

# Hong Kong dollar debt market development in 2006

by Alfred Wong, Maggie Mok and Phyllis Leung of the Research Department, and Daryl Ho and Daniel Chu of the Monetary Management & Infrastructure Department

Growth in the Hong Kong dollar debt market picked up further momentum in 2006. New issuance and the total amount of outstanding Hong Kong dollar debt both registered strong growth. The issuance market continued to be dominated by fixed-rate debt, while the popularity of the floating-rate debt declined.

In 2006, the HKMA completed a review of the domestic debt market and recommended a number of measures to improve the Exchange Fund Bills and Notes (EFBN) programme and the abolition of a restriction imposed since the Asian financial crisis on debt issuance by multilateral development banks. In a drive to promote the liquidity of the secondary market, these measures included significant refinements to the existing market-making system for EFBNs.

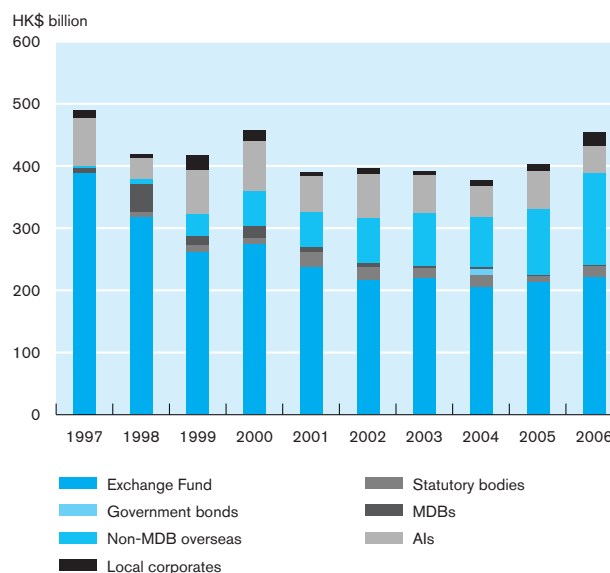
## Market overview

Total gross issuance of Hong Kong dollar debt rose by 13% to HK\$454 billion in 2006 (Chart 1). Authorized institutions (AIs)<sup>1</sup> reduced their debt issuance by 28% last year, largely due to ample liquidity in the banking system and, thus, a reduced need to raise funds in the debt market. However, the Exchange Fund, statutory bodies and government-owned corporations<sup>2</sup>, multilateral development banks (MDBs)<sup>3</sup>, non-MDB overseas borrowers and local corporations all increased their borrowing in the market, more than offsetting the reduction in issuance by AIs.

The amount of EFBNs issued in 2006 increased to HK\$220 billion from HK\$214 billion in 2005. Reflecting strong demand for EFBNs, subscription

CHART 1

New issues of Hong Kong dollar debt instruments



<sup>1</sup> AIs include licensed banks, restricted licence banks, and deposit-taking companies.

<sup>2</sup> Statutory bodies and government-owned corporations include Bauhinia Mortgage-backed Securities 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.

<sup>3</sup> 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.

averaged around four times the issue size, which exerted downward pressure on yields. The yield on the 10-year paper declined by 45 basis points to 3.73% at the end of 2006, almost one full percentage point below the yield of comparable US Treasury notes.

Total outstanding Hong Kong dollar debt increased by 13% to HK\$748 billion at the end of 2006, as new issues exceeded maturing securities (Chart 2). The outstanding debt of the corporate sector registered a robust 37% growth last year. Non-MDB overseas borrowers as a whole remained the single largest borrower, with outstanding debt totalling HK\$332 billion, representing a 30% increase over the previous year. However, outstanding debts of statutory bodies and government-owned corporations, the Government, MDBs and Als all

declined. A detailed breakdown of issuance activities and outstanding debt instruments is available in Appendix A.

At the retail level, there has been a growing interest in bond investment following the launch of a refined retail Exchange Fund Notes programme in May 2005, under which investors can purchase the papers through a larger distribution network and at lower prices. The HKMA has since offered seven issues of retail Exchange Fund Notes, totalling \$1,500 million.<sup>4</sup> The Hong Kong Mortgage Corporation (HKMC) also issued HK\$661 million worth of 2-year Hong Kong dollar notes and HK\$205 million worth of 10-year zero coupon bonds to retail investors last year. All these HKMA and HKMC issues were well received.

## Fixed-rate debt

Fixed-rate debt continued to dominate new issuance in 2006, with gross issuance excluding EFBNs rising by 31% to HK\$181 billion. The proportion of fixed-rate debt increased to 78% of total gross issuance excluding EFBNs. Total amount of outstanding non-EFBN fixed-rate debt grew by 18% to HK\$459 billion at the end of the year. The dominance of fixed-rate debt may be due to the low interest rate environment in Hong Kong. As shown in Table 1, issuers all tended to reduce the tenor of their debt issues in 2006, with the overall average maturity shortening from 4.2 years in 2005 to 3.1 years in 2006.

CHART 2

Outstanding amount of Hong Kong dollar debt instruments

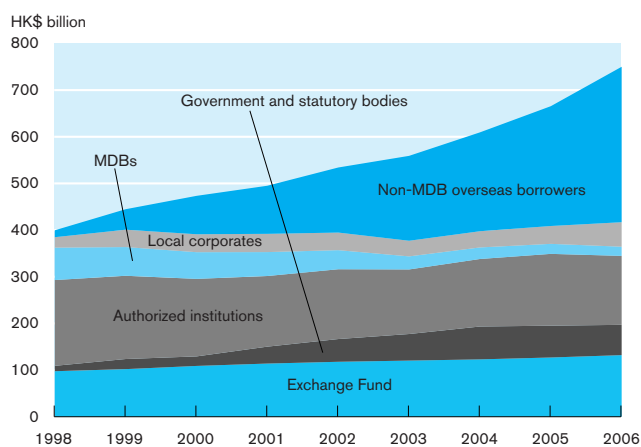


TABLE 1

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

| Issuer   | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|--|------|------|------|------|------|------|------|------|------|
| Government                                       | –    | –    | –    | –    | –    | –    | 5.5  | –    | –    |
| Statutory bodies/<br>government-owned corporates | 2.9  | 2.0  | 2.0  | 3.6  | 2.9  | 6.7  | 4.5  | 6.6  | 3.3  |
| MDBs   | 2.0  | 3.4  | 4.0  | 4.8  | 5.6  | 7.5  | 8.2  | 7.0  | 2.8  |
| Non-MDB  | 2.1  | 1.6  | 2.2  | 2.9  | 3.7  | 3.1  | 4.0  | 4.5  | 3.0  |
| Als  | 3.5  | 2.0  | 2.1  | 2.4  | 2.4  | 3.0  | 3.0  | 2.4  | 1.7  |
| Local corporates                                 | 0.2  | 2.4  | 3.3  | 2.6  | 4.3  | 4.5  | 5.6  | 6.9  | 5.3  |
| Total  | 2.3  | 2.2  | 2.5  | 3.0  | 3.3  | 3.6  | 4.1  | 4.2  | 3.1  |

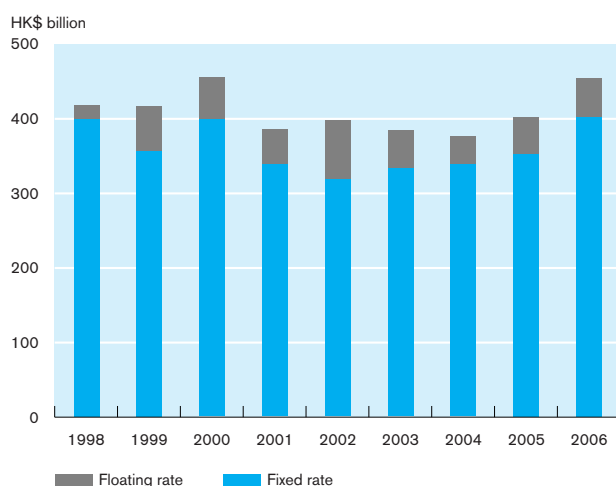
<sup>4</sup> Of this amount, HK\$800 million worth of papers were issued in 2006.

## Floating-rate debt

Floating-rate debt became relatively less popular in 2006, with gross issuance growing 5% to HK\$52 billion (Chart 3), much slower than the rate for fixed-rate debt. As a result, the proportion of floating-rate debt to total gross issuance, excluding the EFBNs, fell from 26% in 2005 to 22% in 2006. With new issues exceeding maturing debt, the total amount of outstanding floating-rate debt increased moderately by 5.7% to \$157 billion at the end of 2006.

CHART 3

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



## Measures to promote debt market development in Hong Kong

### Refining the EFBN programme

The HKMA completed a review of the EFBN market in 2006. The review took account of overseas practices and comments from market participants. Steps were taken in the second half of the year to implement the recommendations arising from this review. One of the recommendations to improve liquidity in the EFBN market was to promote secondary market activities by providing market makers with incentives, including publishing league tables of the top market makers, and making tenders of EFBNs available exclusively to these players (see Appendix B for more details on the review of the market-making system). The first set of league tables

was released in December 2006. Other recommendations included extending the benchmark yield curve by issuing 15-year Exchange Fund Notes (EFN), streamlining the issuance programme by making greater use of re-opening, and introducing an electronic trading platform for the EFBN market. Consideration is also being given to adopting a single-price auction method to replace the existing multiple-price auction method in EFBN tenders. These recommendations will be implemented in 2007 and beyond.

### Abolishing the restriction on issuance by MDBs

The review also recommended the removal of the three-year rule to stimulate primary market activities. The three-year rule was a request made by the HKMA to MDBs in 1998 to confine their issuance of Hong Kong dollar denominated bonds to tenors of three years or longer.

## APPENDIX A

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

|                                | Exchange fund | Statutory bodies* | Government | MDBs   | Non-MDB overseas borrowers | Als      | 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                           | 237,009       | 24,316            | 0          | 7,462  | 56,865                     | 57,807   | 5,600            | 389,059 |
| 2002                           | 216,228       | 21,557            | 0          | 5,200  | 73,065                     | 71,406   | 8,854            | 396,312 |
| 2003                           | 219,648       | 16,002            | 0          | 2,641  | 85,509                     | 60,850   | 5,470            | 390,120 |
| 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 |
| 2006                           | 220,415       | 17,419            | 0          | 2,950  | 147,009                    | 44,930   | 21,371           | 454,094 |
| Increase/ (decrease) over 2005 | 6,654         | 8,859             | 0          | 1,150  | 41,626                     | (17,612) | 11,420           | 52,097  |

### Outstanding Hong Kong dollar debt instruments (HK\$ million)

|                                | Exchange fund | Statutory bodies* | Government | MDBs    | Non-MDB overseas borrowers | Als     | 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 |
| 2006                           | 131,788       | 56,876            | 7,700      | 19,555  | 332,396                    | 147,428 | 52,398           | 748,141 |
| Increase/ (decrease) over 2005 | 5,079         | (836)             | (2,550)    | (1,980) | 76,397                     | (5,957) | 14,260           | 84,413  |

\* Includes government-owned corporations

Source: HKMA.

## APPENDIX B

### Improving the market-making system for Exchange Fund Bills and Notes

The HKMA conducted a study of the development of Hong Kong's domestic debt market in 2006. The study included a review of the market-making system to promote the liquidity of the Exchange Fund Bills and Notes market. This entailed extensive consultations with market practitioners, including Market Makers (MMs) and Recognised Dealers (RDs), and a survey of overseas practices. Based on this review, three recommendations are now being implemented in phases to improve the market-making system for EFBNs: (i) publishing regularly league tables of the most active market-makers; (ii) restricting EFBN tenders to those in the league tables; and (iii) considering the adoption of a single-price auction method in EFBN tenders. This appendix explains the rationale behind these recommendations.

#### Background

The EFBN programme was launched to develop the domestic debt market through introducing a regular supply of high-quality papers in 1990. EFBNs with tenors from three months to 10 years were issued to establish a benchmark yield curve. As market liquidity is instrumental in maintaining a credible benchmark yield curve, a market-making system was introduced in parallel.

There are now 144 RDs in the market, of which 25 are MMs. The HKMA assesses and reviews their status regularly.<sup>5</sup> Under the current system, MMs are obliged to quote two-way prices on request. In return, they enjoy the privilege of being able to take short positions during the trading day.<sup>6</sup>

#### League tables

Market consultations and overseas experience suggest that trading activities can be encouraged by providing recognition to active MMs in the market. The HKMA launched the first set of league tables of MMs for EFBNs in December 2006. The league tables, one for Exchange Fund Bills and the other for Exchange Fund Notes, list the ranking of the 12 MMs with the highest turnover in the respective markets between June and November 2006. The tables will be prepared every six months and published in early June and December based on turnover from 1 December to 31 May and from 1 June to 30 November, respectively.

#### Tendering rights

Under the existing arrangement, all MMs and RDs are allowed to participate in EFBN tenders. To provide incentives for MMs to better perform their duties, it has been decided to make EFBN tenders available exclusively to the top MMs. All primary offers of EFN and EFB issues will be made available exclusively to top MMs in the respective league tables. Under this arrangement, other MMs and RDs needing Exchange Fund papers will have to buy them in the secondary market.

The exclusion of non-MM Recognised Dealers in EFBN tenders is unlikely to reduce competition in the primary market: while the current arrangement allows these RDs to bid for EFBNs in the primary market, they seldom do so in

<sup>5</sup> At a minimum, they should attain a 1.5% successful EFBN allotment rate, 1.5% share in EFBN turnover and HK\$500 million gross EFN turnover every quarter.

<sup>6</sup> The short-selling capability of MMs can deter cornering activities as well as helping promote secondary market liquidity.

practice. EFBN tender records show that they account for a very small market share – only 1% of total allotments for EFB, and 0.01% for EFN in 2006. The competition among MMs in the secondary market will however intensify because of the introduction of the league tables and the exclusive tender arrangement. As a result, MMs are likely to quote more competitive prices (i.e., smaller spreads) to maximise turnover.

The exclusive tender arrangement is planned to be implemented in the second half of 2007.

### Single-price auction

The two most commonly used methods for determining government bond prices in the primary market are *multiple-price auction* and *single-price auction*. In the former, which is the method currently adopted for EFBN tenders, each successful bidder pays the price they bid. In the latter, all successful bidders pay the lowest of the successful bids, regardless of their own original bid.<sup>7</sup>

Single-price auctions enable even the less experienced bidders to receive allotments at reasonable prices. To encourage smaller MMs to take part in tenders, consideration is being given to switching from multiple-price auctions to the single-price auction.

To familiarise market participants with the single-price auction method and to assess its suitability for Hong Kong, the HKMA intends to run a series of tests later in 2007.

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<sup>7</sup> The US Treasury switched from multiple-price auction to uniform-price auction in September 1992 to broaden participation and reduce concentration of securities on original issue.

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