FEATURE ARTICLE

The Hong Kong debt market in 2015

by Financial Infrastructure Department

The international bond market faced a mixed environment in 2015. The Greek government debt crisis hampered the recovery progress in Europe and expansionary monetary policies were adopted in most of the developed countries with a view to stimulating the economy. Meanwhile, the US Federal Reserve finally raised the target range for the federal funds rate in December, signalling the start of US interest rate normalisation. In the Hong Kong dollar debt market, the total issuance volume of Hong Kong dollar debt instruments continued to grow to a record level. Further measures were implemented by the Hong Kong SAR Government to support the development of the local bond market under the Government Bond Programme, including the issuance of the second sukuk (Islamic bond) in June and the debut 15-year Government Bond in July.

Overview of the international bond market

Market expectations of interest rate normalisation in the US, coupled with divergent monetary policies in developed markets, had increased volatility in the international bond markets.

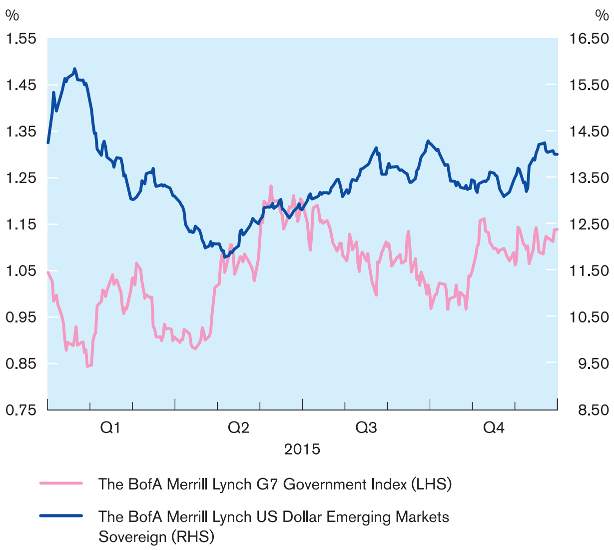
The European Central Bank adopted expansionary monetary policies in early 2015 through the expansion of its asset-purchase programme to stimulate economic recovery. However, the Greek government debt crisis triggered concerns over a possible Greek exit from the eurozone in early summer, leading to a slump in the bond market in eurozone. Although negotiations between the Greek government and the eurozone members were held in late June, the rejection of the bailout terms in a Greek referendum further affected market sentiment. The market gradually stabilised only after a new agreement was reached in July.

With the conclusion of the US Federal Reserve (Fed)'s asset-purchase programme in late 2014, expectations that the Fed would begin raising interest rates gathered pace. This was particularly so before the September and October Federal Open Market Committee (FOMC) meetings. The target range for the federal funds rate was finally increased by 25 basis points to 0.25%–0.5% at the December FOMC meeting. As the decision had been widely expected, it did not cause significant fluctuation to the market. The lift-off signified the beginning of the US interest rate normalisation. The market in general expected that the pace of future rate hikes would likely be gradual and depend on the pace of US economic recovery.

In the developed economies, interest rates were volatile and generally on an increasing trend in 2015 (Chart 1), affected mainly by market expectation of US interest rate normalisation. The outlook for the bond market in the coming year will be challenging against the backdrop of uncertainties in the global economic recovery. In addition, economic conditions in Mainland China, oil price movements and excess capacity in commodity markets could also be key factors affecting the debt market.

CHART 1

Average borrowing costs in developed and emerging markets



Average yields of the following benchmark indices are used as proxies to the yield levels of the corresponding markets.	
Developed markets	The BofA Merrill Lynch G7 Government Index
Emerging markets	The BofA Merrill Lynch US Dollar Emerging Markets Sovereign

Source: Thomson Reuters.

Hong Kong Debt Market Review

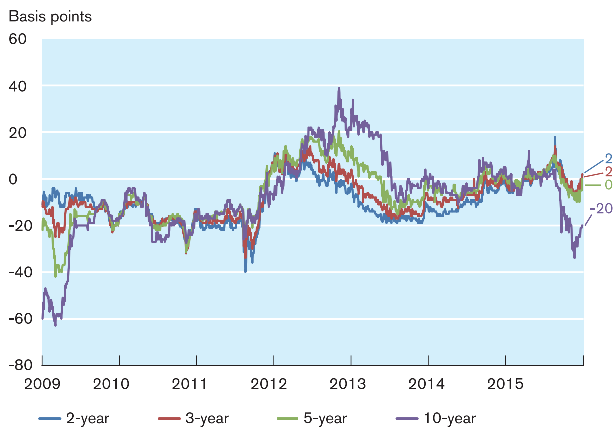
Hong Kong dollar debt issuance increased for the seventh consecutive year to reach HK$2.49 trillion in 2015, an increase of 2.6% from 2014. Steady growth in the size of bond issues amid the volatile international bond market demonstrated the healthy development of the local debt market. The broad investor base here has attracted more issuers to utilise the funding platform in Hong Kong.

Overseas corporates

Overseas issuers continued to tap the Hong Kong dollar market in 2015, with issuance volume rising by 16.5% from 2014. Riding on the momentum in 2014, the US dollar/HK dollar basis swap rates were positive during most of 2015 (Chart 2). This favourable swap market environment allowed overseas issuers to issue bonds in Hong Kong and then swap the proceeds back to US dollar to achieve cheaper all-in funding costs. Overseas corporates could also expand their investor base and broaden the funding sources through the issuance in Hong Kong, which assisted them to build up a better funding structure.

CHART 2

Key tenors of USD/HKD basis swaps



Source: Bloomberg.

Local corporates

In contrast to overseas issuers, local corporates lowered their funding scale in the local debt market, with issuance volume dropping to HK$14.2 billion, down 57.4% from 2014. With expectation that interest rates would start rising in 2015, most local corporates had already completed their major funding plans in 2014 and tended to be more opportunistic in new bond issuance. Companies were also more cautious about expanding their business due to an uncertain economic outlook, leading to fewer funding activities by local corporates.

Government Bond Programme

The HKMA continued to implement the Government Bond (GB) Programme in 2015 to promote the further and sustainable development of the local bond market. Thirteen issues of institutional bonds totalling HK$68.9 billion and three issues of inflation-linked retail bonds (i.e. iBonds) totalling HK$30 billion were outstanding at the end of 2015. Apart from the Hong Kong dollar bonds, two US dollar sukuk issues, each with an issuance size of US$1 billion, were also outstanding (i.e. total US$2 billion).

Establishing benchmark yield curve

Starting from 2015, the tenors of bonds issued under the Exchange Fund Bills and Notes Programme and the GB Programme were streamlined. The HKMA only issues new Exchange Fund papers for tenors of two years or below; and new GBs for tenors of three years or above. After the streamlining, a unitary benchmark yield curve representing the credit standing of the Government could be formed in the long run, with Exchange Fund Bills and Notes providing the benchmark yield for two years and below and GBs providing the benchmark yield for three years and above. A unitary benchmark yield curve could provide a better reference for other issuers in pricing their Hong Kong dollar issues.

As part of the streamlining, the first 15-year GB tender, worth HK$0.6 billion, was held on 15 July. The tender was well received by the market with the bid-to-cover ratio (the ratio of bonds applied for to bonds issued) at 2.76. The HKMA will continue to hold 15-year GB tender on a regular basis to meet investor demand and build a credible reference point at the long end of the benchmark yield curve.

Sukuk in Wakalah structure

Following the successful issuance of the inaugural sukuk in 2014, the Government issued another sukuk under the GB Programme with an issuance size of US$1 billion and a tenor of 5 years on 3 June 2015. This issue used Wakalah structure, where one-third of assets were underpinned by selected units in an office building in Hong Kong, and two-thirds of the assets were underpinned by shariah-compliant commodities, making Hong Kong the first AAA-government sukuk issuer to adopt this structure. The sukuk was issued by a special-purpose vehicle wholly owned by the HKSAR Government, and was listed in Hong Kong, Malaysia and Dubai. The sukuk received warm welcome from global investors, attracting orders of US$2 billion from a diverse group of international investors. Priced at 1.894%, it gave the Government a cheaper funding cost than that for the inaugural sukuk issue in 2014 (2.005%).
The use of the "asset light" structure in the latest issuance set a benchmark for potential issuers in the private sector and demonstrated the flexibility of Hong Kong's Islamic finance platform.

TABLE 1

Summary of the key parameters of the two series of sukuk under the GB Programme

	Sukuk 1	Sukuk 2
Issue date	▪ Sep 2014	▪ Jun 2015
Size	▪ US$1 billion	▪ US$1 billion
Tenor	▪ 5 years	▪ 5 years
Format	▪ Rule 144A / Reg S	▪ Reg S
Price	▪ 2.005% ▪ 5Y UST + 23 bps	▪ 1.894% ▪ 5Y UST + 35 bps
Investor orders	▪ US$4.7 billion ▪ Over 120 investors	▪ US$2 billion ▪ 49 investors
Investors by location	▪ 47% Asia ▪ 36% Middle East ▪ 11% US ▪ 6% Europe	▪ 43% Asia ▪ 42% Middle East ▪ 15% Europe
Investors by type	▪ 56% banks and private banks ▪ 30% sovereign wealth funds ▪ 11% fund managers ▪ 3% insurance companies	▪ 77% banks, private banks and fund managers ▪ 23% sovereign wealth funds, central banks and supranationals
Islamic structure	▪ Ijarah	▪ Wakalah
Underlying assets	▪ 100% government properties	▪ 34% government properties ▪ 66% exchange-traded commodities

Retail bonds

The Government issued HK$10 billion iBond in 2015. It was the fifth-consecutive series of iBond since 2011. The number of valid applications was a record high of 597,895, with total subscription of nearly HK$36 billion. According to market sources, first-time investors made up 9–15% of the successful subscribers in the past five issuances. The iBond issuances not only provided an additional choice of investment to the public, but also sustained the growth momentum of the local bond market through enhancing public awareness of, and interest in, bond investments. The iBond issuance successfully broadened the investor base of the local bond market, encouraging more issuers to consider tapping the market through retail issuance.

Looking forward

Not long ago, many investors thought that the global bond market had reached its climax as short term policy interest rates were already at rock-bottom level. However, with the European Central Bank and the Bank of Japan adopting negative interest rate policy, this has become less certain. Very short term up to 10-year Japanese Government Bonds (JGBs), which account for the lion's share of the outstanding total, are now trading in negative yield territory. German government bonds are now trading in negative territory from very short term up to 5 years, which account for more than half of the outstanding total. As bonds are now in great demand in these major economies, it is not impossible that some of the demand may spill over to government bonds in other economies, especially those which are still yielding positive rates.

Through the implementation of the GB Programme, the HKMA will continue to support the development of the Hong Kong dollar debt market. Continued communication with market participants will enhance the competitiveness of the local market as a fund raising platform. With a view to supporting the development of Islamic finance in the local market, the Government will launch another sukuk when market conditions are favourable.

APPENDIX (see notes)

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	32,889	7,320	44,502	7,006	9,171	100,888	**417,738**
1999	261,443	0	261,443 (-17.5%)	81,280	26,228	15,920	21,197	8,931	153,556 (52.2%)	**414,999 (-0.7%)**
2000	275,036	0	275,036 (5.2%)	97,949	17,902	19,330	37,404	8,325	180,910 (17.8%)	**455,946 (9.9%)**
2001	237,009	0	237,009 (-13.8%)	72,001	5,808	7,462	42,464	24,075	151,810 (-16.1%)	**388,818 (-14.7%)**
2002	216,228	0	216,228 (-8.8%)	94,133	9,484	5,200	50,746	20,760	180,323 (18.8%)	**396,551 (2.0%)**
2003	219,648	0	219,648 (1.6%)	94,374	5,470	2,641	51,955	15,724	170,164 (-5.6%)	**389,811 (-1.7%)**
2004	205,986	10,250	216,236 (-1.6%)	74,289	9,321	3,530	55,649	17,799	160,588 (-5.6%)	**376,824 (-3.3%)**
2005	213,761	0	213,761 (-1.1%)	97,795	11,067	1,800	69,014	8,560	188,236 (17.2%)	**401,997 (6.7%)**
2006	220,415	0	220,415 (3.1%)	82,242	21,771	2,950	109,297	17,419	233,679 (24.1%)	**454,094 (13.0%)**
2007	223,521	0	223,521 (1.4%)	100,143	19,078	1,700	80,977	19,368	221,266 (-5.3%)	**444,787 (-2.0%)**
2008	285,875	0	285,875 (27.9%)	68,029	14,592	3,000	28,556	24,308	138,485 (-37.4%)	**424,360 (-4.6%)**
2009	1,047,728	5,500	1,053,228 (268.4%)	75,566	19,539	13,145	50,744	29,852	188,846 (36.4%)	**1,242,073 (192.7%)**
2010	1,816,752	18,500	1,835,252 (74.3%)	103,413	13,583	315	32,222	11,187	160,720 (-14.9%)	**1,995,972 (60.7%)**
2011	1,841,278	27,500	1,868,778 (1.8%)	136,310	28,282	0	17,779	20,195	202,566 (26.0%)	**2,071,345 (3.8%)**
2012	1,851,575	26,000	1,877,575 (0.5%)	190,078	27,688	790	22,219	12,027	252,802 (24.8%)	**2,130,377 (2.8%)**
2013	2,123,448	30,000	2,153,448 (14.7%)	143,027	25,573	940	23,121	10,665	203,326 (-19.6%)	**2,356,774 (10.6%)**
2014	2,177,293	30,800	2,208,093 (2.5%)	127,130	33,278	1337	50,529	9,647	221,921 (9.1%)	**2,430,015 (3.1%)**
2015	2,242,206	30,400	2,272,606 (2.9%)	136,350	14,186	0	58,859	12,015	221,410 (-0.2%)	**2,494,017 (2.6%)**

Source: HKMA.

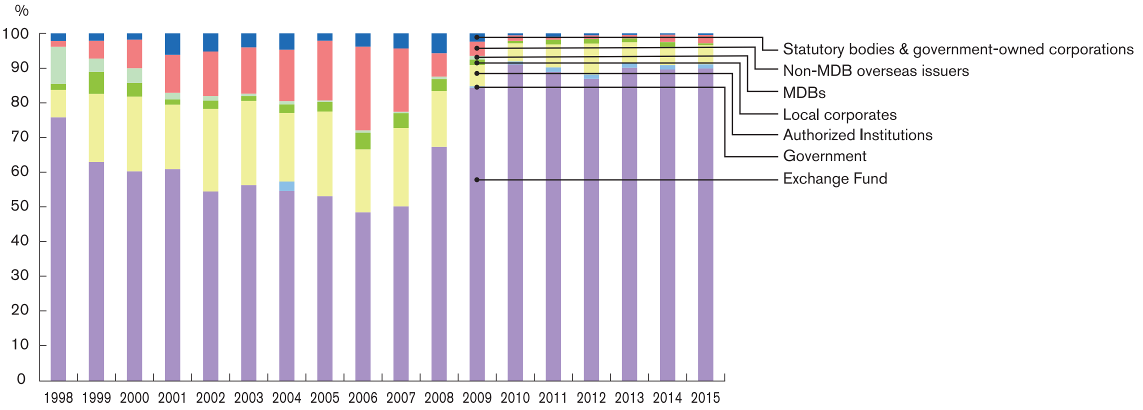
Outstanding size of Hong Kong dollar debt instruments (in HK$ million)

	(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	161,110	28,286	69,402	25,529	11,366	295,693	**393,143**
1999	101,874	0	101,874 (4.5%)	177,437	41,219	61,287	37,259	20,117	337,319 (14.1%)	**439,192 (11.7%)**
2000	108,602	0	108,602 (6.6%)	189,137	41,970	57,062	55,103	20,047	363,319 (7.7%)	**471,921 (7.5%)**
2001	113,750	0	113,750 (4.7%)	178,788	41,703	51,104	72,351	35,873	379,819 (4.5%)	**493,568 (4.6%)**
2002	117,476	0	117,476 (3.3%)	184,736	40,245	40,834	99,514	48,212	413,541 (8.9%)	**531,018 (7.6%)**
2003	120,152	0	120,152 (2.3%)	196,972	34,519	27,855	121,486	56,441	437,273 (5.7%)	**557,426 (5.0%)**
2004	122,579	10,250	132,829 (10.6%)	207,214	35,338	24,735	147,579	60,186	475,052 (8.6%)	**607,880 (9.1%)**
2005	126,709	10,250	136,959 (3.1%)	233,442	39,624	21,535	174,247	57,712	526,560 (10.8%)	**663,520 (9.2%)**
2006	131,788	7,700	139,488 (1.8%)	241,030	53,864	19,555	237,308	56,876	608,633 (15.6%)	**748,121 (12.8%)**
2007	136,646	7,700	144,346 (3.5%)	250,941	62,044	13,155	234,482	58,476	619,098 (1.7%)	**763,443 (2.0%)**
2008	157,653	5,000	162,653 (12.7%)	206,471	68,265	14,253	199,943	64,618	553,550 (-10.6%)	**716,202 (-6.2%)**
2009	534,062	7,000	541,062 (232.6%)	194,590	79,962	24,348	200,686	66,643	566,229 (2.3%)	**1,107,291 (54.6%)**
2010	653,138	25,500	678,638 (25.4%)	218,866	85,575	15,513	186,166	60,592	566,712 (0.1%)	**1,245,350 (12.5%)**
2011	655,413	49,500	704,913 (3.9%)	228,943	97,284	14,731	163,724	51,034	555,716 (-1.9%)	**1,260,629 (1.2%)**
2012	657,384	68,500	725,884 (3.0%)	263,418	116,188	10,271	147,669	45,159	582,705 (4.9%)	**1,308,590 (3.8%)**
2013	751,151	91,500	842,651 (16.1%)	250,104	127,937	10,214	148,698	39,816	576,769 (-1.0%)	**1,419,420 (8.5%)**
2014	752,630	98,000	850,630 (0.9%)	232,796	137,624	6,101	141,670	40,990	559,181 (-3.0%)	**1,409,812 (-0.7%)**
2015	828,421	100,400	928,821 (9.2%)	242,593	141,659	5,301	162,133	44,050	595,736 (6.5%)	**1,524,558 (8.1%)**

Source: HKMA.

CHART B1

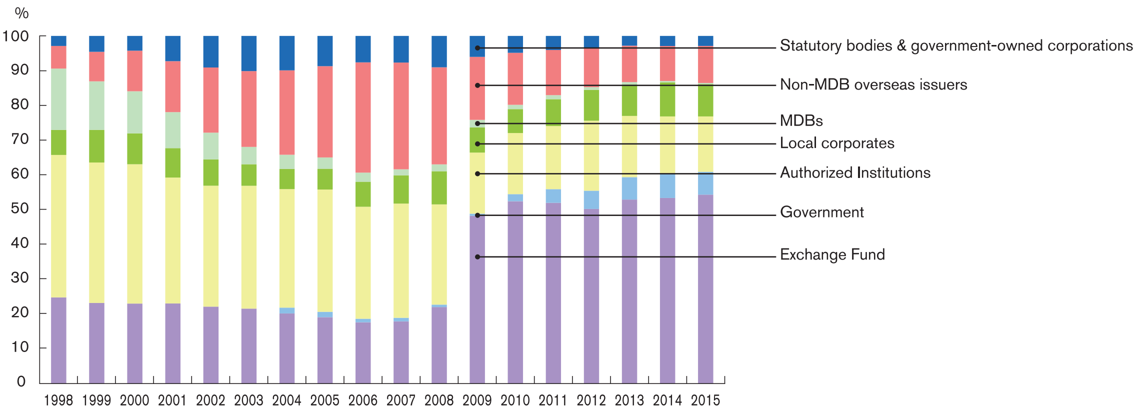
Proportions of Hong Kong dollar debt issuance activities (by type of issuers)



Source: HKMA.

CHART B2

Proportions of outstanding Hong Kong dollar debt instruments (by type of issuers)



Source: HKMA.

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 Development Bank (formerly known as 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, the Nordic Investment Bank, and the CAF - Development Bank of Latin America. 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 Link 2004 Limited, Kowloon-Canton Railway Corporation, MTR Corporation Limited, Hong Kong Interbank Clearing Limited, Urban Renewal Authority, Hong Kong Housing Society, and the Hong Kong Science and Technology Parks Corporation. 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 2014 have been revised.
5. Figures may not add up to total because of rounding.