

HONG KONG DOLLAR DEBT MARKET DEVELOPMENTS IN 2001

New issuance of Hong Kong dollar debt declined in 2001 amid economic downturn and a poor external environment, despite easing interest rates. All classes of issuer other than statutory bodies/government-owned corporations registered a reduction in issuance. Nevertheless, the market saw an increase in product variety and strong retail interest in debt securities, and outstanding debt continued to grow, as new issuance exceeded maturities.

In 2001, the HKMA's Central Moneymarkets Unit (CMU) reached an agreement with Euroclear to develop a direct link between them. Hong Kong Exchanges and Clearing Limited (HKEx) launched the Exchange Fund Notes futures contract. Several electronic trading platforms for debt securities have been established by private sector initiatives, which could improve price transparency, liquidity and depth of the bond market.

Market Overview

New issuance of Hong Kong dollar debt declined in 2001 amid economic downturn and a poor external environment, despite easing interest rates. Total new issues amounted to HK\$386 billion, down 15% from 2000 (Chart 1). All classes of issuer other than statutory bodies/government-owned corporations registered a reduction in issuance. Notwithstanding the slackened issuance activity, the market saw an increase in product variety and strong retail interest in debt securities. The low interest rate environment prompted a number of borrowers to issue debt securities with embedded structures such as step-up coupons and call options to attract investors.¹ Retail interest in bond investment grew in the year amid low bank deposit rates and volatile equity market conditions.

Outstanding Hong Kong dollar debt increased by 5% to HK\$494 billion at the end of 2001, as new issuance exceeded maturities (Chart 2). The Exchange Fund accounted for about 23% of total outstanding debt and over 60% of issuance during the year. Other issuers included statutory bodies/government-owned corporations (7%), multilateral development banks (MDBs)² (10%), non-MDB overseas borrowers (21%), authorized institutions (Als)³ (31%) and local corporates (8%). A detailed breakdown of issuance activities and outstanding amount is in Annex A.

Hong Kong Dollar Fixed-Rate Debt Market

Fixed-rate debt continued to dominate the market and constituted about 70% of total new issues, excluding Exchange Fund paper, in 2001.⁴ Statutory bodies/government-owned corporations

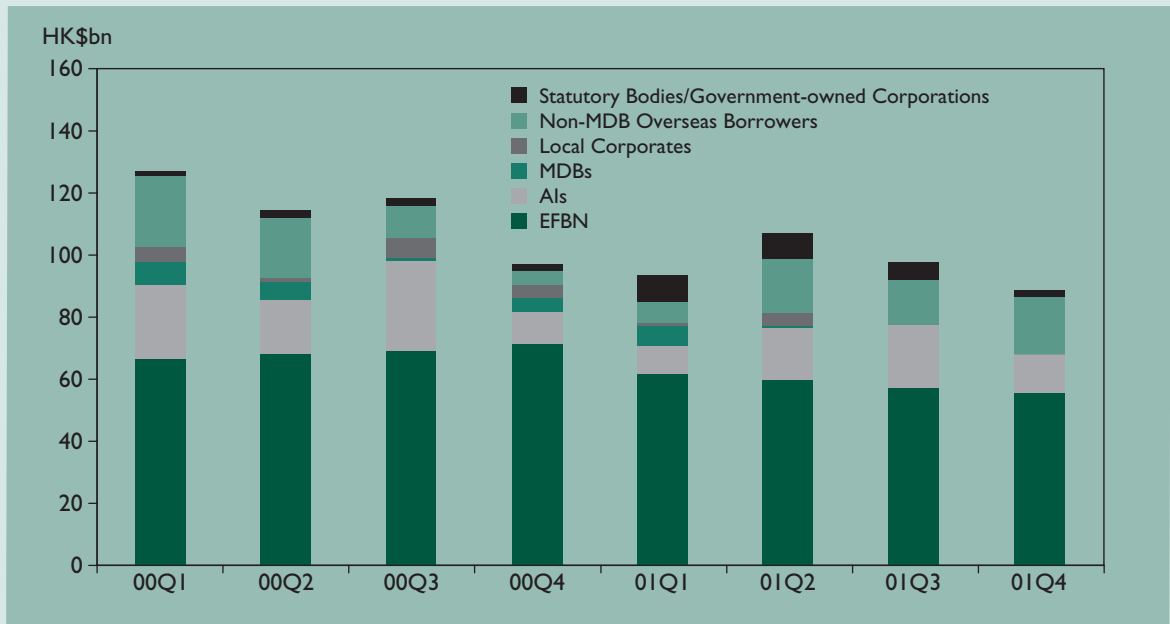
¹ Step-up issues carry lower coupons in the initial years of tenor, and higher coupons for the subsequent years. Call options provide issuers with the flexibility to redeem issues before the maturity date of the bonds and refinance debt in the future.

² MDBs refer to Asian Development Bank (ADB), Council of Europe Social Development Fund (CEF), European Company for the Financing of Railroad Rolling Stock (Eurofima), European Investment Bank (EIB), European Bank for Reconstruction and Development (EBRD), Inter-American Development Bank (IADB), International Bank for Reconstruction and Development (IBRD), International Finance Corporation (IFC), African Development Bank (AfDB), and Nordic Investment Bank (NIB). Income on debt securities issued by the MDBs is exempted from profits tax.

³ Als include licensed banks, restricted licence banks (RLBs), and deposit-taking companies (DTCs).

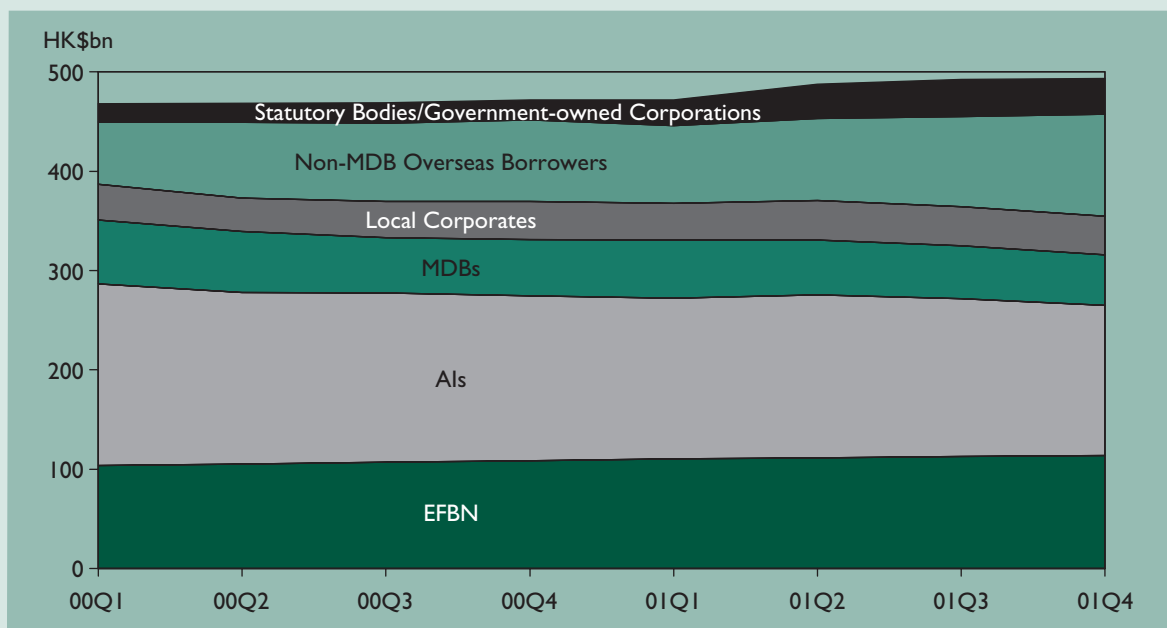
⁴ All Exchange Fund Bills and Notes are fixed-rate debt.

Chart 1
New Hong Kong Dollar Debt Securities Issued (HK\$ billion)



Sources: HKMA, Bloomberg, Basisfield, and Thomson Financial.

Chart 2
Hong Kong Dollar Debt Securities Outstanding at Quarter-End (HK\$ billion)



Sources: HKMA, Bloomberg, Basisfield, and Thomson Financial.

registered a significant increase in fixed-rate debt issuance, whereas issuance activity of all other types of issuer slackened in the year. At the end of 2001, outstanding fixed-rate debt, excluding Exchange Fund paper, stood at HK\$246 billion, an 8% increase over 2000. The average maturity profile of new and outstanding fixed-rate debt issues in 2001 increased markedly for highly rated entities, such as statutory bodies/government-owned corporations and non-MDB overseas borrowers (Table 1).

Hong Kong Dollar Floating-Rate Debt Market

Floating-rate debt issuance fell by 17% to HK\$46 billion (Chart 3). Its share in total Hong Kong dollar debt issuance, excluding Exchange Fund paper, was about 30% in 2001, similar to that in 2000. Statutory bodies/government-owned corporations resumed their floating-rate debt issuance in 2001 for the first time since 1999. Non-MDB overseas borrowers doubled their floating-rate debt issuance, which was offset by a significant reduction in issuance by AIs and local corporates. At the end of 2001, outstanding floating-rate debt amounted to HK\$134 billion, down 1% from 2000.

Issuance Activity by Types of Issuer

Authorized Institutions

In 2001, new Hong Kong dollar debt issued by AIs decreased by 28% to HK\$58 billion, reflecting excess liquidity in the banking sector amid economic downturn. At the end of 2001, outstanding Hong Kong dollar debt of AIs stood at HK\$151 billion, down 9% from 2000.

Local Corporates

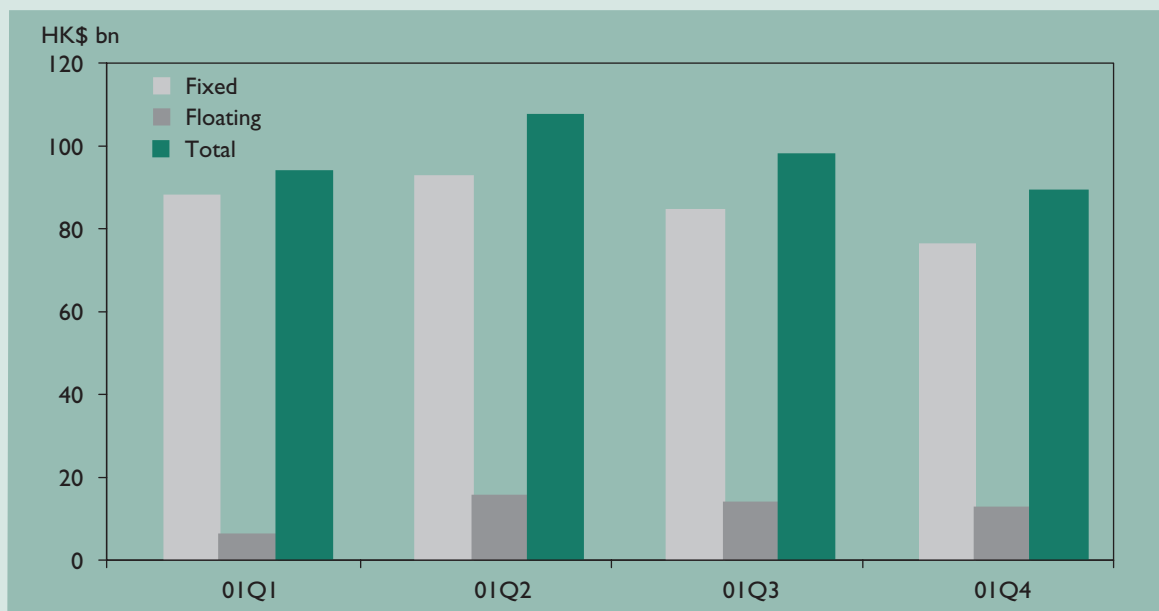
New local corporate debt issuance declined by over 65% to about HK\$6 billion in 2001, reflecting global economic slowdown and a weakening of financing needs. In addition, the decline was partly attributable to a shift to international issuance at the long end and the syndicated loan market in a declining interest rate environment with ample liquidity in the banking sector. Apart from the substantial amount of issuance in the second quarter of 2001, corporate issuance was, on the whole, subdued in the year. The local corporate bond market continued to be dominated by a handful of top-rated companies. Outstanding debt totalled HK\$39 billion at the end of 2001, little changed from the previous year.

Table 1
Average Maturity of Fixed-Rate Debt (Years)

Issuer	Average Maturity			
	New Issues		Outstanding Issues	
	2000	2001	End-2000	End-2001
Exchange Fund	0.4	0.5	1.2	1.2
Statutory Bodies/ Government-owned Corporations	2.0	3.6	1.7	2.3
MDBs	4.0	4.8	2.3	2.2
Non-MDB Overseas Borrowers	2.3	3.0	1.6	2.1
AIs	2.1	2.4	2.0	2.0
Local Corporates	3.3	2.6	2.7	2.2
All Issuers	1.1	1.3	1.7	1.8

Sources: HKMA, Bloomberg, Basisfield, and Thomson Financial.

Chart 3
New Fixed-Rate and Floating-Rate Debt Issued in Hong Kong (HK\$ billion)



Sources: HKMA, Bloomberg, Basisfield, and Thomson Financial.

MDBs

MDB debt issuance in 2001, at about HK\$7 billion, registered its lowest level since 1996. This in part reflected a shift of issuance to Australia and Taiwan, in response to investor demand. The demand for MDB issues by banks in Australia was boosted by changes in the Reserve Bank of Australia's policy to accept triple A-rated MDB issues as collateral for repurchase agreements.⁵ In Taiwan, many commercial banks and bond funds had resorted to high quality MDB issues, in view of the increasing credit risk of local corporate bonds following economic downturn.⁶

Non-MDB Overseas Borrowers

New debt issuance by non-MDB overseas borrowers edged down to HK\$57 billion in 2001.

European and Australian banks and financial institutions continued to be the major issuers, accounting for 52% and 39% respectively of the total. The proportion of floating-rate debt issuance by non-MDB overseas borrowers increased in 2001. Some of the floating-rate deals involve an interest rate cap in a bid to protect issuers against an increase in interest rates. At the end of 2001, outstanding debt issued by non-MDB overseas borrowers stood at HK\$103 billion, a 25% increase over 2000.

Statutory Bodies/Government-owned Corporations

New debt issuance by statutory bodies or government-owned corporations reached a record high of HK\$24 billion in 2001. The Hong Kong Mortgage Corporation (HKMC) was the most active issuer in the year, tapping the Hong Kong

5 In late 2000, in view of the declining stock of Commonwealth Government securities (CGS) associated with strong fiscal performance over the recent years, the Reserve Bank of Australia expanded the range of eligible debt securities as repo collateral to include Australian dollar denominated securities issued in Australia by several MDBs, including the IBRD, ADB, and EBRD. Decisions about eligible collateral from other MDBs will be made on a case-by-case basis.

6 S&P lowered Taiwan's local currency long-term debt sovereign rating to AA from AA+ in July 2001. The downgrade reflected Taiwan's diminished fiscal flexibility, and a weakening banking sector.

dollar debt market for over HK\$16 billion.⁷ Against a background of low interest rates and a strong demand for high quality paper, the HKMC issued HK\$5 billion 5-year fixed-rate notes in April 2001 - the largest fixed-rate issue in the Hong Kong dollar debt market to date. The HKMC also provided the market with a wide product variety, including notes with a retail tranche, mortgage-backed securities (MBS)⁸, retail bonds, and structured deals with step-up coupons and/or call options. In an effort to further develop the retail bond market, in August 2001 the HKMC issued HK\$500 million 3-year notes with a retail tranche of HK\$250 million, which attracted strong interest. Another milestone was HKMC's launch of a retail bond in November 2001 under a new mechanism,⁹ enabling retail investors to subscribe through three appointed placing banks - Dao Heng Bank, HSBC, and Hang Seng Bank, which also formed a market-making arrangement to provide liquidity in the secondary market. Other features of the mechanism included offering bonds in different maturities and yields to suit the needs of individual investors. Record low bank deposit rates and volatile equity market conditions made high quality debt instruments attractive to retail investors. In December 2001, the HKMC launched the Bauhinia MBS Limited US\$3 billion Mortgage-Backed Securitisation Programme, which is a multi-currency, conventional bond style securitisation programme.¹⁰ This is expected to help develop an active secondary mortgage market in Hong Kong. It should also help banks manage the liquidity and maturity mismatch risks and further broaden the product range of the financial market in Hong Kong. At the end of 2001, outstanding paper of statutory bodies/government-owned corporation amounted to HK\$36 billion, up 77% from 2000.

Exchange Fund Paper

New issuance of Exchange Fund paper, which was limited in total to the sum of maturities and interest payments on the existing stock, amounted to HK\$234 billion in 2001. This was 15% less than in 2000 because of a shift away from short-dated issues, but still accounted for over 60% of total new Hong Kong dollar debt issuance in the year. Demand for Exchange Fund paper remained strong in 2001, with an average over-subscription rate for Exchange Fund Notes of over 4 times in the year. Average daily turnover of Exchange Fund paper stood at HK\$21 billion, down 10% over 2000, mainly owing to lower turnover of Exchange Fund Bills (EFB). The flattening of the Hong Kong dollar yield curve at the short end in the first three quarters of 2001 limited the opportunities for running profitable gapping positions.¹¹ Record low yields also reduced the attractiveness of EFB. On the other hand, the average daily turnover of Exchange Fund Notes increased significantly in 2001, in part reflecting the improved performance of market makers after the implementation of the regular performance review scheme.

Measures to Promote Debt Market Development in Hong Kong

The various measures implemented by the HKMA in 2000 have contributed to greater transparency and liquidity in the Exchange Fund paper market. In 2001, the performance of market makers improved in both the primary and secondary markets in terms of allotment as well as market turnover, as a result of the regular review of market makers against benchmark criteria. The replacement of short-dated Exchange Fund paper by

7 The figure included the mortgage-backed securities issued by the HKMC Funding Corporation (I) Limited, a bankruptcy-remote special purpose company (SPC).

8 In August 2001, the HKMC issued the third MBS (HK\$633 million) under the Guaranteed Mortgage-Backed Pass-Through Securitisation Programme since October 1999. Such Programme adopted a back-to-back and pass-through structure. The HKMC acquired mortgage loans from American Express Bank and sold them directly to the SPC, which then issued MBS back to the bank with the HKMC's guarantee for the timely payment of principal and interest.

9 Total issuance of the retail bonds amounted to HK\$649 million (HK\$536.3 million 3-year notes with coupon of 3.5% and HK\$112.3 million 5-year notes with coupon of 4.3%), 5.5 times above the total minimum issue amount of HK\$100 million set by the HKMC.

10 Bauhinia is a bankruptcy-remote SPC formed by the HKMC to act as the vehicle for issuance of MBS under the Programme. The HKMC will sell mortgage portfolios to Bauhinia, which will then package them into MBS of different series for issue to investors.

11 Gapping refers to selling short of short-dated EFB against long positions in longer-dated EFB. If the interest cost on the short positions is less than that earned from the long positions, the player can capture gains from running this gapping position.

longer-dated paper and the publication of an advance quarterly issuance schedule of Exchange Fund paper were well received by the market. Meanwhile, the launch of the US dollar clearing system in 2000 has provided an efficient platform for issuing and trading US dollar denominated debt instruments.


In 2001, a number of measures were initiated to develop further the local debt market. The HKMA reached an agreement to set up a direct link between its Central Moneymarkets Unit (CMU) and Euroclear, the Brussels-based clearance and settlement system.¹² This fully-automated real-time link will enable Asian investors to directly hold and settle Euroclear-eligible securities via their CMU accounts, thus significantly improving settlement efficiency. Separately, Hong Kong Exchanges and Clearing Limited (HKEx) launched the 3-year Exchange Fund Notes futures contract in November 2001 to provide a hedging instrument for debt securities. This may also stimulate activity in the cash Exchange Fund paper market.

Several private sector financial institution groups have set up electronic trading platforms for institutional clients, and individual banks and brokerage houses have been providing on-line trading to their retail clients. The continued development of on-line trading is expected to enhance price transparency and accessibility of bond trading in general.

With a view to ensuring strict adherence to currency board principles, the HKMA ceased to be the arranger for Note Issuance Programmes (NIPs) of the four corporations - the Airport Authority (AA), HKMC, Kowloon-Canton Railway (KCRC), and MTR Corporation Limited (MTRC), effective from 1 September 2001.¹³ This change may result

in additional business opportunities for private sector arrangers in the wake of the HKMA's exit from debt arrangement business.

Conclusion

Notwithstanding the slowdown of the Hong Kong dollar debt market activity in the year, the market saw an increase in retail participation as well as product variety. Looking ahead, continued improvement in market infrastructure, increased public awareness of bond investment opportunities, further evolution of electronic trading, and the accumulation of funds managed under the Mandatory Provident Fund Scheme are expected to add impetus to the growth of the Hong Kong dollar debt market. 

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12 The existing indirect one-way link, in which Euroclear operates an account with the CMU through its agent in Hong Kong, was established in December 1994. This link enables Euroclear clients to clear and settle debt securities lodged with the CMU. The new link is a direct link, in which CMU opens an account with Euroclear itself.

13 Under the NIPs, debt securities issued by the four statutory bodies/government-owned corporations - specified instruments (SIs) - have been fungible with EFBN. In other words, a short position of a market maker in EFBN can be covered by a long position in SIs, or vice versa. In this regard, there is a possibility for holders of SIs to create additional EFBN, without specific foreign reserve backing as required under the currency board arrangements. Those debt securities issued under the NIPs prior to 1 September 2001 will remain fungible with EFBN until maturity.

**New Hong Kong Dollar Debt Securities Issued
(HK\$ million)**

	Exchange Fund	Statutory Bodies*	MDBs	Non-MDB Overseas Borrowers	Als	Local Corporates	Total
00Q1	66,558	1,500	7,630	23,037	23,558	4,650	126,933
Q2	68,058	2,300	5,600	19,112	17,419	1,450	113,939
Q3	69,068	2,500	1,300	10,352	28,777	6,050	118,047
Q4	71,352	2,025	4,800	4,609	10,000	3,957	96,743
2000	275,036	8,325	19,330	57,110	79,753	16,107	455,661
01Q1	61,635	8,550	6,630	6,780	8,857	800	93,252
Q2	59,576	8,000	732	17,545	16,712	4,300	106,865
Q3	57,099	5,583	0	14,235	20,037	300	97,254
Q4	55,650	2,184	100	18,089	12,202	200	88,424
2001	233,960	24,316	7,462	56,649	57,807	5,600	385,794
Increase/ (Decrease) Over 2000	(41,076)	15,991	(11,868)	(462)	(21,945)	(10,507)	(69,867)

**Hong Kong Dollar Debt Securities Outstanding at Quarter-End
(HK\$ million)**

	Exchange Fund	Statutory Bodies*	MDBs	Non-MDB Overseas Borrowers	Als	Local Corporates	Total
00Q1	103,458	18,739	63,962	62,469	183,357	36,131	468,116
Q2	105,158	19,058	61,362	76,281	172,629	33,881	468,369
Q3	106,818	20,704	55,612	78,581	170,735	36,448	468,897
Q4	108,602	20,509	57,062	81,840	165,680	38,405	472,098
01Q1	110,135	26,330	58,892	78,133	161,882	36,785	472,156
Q2	111,526	34,245	55,104	82,693	164,179	39,785	487,531
Q3	112,699	37,574	53,104	90,639	158,898	39,930	492,843
Q4	113,750	36,227	51,104	102,680	150,962	38,880	493,603
Increase/ (Decrease) Over 2000	5,148	15,719	(5,958)	20,840	(14,718)	475	21,506

*Include government-owned corporations.

Sources: HKMA, Bloomberg, Basisfield, and Thomson Financial.