issuers were particularly attractive to these institutional investors given their preference for higher quality credit arising from their compliance requirements and investment mandates.

Overseas issuers continued to play a substantial role in the local debt market in 2009 in keeping with Hong Kong's position as an international fund-raising centre. Excluding Exchange Fund paper, overseas borrowers accounted for almost half of the issuance. Issuers from Australia topped the list, followed by those from Europe and North America (Chart 2). It is worth noting that borrowers from other Asian economies, such as South Korea, Mainland China and Singapore, were increasingly seen during the year, probably attributable to the relatively low funding costs in Hong Kong on the back of the abundant liquidity in the local banking system.

CHART 2

Issuance of Hong Kong-dollar debt instruments in 2009 excluding Exchange Fund paper (by nationality of issuer)



Note: Figures do not add up to 100% because of rounding.

Source: HKMA.

Borrowers tended to issue bonds with a longer tenor in recent years. The average maturity of fixed-rate debt issued in 2009, excluding Exchange Fund paper, lengthened to 4.3 years from 4.0 years in 2008 (Table 1). One of the highlights was the issuance by a local utilities company of the first ultra-long-dated bonds with maturity of 30 and 40 years. This reflected increasing demand from institutional investors for long-dated bonds to match the long-term liabilities on their balance sheets. Separately, fixed-rate debt paper continued to dominate the local debt market, accounting for 68% of total debt issuance (excluding Exchange Fund paper) in 2009. This was mainly due to investors' preference for plain vanilla bonds with fixed interest rates.

Reflecting the easy monetary conditions created by quantitative easing in the US and persistent capital inflows into Hong Kong, the yields of Hong Kong-dollar debt securities remained at low levels following a sharp fall in the latter part of 2008. In particular, the yields of Exchange Fund paper and Government Bonds were suppressed by the strong demand for high-quality Hong Kong-dollar assets, leading to a

TABLE 1

Average maturity of fixed-rate debt issuance excluding Exchange Fund paper (years)

Issuer	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Government	–	–	–	–	–	–	5.5	–	–	–	–	3.1
Statutory bodies and government-owned corporations	3.3	2.0	2.0	3.6	2.9	6.7	4.5	6.6	3.3	3.5	3.0	3.8
Authorized institutions	3.5	2.0	2.1	2.4	2.5	3.0	2.8	2.4	1.7	2.2	1.5	2.3
Local corporates	0.2	2.2	3.3	2.6	4.3	4.5	5.6	6.9	5.3	5.0	6.2	8.4
MDBs	2.0	3.4	4.0	4.8	5.6	7.5	8.2	7.0	2.8	4.8	–	4.4
Non-MDB overseas borrowers	2.1	1.6	2.3	2.9	3.6	3.1	4.1	4.5	3.0	3.8	5.4	4.0
Total	**2.4**	**2.2**	**2.5**	**3.0**	**3.3**	**3.6**	**4.1**	**4.2**	**3.1**	**3.6**	**4.0**	**4.3**

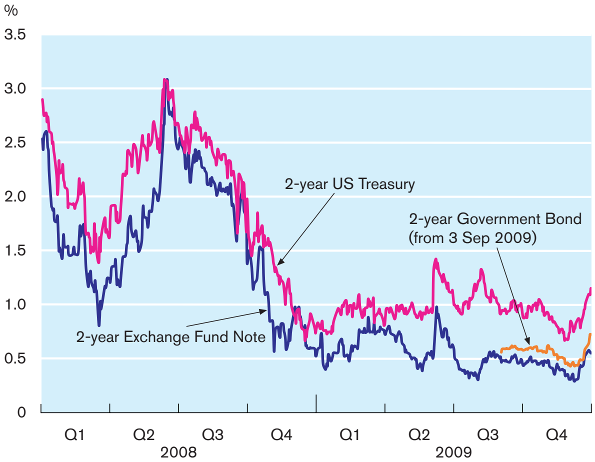
Note: Figures between 1998 and 2004 have been revised.

Source: HKMA.

widening negative yield spread against US Treasuries (Chart 3). As for Hong Kong-dollar non-government bonds, their yields largely mirrored the Hong Kong-dollar interest rate swap rates, but along with improved investor sentiment and lessened risk aversion, the yield spread, as a proxy for credit risk, has narrowed markedly since the middle of last year (Chart 4).

CHART 3

Yields of two-year Exchange Fund Note, Government Bond and US Treasury



Note: Yield for the two-year Government Bond has been adjusted for constant maturity.

Sources: HKMA and Bloomberg.

CHART 4

Hong Kong-dollar non-government bond yield and interest rate swap rate

Notes:
1. Hong Kong-dollar non-government bond yield is proxied by the non-government sub-index of the HSBC Hong Kong Dollar Bond Index, which is one of the sub-indices of the HSBC Asian Local Bond Index.
2. Hong Kong-dollar interest rate swap rate has been adjusted to match the average maturity of the Bond Index.

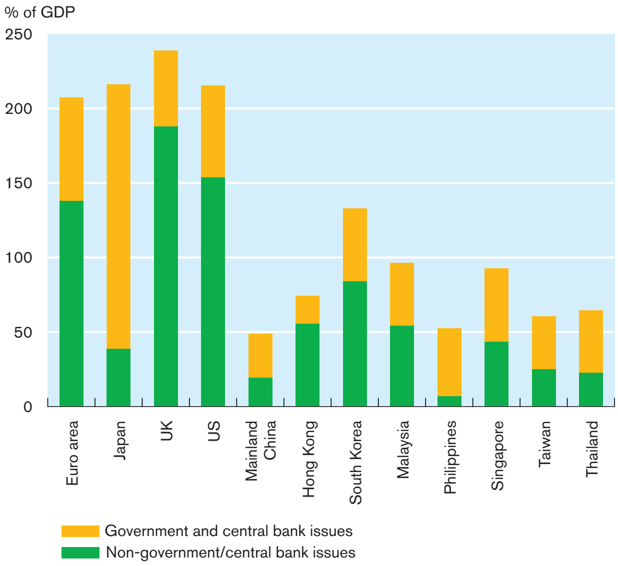
Source: Bloomberg.

Further development of the Hong Kong debt market

The size of the local debt market has grown steadily over the past decade, but it remains relatively small compared with other Asian markets and advanced economies (Chart 5). It also lags behind the equity market and the banking sector as a fund raising channel (Table 2).

CHART 5

Outstanding amount of debt securities (end of June 2009)



Sources: HKMA, Bank for International Settlements and International Monetary Fund.

TABLE 2

Fund raising activities in Hong Kong (2002-2008) (HK$ billion)

	Hong Kong-dollar debt issuance other than Exchange Fund paper	Funds raised through equity market	Syndicated loans
2002	180	111	150
2003	170	214	131
2004	171	282	154
2005	188	302	172
2006	234	525	243
2007	221	591	203
2008	138	427	154

Sources: HKMA, Hong Kong Stock Exchange and International Financing Review Asia.

In previous consultations with major market players, one of the main findings is that the supply of Hong Kong-dollar bonds has not been large enough to satisfy investor demand. For example, pension funds[1] and insurance companies receive substantial contributions (or premiums) from scheme members (or policyholders) every year, and have large investment demand for debt securities. In 2008 the total contributions and premiums received amounted to HK$212.2 billion (Table 3). But the issuance of Hong Kong-dollar bonds, excluding Exchange Fund paper, during the same period was much smaller at HK$138.5 billion. While these two figures are not directly comparable, the large difference, to a certain extent, suggests that the current supply in the market is insufficient to fully satisfy the demand for Hong Kong-dollar debt securities. Against this background, it is considered desirable to develop the local debt market more fully to satisfy such demand.

In building an active local debt market, overseas experience and relevant research studies suggest that a well-developed government bond market is an important pre-requisite. However, the government bond market in Hong Kong has remained relatively small in depth and breadth given the HKSAR Government's strong fiscal position, which reduces the need to finance expenditure by issuing bonds. While Exchange Fund paper is also regarded as a special type of government bond, they are issued by the Exchange Fund as part of the Monetary Base under the Currency Board system to serve the overriding objective of maintaining exchange-rate stability. Issuance of Exchange Fund paper is governed by the inflow of US dollars, which leaves little room for issuance for market development purposes. Therefore, a separate, long-term programme of government bond issuance would be a more appropriate tool to achieve the market development goal.

[1] Pension funds include Mandatory Provident Fund (MPF) schemes and Occupational Retirement Schemes Ordinance (ORSO) schemes.

TABLE 3

Contributions/premiums received by pension funds and insurance companies (2002-2008) (HK$ billion)

	MPF and ORSO contributions	Long-term insurance business premiums	Total
2002	20*	66	85*
2003	16*	77	93*
2004	17*	98	116*
2005	42	115	157
2006	44	133	177
2007	47	173	220
2008	50	162	212

* These figures do not take into account MPF contributions as such data is not available in 2002-2004.

Note: Figures may not add up to total because of rounding.

Sources: Office of the Commissioner of Insurance and Mandatory Provident Fund Schemes Authority.

Government Bond Programme

The proposal to establish the Government Bond Programme (GB Programme) was announced by the Financial Secretary in February 2009 and passed by the Legislative Council in July 2009. Government Bonds (GBs) are issued in a consistent and systematic manner under the GB Programme, with their size and tenor being determined by prevailing market conditions and demand. Under the established framework, there are two separate programmes – the Institutional Bond Issuance Programme (Institutional Programme) and the Retail Bond Issuance Programme (Retail Programme) – to meet different investment demands and horizons. Box 2 provides more details on the GB Programme's framework and features.

In the first six months since the launch of the Institutional Programme in September 2009, three tenders were successfully held, including a two-year GB in the same month, a five-year GB in November and a 10-year GB in January 2010. All three issues were well-received by the market, as evidenced by the high bid-to-cover ratios (Table 4). The average accepted yields lie between the prevailing yields of Exchange Fund paper and Hong Kong-dollar interest rate swaps of comparable tenors, with yields tilted towards the former, reflecting strong demand for high-quality public debt paper in the market.

The three GB issues have attracted different groups of investors due to the varying maturities. According to the Primary Dealers, the two-year GB was widely sought by banks given the ample liquidity in Hong Kong's banking system, while the five-year and 10-year issues have attracted a more diverse group of non-bank end-investors, such as life insurers, pension funds and investment funds. As the GB Programme is still in its infancy, secondary market activity has remained thin, as indicated by the relatively low turnover and wide bid-ask spreads. Between September and December 2009, the average daily turnover was about 12% of the average outstanding size. However, liquidity is expected to improve gradually as the GB Programme continues to grow in size with more tenor choices in time.

TABLE 4

Key tender results of the first three Government Bonds issued under the Institutional Programme

	2-year GB (02GB1109)	5-year GB (05GB1411)	10-year GB (10GB2001)
Tender date	2 Sep 2009	2 Nov 2009	11 Jan 2010
Issuance size (HK$ million)	3,500	2,000	2,500
Bid-to-cover ratio	6.45	4.56	4.72

Source: HKMA.

Way forward

As part of its efforts to improve the competitiveness of Hong Kong's financial markets, the HKMA will continue to support the Government's initiatives and take further steps to increase the depth and breadth of the local debt market. It will also maintain close contact and partnership with market participants to further improve the Government Bond Programme and the local debt market as a whole, consolidating Hong Kong's position as an international financial centre.

APPENDIX

Issuance of Hong Kong-dollar debt instruments (HK$ million)

	Exchange Fund	Government	Statutory bodies and government-owned corporations	Authorized institutions	Local corporates	MDBs	Non-MDB overseas borrowers	Total
1998	316,850	0	9,171	33,307	6,180	44,502	7,728	417,738
1999	261,443	0	8,931	70,190	24,098	15,920	34,417	414,999
2000	275,036	0	8,325	80,138	16,107	19,330	57,010	455,946
2001	237,009	0	24,075	57,787	5,600	7,462	56,865	388,798
2002	216,228	0	20,760	72,894	8,854	5,200	72,615	396,551
2003	219,648	0	15,724	60,819	5,470	2,641	85,509	389,810
2004	205,986	10,250	17,799	50,801	9,171	3,530	79,287	376,824
2005	213,761	0	8,560	62,542	9,951	1,800	105,383	401,997
2006	220,415	0	17,419	44,930	21,371	2,950	147,009	454,094
2007	223,521	0	19,368	49,645	18,678	1,700	131,875	444,787
2008	285,875	0	24,308	45,237	14,292	3,000	51,648	424,360
2009	1,047,728	5,500	29,852	43,878	19,539	13,145	82,431	1,242,073

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

	Exchange Fund	Government	Statutory bodies and government-owned corporations	Authorized institutions	Local corporates	MDBs	Non-MDB overseas borrowers	Total
1998	97,450	0	11,366	179,353	19,950	69,402	15,622	393,143
1999	101,874	0	20,117	176,400	34,748	61,287	44,767	439,192
2000	108,602	0	20,047	166,065	38,405	57,062	81,740	471,921
2001	113,750	0	35,873	151,145	38,880	51,104	102,797	493,548
2002	117,476	0	48,212	147,763	37,567	40,834	139,145	530,998
2003	120,152	0	56,441	137,988	33,466	27,855	181,522	557,425
2004	122,579	10,250	60,186	141,458	34,708	24,735	213,988	607,904
2005	126,709	10,250	57,712	153,385	38,138	21,535	255,999	663,728
2006	131,788	7,700	56,876	147,428	52,398	19,555	332,396	748,141
2007	136,646	7,700	58,476	136,352	60,628	13,155	351,263	764,220
2008	157,653	5,000	64,618	95,053	67,015	14,253	313,017	716,608
2009	534,062	7,000	69,723	84,675	79,462	24,348	312,056	1,111,327

Notes:

1. Statutory bodies and government-owned corporations include Bauhinia Mortgage-backed Securities Limited, the Hong Kong Mortgage Corporation, the Hong Kong Airport Authority, and the Hong Kong Housing Authority, Hong Kong Link 2004 Limited, the Kowloon-Canton Railway Corporation, and the MTR Corporation Limited.
2. Authorized institutions include licensed banks, restricted licence banks, and deposit-taking companies.
3. 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.
4. Figures between 1998 and 2004 have been revised.
5. Figures may not add up to total because of rounding.

Source: HKMA.

BOX 1

What has driven the strong demand for Exchange Fund Bills?

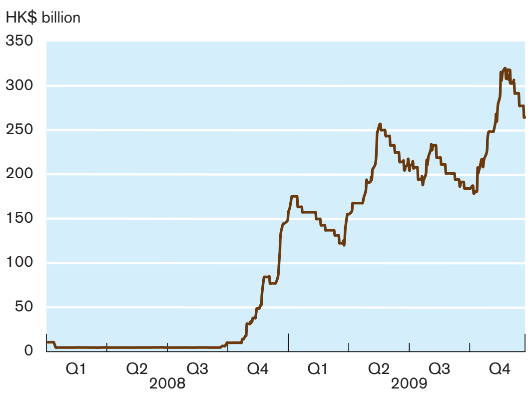
Exchange Fund Bills and Notes are highly liquid Hong Kong-dollar money market instruments issued by the HKMA, constituting direct, unsecured, unconditional and general obligations of the HKSAR Government for the account of the Exchange Fund. They are part of the Monetary Base and eligible for use as collateral to obtain intraday or overnight funding from the HKMA. Many banks are keen on holding them, especially the short-dated ones, to earn interest income, while still being able to easily obtain necessary intraday or overnight liquidity by conducting repurchase agreement (repo) transactions. In 2009 banks' demand for Exchange Fund Bills increased substantially because of their need to manage the huge surplus funds on their balance sheets arising from abundant liquidity in the local banking system amid persistent capital inflows to Hong Kong.

Market participants generally believe the strong capital inflows last year were driven by a number of factors. First, in the face of tightened credit conditions following the onset of the global financial crisis, many corporates and individuals repatriated large amounts of funds from abroad to Hong Kong to meet their liquidity needs. Secondly, Hong Kong's robust banking sector and the introduction of the full deposit guarantee may have attracted some safe-haven inflows. Thirdly, with a strengthening Mainland economy, optimism of better prospects for recovery in Hong Kong has likely attracted large amounts of international investment funds into Hong Kong in search of higher returns from the buoyant local stock market. The first two factors seem to explain a large part of the capital inflows in early 2009, while the third factor, particularly those investments related to IPOs, appears to have played a more substantial role for the remainder of the year.

Against this background, the Hong Kong dollar strengthened and the strong-side Convertibility Undertaking was triggered repeatedly, resulting in a substantial increase in the Aggregate Balance (Chart B1). During 2009 the HKMA purchased a total of US$62.0 billion in response to market demand, equivalent to injecting HK$480.8 billion into the banking system.

CHART B1

Aggregate Balance



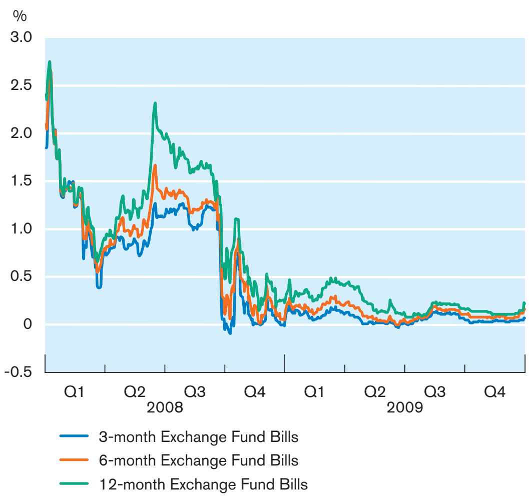
Source: HKMA.

With ample liquidity, it is necessary for banks to find avenues to manage their funds effectively. Rather than leaving the surplus funds lying idle in their settlement accounts with the HKMA, which are interest-free, most banks prefer to park a certain portion of their funds in highly liquid and low-risk debt instruments to gain interest income.

Clearly, Exchange Fund Bills are a natural choice. Reflecting the strong demand for Exchange Fund Bills, their yields were suppressed to very low levels, even briefly turning negative at times (Chart B2).

CHART B2

Yields of Exchange Fund Bills

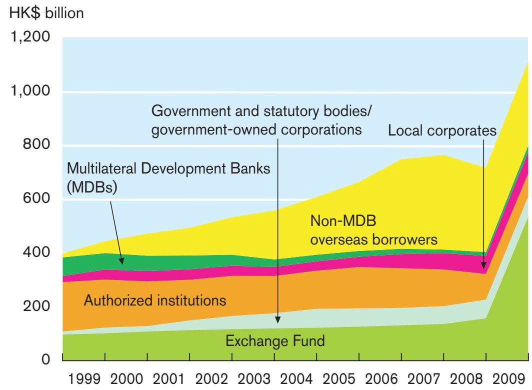


Source: HKMA.

To address such strong market demand, a total of HK$374.4 billion of additional Exchange Fund Bills were issued in 2009. The additional issuances, covering the three benchmark tenors of 91, 182 and 364 days, were well-received by the market. Given the large Aggregate Balance, the issuance of additional Exchange Fund Bills did not have a significant impact on the exchange rate and interest rates. By the end of 2009, outstanding Exchange Fund Bills and Notes reached HK$534.1 billion, making the Exchange Fund the largest issuer in the Hong Kong-dollar debt market in place of non-Multilateral Development Bank overseas borrowers (Chart B3).

CHART B3

Outstanding amount of Hong Kong-dollar debt instruments



Source: HKMA.

BOX 2

Framework for the Government Bond Programme

With the necessary resolutions for the Government Bond Programme (GB Programme) passed by the Legislative Council in July 2009, the HKSAR Government was authorised to borrow up to HK$100 billion, or equivalent, in aggregate outstanding principal amount and to set up a fund to manage the moneys raised. The Financial Secretary directed the HKMA, as representative of the Government, to assist in the implementation of the GB Programme, including co-ordinating the offerings of Government Bonds (GBs) and managing the moneys in the bond fund. The GB Programme is comprised of institutional and retail bond issuance programmes.

Institutional Bond Issuance Programme

GBs under the Institutional Programme are offered to investors through competitive tenders, which is similar to the mechanism used in the Exchange Fund Note programme as well as many other sovereign bond programmes. To increase transparency, the HKMA will make regular announcements of the tentative issuance schedule at half-yearly intervals. Individual GBs are listed on the Stock Exchange of Hong Kong to broaden the investor base and to satisfy certain regulatory requirements and internal investment mandates of some institutional investors.

A two-tier dealership framework has been put in place for the Institutional Programme with the appointment of over 100 Recognized Dealers and 12 Primary Dealers by the HKMA. Recognized Dealers are financial institutions that maintain securities accounts with the HKMA and have been appointed to hold and trade GBs for themselves and on behalf of their customers. Among these Recognized Dealers, 12 have been selected and appointed as Primary Dealers with a number of obligations, including underwriting the unsubscribed portions of GBs during the primary offer in the case of under-subscription and maintaining a secondary market in GBs by providing two-way prices on request during normal trading hours. In return, these Primary Dealers are granted the exclusive right to participate in the competitive tenders for GBs.

Several measures have also been put in place to facilitate secondary market activity of GBs. Daily price fixings of GBs provided by the Primary Dealers are available to the public to improve transparency; an Electronic Trading Platform for GBs has been set up to streamline the trading process; and existing GBs will be re-opened as far as practicable to reduce the number of off-the-run issues and build up the size of individual bond issues. These measures are expected to help improve liquidity of GBs in the secondary market over time.

More information on the GB Programme is available on http://www.hkgb.gov.hk.

Retail Bond Issuance Programme

Co-arranger banks will assist the HKMA in arranging and managing the offerings of retail GBs. They will advise on various aspects of the retail bond offerings, including timing, structure and the appropriate channels, and assist in implementing the distribution and marketing arrangements.

The HKMA will take into account the prevailing market conditions and the advice of the co-arranger banks in deliberating the issuance schedule of the inaugural retail issues. Details of the Retail Programme framework will be announced nearer the time.