FEATURE ARTICLE

Hong Kong dollar debt market development in 2005

by Alfred Wong, Maggie Mok and Vincent Yeung of the Research Department, and Eric Wong and Daniel Chu of the Monetary Management & Infrastructure Department

The domestic debt market expanded steadily in 2005. New issuance and the total amount of outstanding Hong Kong dollar debt both registered healthy growth. Fixed-rate debt continued to dominate the market as issuers tried to lock in lower borrowing costs in a rising interest rate environment, while floating-rate debt also gained popularity.

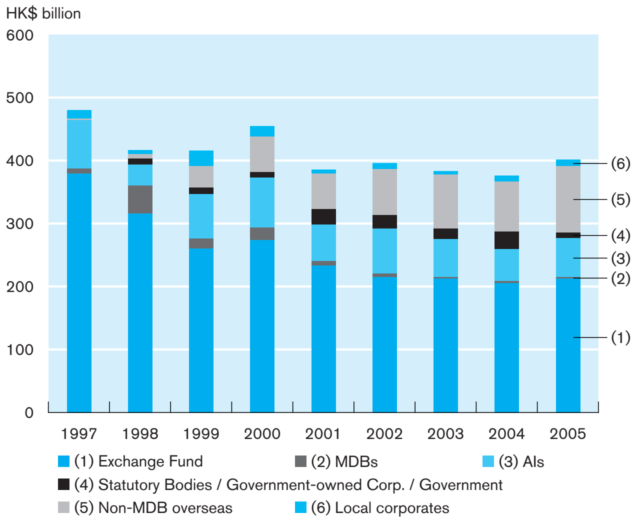
Since the Asian financial crisis, the Government and the HKMA have introduced wide-ranging measures to promote the development of the domestic bond market in three key areas – tax and regulation, product development and market infrastructure. As a result, the market has grown considerably, with total outstanding debt rising by 87% between 1997 and 2005. However, there is much potential for expansion, especially with increasing economic integration with the Mainland and the rapidly growing demand for retirement-related investment products as the population ages and retirement funds expand.

Market overview

Total gross issuance of Hong Kong dollar debt increased by 7% to HK$402 billion in 2005 (Chart 1). While gross debt issued by multilateral development banks (MDBs)[1], and statutory bodies and government-owned corporations[2] fell, the reduction was more than offset by an increase in issuance by the Exchange Fund, authorized institutions (AIs),[3] local corporates and non-MDB overseas borrowers. Gross MDB debt issuance declined sharply by 49% to HK$1.8 billion last year. In contrast, non-MDB overseas borrowers tapped the domestic market most, raising 33% more funds than in 2004. AIs also registered strong growth of 23% in gross issuance in 2005.

CHART 1

New issues of Hong Kong dollar debt instruments



[1] 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.

[2] Statutory bodies or government-owned corporations include Bauhinia MBS 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.

[3] AIs include licensed banks, restricted license banks, and deposit-taking companies.

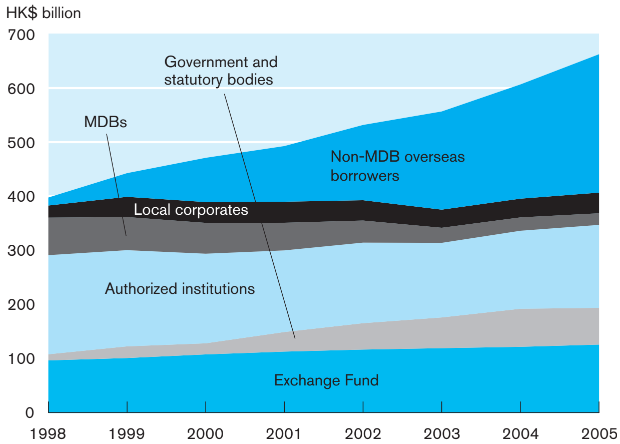
Exchange Fund Bills and Notes (EFBNs) issued in 2005 rose by 4% and accounted for 53% of all new issues. The 2-year paper was particularly welcomed by the market, with subscription averaging almost three times the issue size. Against the background of an increasingly restrictive monetary policy in the US and the introduction of the refinements to the Linked Exchange Rate system, liquidity tightened in the banking system in 2005, putting upward pressure on yields, particularly at the shorter end.[4] The yield on the one-year EFBN rose markedly by 332 basis points to 3.9% at the end of 2005.

With total new issues exceeding maturing securities, outstanding Hong Kong dollar debt increased by 9% to HK$664 billion in 2005 (Chart 2). Non-MDB overseas borrowers as a whole remained the single largest borrower in Hong Kong dollar debt, with the outstanding amount of debt rising by 19% to HK$256 billion. Amid reduced liquidity in the banking system, AIs also increased their outstanding Hong Kong dollar debt by 8% to HK$153 billion in 2005. But, the outstanding amount of debt of MDBs continued to slide, reducing by 13% to only HK$22 billion. Appendix A contains a detailed breakdown of issuance activities and outstanding debt instruments.

During the year, there was a growing interest in bond offerings at the retail level. The HKMA offered two issues of retail Exchange Fund Notes, totalling HK$500 million.[5] The Hong Kong Mortgage Corporation (HKMC) also issued four series of retail bonds to the public, comprising two series of Hong

CHART 2

Outstanding amount of Hong Kong dollar debt instruments



Kong dollar bonds amounting to HK$100 million and two series of US dollar bonds totalling US$10 million. All these HKMA and HKMC issues were well received and oversubscribed.

Fixed-rate debt market

Fixed-rate debt dominated new issuance in 2005. The introduction of the three refinements to the Linked Exchange Rate system brought domestic interest rates in line with their US counterparts. As interest rates were expected to remain on an upward trend in the US over the course of 2005, issuers generally favoured the issuance of fixed-rate debt to lock in lower borrowing costs. Of all new debt issues excluding EFBNs[6], fixed-rate debt accounted for 74%. The average maturity of the new fixed-rate

[4] The Aggregate Balance, a measure of interbank liquidity, declined sharply from a daily average of HK$30 billion in 2004 to HK$4 billion in 2005.

[5] These issues followed the introduction of the refined Retail Exchange Fund Programme under which investors could purchase Exchange Fund Notes through a larger distribution network and at lower prices.

[6] All Exchange Fund papers are fixed-rate debts.

TABLE 1

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

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

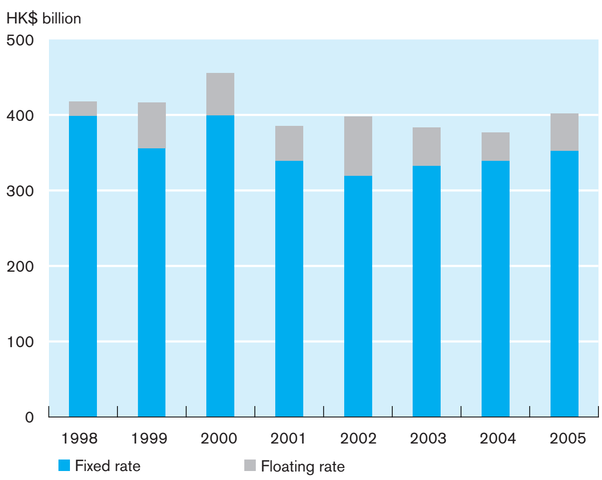
debt was broadly stable (Table 1), with longer maturities of the new issues by statutory bodies and government-owned corporations, local corporates and non-MDB overseas borrowers offsetting shorter maturities of the new issues by MDBs and AIs.

Floating-rate debt market

Despite the dominance of fixed-rate debt in the local bond market, floating-rate debt gained increased popularity during the year (Chart 3). Higher interest rates may have convinced more issuers that interest rates could peak over the foreseeable horizon, prompting them to issue more floating-rate debt. New issuance of floating rate-debt rose sharply by 34% to HK$50 billion, with the share in total issuance, excluding Exchange Fund papers, rising from 22% in 2004 to 26%. As new issues of floating-rate debt outpaced maturing securities, outstanding floating-rate debt rose to HK$148 billion at the end of December 2005.

CHART 3

New fixed-rate and floating-rate debt issued in Hong Kong



Measures to promote debt market development in Hong Kong

Refinements to the retail Exchange Fund Notes programme

As part of the effort to broaden the domestic debt market's investor base, the HKMA launched the retail Exchange Fund Notes programme in August 2003. Appendix B provides a detailed account of the initiatives taken by the Government and the HKMA to promote the development of the domestic bond market since the Asian financial crisis. Refinements to the programme were introduced in 2005 to make it more appealing to retail investors. The refinements included retail bids allotted at the lowest price, or the highest yield, accepted at the competitive-bid tenders; distribution through a wide network of seven distributor banks with extensive retail networks in Hong Kong; and flexible selection of Exchange Fund Note issues for retail subscription, taking into account market conditions.

The CMU Bond Price Bulletin

To enhance retail investors' awareness of bond products and improve the transparency of bond prices, the HKMA's Central Moneymarkets Unit (CMU) developed a website, the CMU Bond Price Bulletin, which provides retail investors with convenient on-line access to indicative bond prices quoted by the major banks in Hong Kong. The website was developed in 2005 on the recommendation of the Exchange Fund Advisory Committee's Financial Infrastructure Sub-Committee, and was launched on 9 January 2006. Users can easily search for bond information and prices, and also make use of the hyperlinks to access the websites of the price providers for direct trading.

Simultaneous Processing of DvP and Collateralisation

The device is a major improvement in the debt securities clearing system developed in 2005 and launched on 23 January 2006. It allows EFBN buyers to obtain liquidity from the HKMA using the incoming EFBNs as collateral. This will help the buying banks to better manage liquidity and encourage greater use of real time Delivery-versus-Payment (DvP) to settle EFBN transactions, thus increasing settlement efficiency and reducing settlement risk. Through this device, the proportion of secondary market transactions settled on real-time DvP is expected to increase over time as market players become more familiar with the new system. Indeed, with the introduction of this device, 4% of the total value of secondary market transactions of EFBNs and 8% of the total number were processed on a real-time DvP basis in the first two weeks (23 January – 3 February 2006) of operation. The rest continued to be settled by DvP at the end of the day. This was already an improvement over the previous situation where 100% were settled by DvP at the end of the day. The average daily secondary market turnover of EFBNs during these two weeks was HK$28 billion.

Conclusion

The Hong Kong dollar debt market had another year of steady growth in 2005. New issuance and the outstanding amount have both risen. Fixed-rate debt continued to dominate issuance activity, but fell relative to floating-rate debt. The retail market also showed strong interest in the new issues by the HKMA and HKMC. As the population ages and retirement funds expand, demand for Hong Kong dollar debt is likely to increase in the medium term, providing considerable scope for the market to grow.

Given that a deep and mature debt market is instrumental in achieving a balanced financial system, the HKMA will continue to keep debt market development high on its policy agenda.

APPENDIX A

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

	Exchange Fund	Statutory bodies*	Govern-ment bonds	MDBs	Non-MDB overseas borrowers	AIs	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	233,960	24,316	0	7,462	56,865	57,807	5,600	**386,011**
2002	216,228	21,557	0	5,200	73,065	71,406	8,854	**396,312**
2003	213,255	16,002	0	2,641	85,509	60,850	5,470	**383,727**
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**
Increase/ (decrease) over 2004	7,775	(9,239)	(10,250)	(1,730)	25,996	11,740	880	**25,172**

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

	Exchange Fund	Statutory bodies*	Govern-ment bonds	MDBs	Non-MDB overseas borrowers	AIs	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**
Increase/ (decrease) over 2004	4,130	(2,474)	0	(3,200)	41,911	11,927	3,531	**55,825**

* Includes government-owned corporations.
Source: HKMA.

APPENDIX B

Bond market development initiatives in Hong Kong

The Asian financial crisis uncovered two major weaknesses in the financial system of most economies in the region – the asset-liability mismatches of banks in maturity and currency, and the over-reliance on banks and stock markets in channelling financial resources to support productive activities. Authorities in Asia quickly realised the importance of developing domestic bond markets to address these weaknesses. As an additional channel to mediate between savers and borrowers, a well-developed domestic bond market could help alleviate the impact of lost access to international capital markets on economic activity. Local currency bonds as an asset class also offer banks a new tool for their balance-sheet management.

In view of these considerable benefits, the Government and the HKMA have been promoting the development of the domestic bond market. This appendix summarises the major initiatives taken since the Asian financial crisis in three areas – developing new products; building and improving market infrastructure; and providing a tax and regulatory environment conducive to market development.

Product development

Product development initiatives include the issuance of government bonds, securitised debt, bond funds, and retail bonds.

The Government launched a HK$20 billion global fixed-rate bond for the first time in two decades and a HK$6 billion toll road securitised bond in 2004. And the HKMC completed a series of mortgage-backed securities offerings that began in 2001, which have helped deepen the securitised debt market.

Built on the 2003 success of the Central Bank-targeted Asian Bond Fund 1, the Executive's Meeting of the East Asia-Pacific Central Banks extended the initiative to local bond markets with the Asian Bond Fund 2 (ABF2).[7] In mid-2005, under ABF2, the Pan-Asian Bond Index Fund and ABF Hong Kong Bond Index Fund were listed in Hong Kong.

Initiatives have also targeted packaging products for, and facilitating sales to, the retail market. The HKMA operated a pilot scheme to stimulate retail investment in Exchange Fund Notes from August 2003 to August 2004, under which the fee structure was simplified and retail distributors were appointed. This paved the way for the subsequent successful sale of the retail tranche of the issues by the Government. The retail programme was refined in May 2005.

Market infrastructure

Building and improving market infrastructure has included maintaining the benchmark yield curve, linking the Hong Kong bond settlement system with its counterparts in major overseas markets, and developing on-line access to market information for retail investors.

[7] ABF2 comprises eight single-market bond funds, and a single-bond fund investing in sovereign and quasi-sovereign local currency denominated bonds issued in all EMEAP markets, except Australia, Japan and New Zealand (the Pan-Asian Bond Index Fund), all of which will be listed in local exchanges and opened to retail investors.

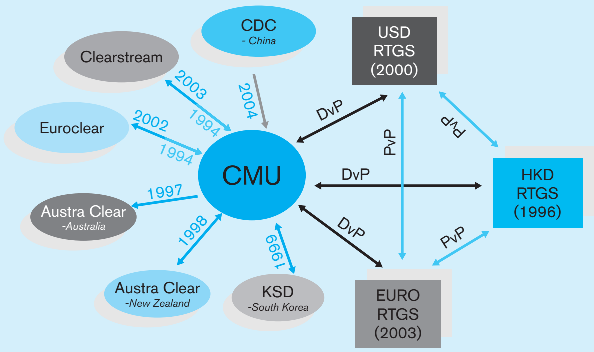
A domestic yield curve gradually took shape when the HKMA began issuing Exchange Fund papers in the early 1990s.[8] Given the importance of having a reliable benchmark for other issuers (in both the private and public sectors), considerable effort has been directed at maintaining a smooth and continuous yield curve in designing the EFBN issuance programme.

Linking the Central Moneymarkets Unit (CMU) with other major international securities settlement systems has been instrumental in fostering cross-border bond trading and investment.[9] Chart 4 shows the full history of the links with other international systems. Major links established following the Asian financial crisis include Brussel's Euroclear in November 2002, Clearstream Banking Luxembourg in January 2003, and the China Government Securities Depository Trust & Clearing Co. Ltd's (CDC) Government Securities Book-entry System (GSBS) in April 2004.[10] The links with the two systems in continental Europe provide Asian investors with a window to clear, settle and hold international debt securities through their CMU accounts, and vice versa for European investors. The current link with CDC's GSBS is a one-way arrangement that allows authorised financial institutions on the Mainland to invest in Hong Kong dollar-denominated debt securities.

To increase market transparency and product awareness, the HKMA launched the CMU Bond Price Bulletin website in January 2006. The website provides convenient on-line access to indicative bond prices quoted by major banks in Hong Kong. At its inception, indicative bid and offer prices for about 200 bonds were available from eight banks.

CHART 4

Links with other international systems



Tax and regulation

Recent government measures to create a more attractive tax and regulatory environment for bond market participants consist of offering tax concessions to bond buyers and making issuance simpler for fund raisers.

To stimulate demand, the scope of tax concessions on debt securities was expanded in 2003. Trading profits from bonds with a maturity period of seven years or more (issued after 5 March 2003) were exempted totally from profits tax, compared with the previous 50% tax concession. In addition, the minimum maturity requirement for the 50% tax concession was relaxed from five to three years.

On the supply side, the Government and the Securities and Futures Commission have together streamlined regulations and procedures for issuing and listing debt securities. This has enabled issuers to market their offers with greater flexibility and effectiveness to the public, thereby lowering their issuance costs.

[8] The first issue was a 91-day Exchange Fund Bill in March 1990. Over the years, this has developed into a programme regularly issuing papers with maturity ranging from three months to 10 years.

[9] The CMU was established by the HKMA in 1990 to provide computerised clearing and settlement facilities first only for Exchange Fund papers, but subsequently extended to other debt securities.

[10] The new two-way links with Euroclear and Clearstream replaced the original one-way links established in the mid-1990s where only overseas investors could make use of the link to participate in Hong Kong's debt market.

Conclusion

In summary, the Government and the HKMA have introduced wide-ranging measures to promote the development of the domestic bond market since the Asian financial crisis. As a result, the market has grown considerably, with total outstanding debt rising by 87% between 1997 and 2005. Hong Kong is often regarded as a regional leader in market depth and infrastructure.[11] However, there is considerable potential for expansion, especially in view of increasing economic integration with the Mainland and the rapidly growing demand for retirement-related investment products. The Hong Kong authorities will maintain the momentum by continuing to explore new ways to help the market grow.

[11] See a detailed survey and analysis in Fabella R. and S. Madhur (2003) "Bond Market Development in East Asia: Issues and Challenges" *ERD Working Paper No. 35*, Asian Development Bank.