HONG KONG BOND MARKET: WORLD BANK STUDY *

A World Bank study reports that the HKMA's issue of Exchange Fund paper and provision of an efficient clearing system have facilitated the development of the bond market in Hong Kong. There is potential for further growth given local infrastructure projects.

Hong Kong is a major international financial centre. The growth of the stock market has been very robust. At the end of 1994, the Hong Kong stock market ranked eighth in the world in terms of market capitalisation (HK$2.1 trillion) and eleventh in the world in terms of stocks traded (HK$1.0 trillion). Stock market capitalisation was about 196% of GDP. The development of the domestic bond market has lagged substantially behind, with debt securities outstanding issued by Hong Kong private issuers (excluding NCDs) representing about 8% of GDP. However, the Hong Kong bond market has grown rapidly since 1993, due in large part to the role played by the Government of Hong Kong, in particularly the HKMA. The experience of Hong Kong provides an interesting example of how, in a relatively free market economy, concerted public policy actions can effectively facilitate capital market development.

Historically, the development of a HK dollar bond market was constrained by several factors. First, the lack of a benchmark in the form of risk-free government securities which hampered the efficient pricing of risk was perhaps the most important impediment. Second, the preference of retail investors for the risk and rewards associated with the more volatile equity markets may have reduced the demand for the bonds of Hong Kong companies in the local market. Third, bank dominance in the financial sector relative to securities firms appears to have contributed to the expansion of bank lending at the expense of capital market debt instruments. Fourth, the absence of a bond rating further hindered bond market development. Fifth, the lack of a government mandated employee retirement or provident fund meant lower demand. Finally, in the view of many market practitioners, the profits tax on interest income and the stamp duty act as an obstacle to the use of the HK dollar debt market by private issuers.

In 1990, the Government launched the Exchange Fund Bills and Notes Programme to provide a tool for monetary management. The gradual lengthening of the maturity of the Exchange Fund Bills and Notes has provided a benchmark for the issuance of debt instruments with longer maturities. The proceeds of the bills and notes offerings are not used to fund government spending; rather, these proceeds are invested prudently by the Exchange Fund, which is managed by the Monetary Authority. The Government has also supported the issuance of debt by supranational organisations in Hong Kong by granting tax exempt status to HK dollar denominated bonds issued by the Asian Development Bank, the World Bank, and a few other multilateral lending institutions.

The Government also established a cost-effective computerised book-entry clearing system, known as the Central Moneymarkets Unit service (CMU), to reduce settlement risk and facilitate secondary market trading in Exchange Fund Bills and Notes. The Monetary Authority extended this service to other Hong Kong debt instruments in January 1994. Thus, the CMU performs the role of central custodian and clearing agent for HK dollar debt instruments, including Exchange Fund Bills and Notes, certificates of deposit, commercial paper, and bonds. The transfer of title is in book-entry form so that physical delivery is not required.

On 3 March 1993, the Financial Secretary of Hong Kong announced that the government bond programme would be taken over by the Monetary Authority, with the proceeds of the issues going to the Exchange Fund rather than the capital works fund. Accordingly, two-year Exchange Fund Notes were introduced to the market by the HKMA in May 1993 to replace government bonds as they matured. In October 1993, the yield curve was further extended with the issuance of three-year Notes. Shortly thereafter, the World Bank was

* The World Bank recently published a report on *The Emerging Asian Bond Market* which was the subject of a conference co-hosted in Hong Kong by the HKMA. As part of the project a number of country reports were prepared. This is the executive summary of the study on Hong Kong prepared by a team from the World Bank led by Ismail Dalla.

able to offer a three-year debt issue just 10 basis points above the benchmark interest rate on the three-year Exchange Fund Note.

A very active primary and secondary market has developed in Exchange Fund Bills and Notes. The value of Exchange Fund Bills and Notes outstanding grew from HK$7.5 bn at year-end 1990 to HK$52.3 bn at year-end 1994. Over this period, average daily trading volume grew from HK$1.5 bn to HK$22.3 bn. Since the first quarter of 1993, the dollar value of average daily turnover has been more than 50% of bills and notes outstanding.

Several types of intermediaries are eligible to participate in the securities markets of Hong Kong. These intermediaries include securities dealers, banks, and deposit taking companies, and are regulated by the Monetary Authority (banks and deposit taking companies) and the Securities and Futures Commission (securities dealers). Many securities dealers are the subsidiaries of banks and foreign institutions. If a registered securities dealer is a member of the Stock Exchange, that dealer is also subject to supervision and monitoring, as the Exchange serves as a self-regulatory organisation.

Since 1993, the Stock Exchange of Hong Kong has been very successful in attracting new bond listings from overseas corporations, supranational organisations, and sovereign issuers whose bonds trade on a regional or global basis. Also, 33 local companies were able to raise HK$42.3 bn in the Euro and foreign bond markets. Prior to 1993, Hong Kong companies were able to tap the international bond market with no more than three issues per year. In 1993, five local companies issued HK dollar bonds in the local market.

Many market professionals in Hong Kong believe that the market for debt instruments has far more potential than has been realised so far, and that the recent success with respect to the flotation of debt offering by supranational organisations and foreign issuers bodes well for the future. The infrastructure needs of the region are enormous. Hong Kong's Mass Transit Railway Corporation has estimated that it will cost HK$22 bn to construct a 34-kilometre railway linking Central and Kowloon with Northern Lantau Island and Hong Kong's new airport. Consequently, the immediate need to finance Hong Kong's local infrastructure is substantial. More importantly for the longer term, however, is the need to develop the bond market to facilitate the financing of China's infrastructure. In addition, other emerging market economies in the region may be able to issue bonds in the years ahead as economic reforms translate into higher growth rates and improved credit standings. As a regional financial centre, Hong Kong is well established to play a role in this process.

The lengthening of the maturities of Exchange Fund Bills and Notes should provide further impetus to the development of the HK dollar bond market by providing a better benchmark for issues denominated in HK dollars. In fact, the HKMA has already launched the first issue for five year notes in September 1994. The benchmark currently provided by the Exchange Fund Bills and Notes Programme is widely followed by market practitioners, and efforts to strengthen this market will contribute to the further maturation of the HK dollar bond market.

The Monetary Authority has increased liquidity in the debt market by allowing Mass Transit Railway Corporation (MTRC) and Airport Authority debt instruments to be used for repurchase agreement (Repo) transactions.[1] From March 1994, the scope of eligible repo securities for discounting under the Liquidity Adjustment Facility has been extended beyond Exchange Fund Bills and Notes. In addition to paper issued by MTRC and the Airport Authority, HK dollar debt instruments are in principle qualified if they: (a) are lodged with and cleared through the CMU, (b) have a minimum credit rating of A3 (Moody's) or A- (S&P) for a bank issuer, and A2 (Moody's) or A (S&P) for a non-bank issuer; and (c) are marketable.

1 A repurchase agreement ("Repo") is a transaction in which the owner of securities sells them and simultaneously agrees to repurchase the same or equivalent securities on a specified date, at an agreed price. The most developed repo market is found in the US. In the US, repos are the least expensive source of funding for dealers' inventories in government securities. Most repos are entered into on an overnight, or short-term basis; however, long-term repos are not uncommon. Repos can involve credit risk to the extent that the parties to the transaction do not meet their obligations, or if dealers hold custody of securities that have been purchased.

Restrictions on the minimum size of the HK dollar denominated certificates of deposit makes it difficult to market these instruments to retail investors. Furthermore, this type of regulation creates market distortions by forcing small savers to place their savings in time deposits whose rates are determined administratively by the Hong Kong Association of Banks rather than by market forces. The liberalisation of the interest rate regime to allow free market forces to play a larger role in the determination of interest rates is underway and will provide a more equal playing field among banks and other financial intermediaries competing in the Hong Kong market. Also, a wider array of debt instruments available to issuers and investors would allow for the allocation of credit in a more economically efficient manner.

There is a need to develop support facilities to allow for the issuance of securitised mortgages in the Hong Kong market. This may take the form of mortgage insurance or letters of credit. Likewise, there may be a need to develop a bond insurance scheme in the region to enhance the ability of companies to issue bonds in Hong Kong, or internationally. Bond insurance would have appeal to institutional investors and is less expensive than bond guarantees. Further expansion of the contractual saving industry will contribute to the development of the bond market. ®