

# Hong Kong-dollar debt-market development in 2008

by the Monetary Management Department

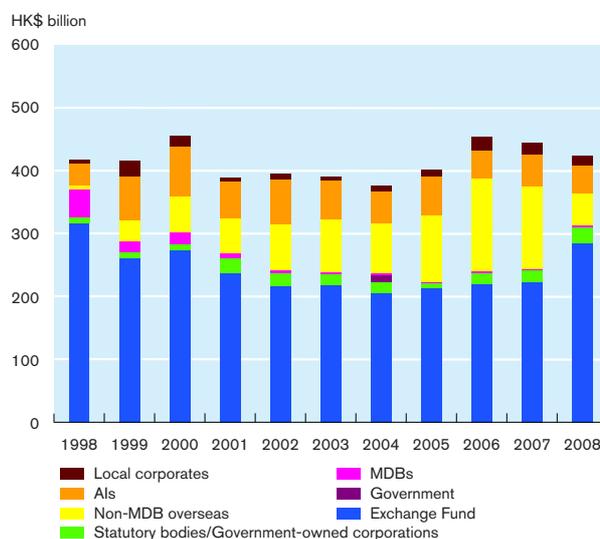
Hong Kong's debt market contracted slightly in 2008 on weakened investor demand for debt securities as the global financial crisis deepened. The decline in debt issuance was concentrated in the private sector, which was affected more severely by investors' re-assessment of credit risk. However, public sector debt issuance grew moderately, with increased issues of Exchange Fund paper to meet banks' strong demand for short-dated paper for liquidity management purposes. In furthering the development of the debt market, the HKMA continued to implement the recommendations identified in the first and second phases of the debt-market review. A four-part approach was also adopted to support the government's initiative to develop an Islamic bond market in Hong Kong.

## Market overview

New issuance of Hong Kong-dollar debt securities declined by 4.6% to HK\$424.4 billion in 2008, as the deepening global financial crisis undermined investor demand for debt securities (Chart 1). The decline in bond issuance was mainly observed among private sector issuers, including non-multilateral development bank (non-MDB)<sup>1</sup> overseas borrowers, local corporates and authorized institutions (AIs)<sup>2</sup>, which were faced with tightening credit conditions as investors became more cautious of credit risk. Among these issuers, non-MDB overseas borrowers posted the largest decline in new issuance, which was down by more than half to HK\$51.6 billion in 2008.

CHART 1

New issues of Hong Kong-dollar debt instruments



<sup>1</sup> Multilateral Development Banks (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.

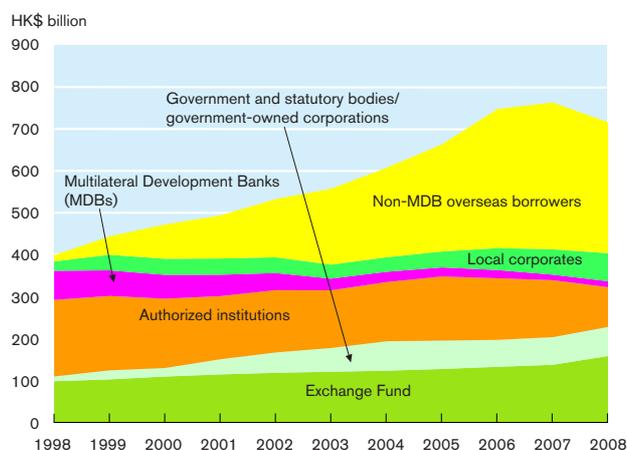
<sup>2</sup> AIs include licensed banks, restricted licence banks, and deposit-taking companies.

On the other hand, new borrowing by the public sector, including the Exchange Fund, statutory bodies and government-owned corporations<sup>3</sup>, registered moderate growth during the year. New issues of Exchange Fund Bills and Notes (EFBNs) increased by 28% to HK\$285.9 billion in 2008, mainly due to several additional issues during the year to meet banks' strong demand for the paper. In particular, an additional HK\$6 billion worth of three-month Exchange Fund Bills were issued in the first quarter of 2008 to meet banks' intra-day liquidity needs arising from the strong stock market activity at that time; and another HK\$12 billion worth of three-month Exchange Fund Bills were issued in the fourth quarter to facilitate banks' liquidity management amid heightened credit and liquidity concerns because of the global financial crisis.

Alongside the decline in new debt issuance, the total outstanding amount of Hong Kong-dollar debt securities fell to HK\$716.6 billion at the end of 2008, representing a 6.2% reduction from a year ago (Chart 2). Non-MDB overseas borrowers remained the largest single group of issuers, with outstanding debt totalling HK\$313 billion, down 11% from the previous year. The outstanding debt of other issuers also declined during the year, except for the Exchange Fund, statutory bodies, government-owned corporations and local corporates. The outstanding amount of EFBNs increased to HK\$157.7 billion at the end of 2008, up 15% from 2007. A detailed breakdown of issuance activities and outstanding debt instruments is in Appendix A.

CHART 2

### Outstanding amount of Hong Kong-dollar debt instruments

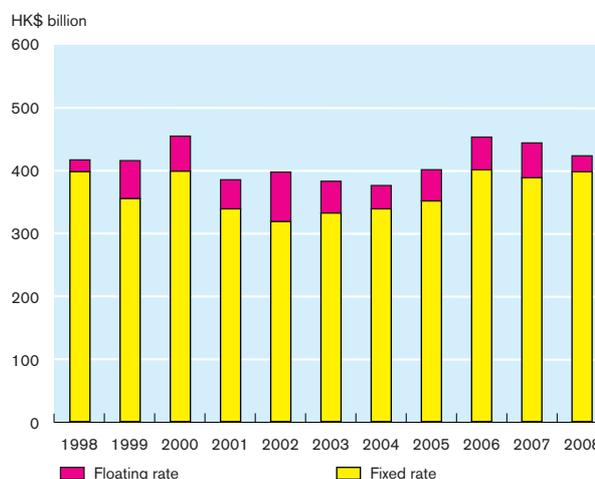


### Fixed-rate versus floating-rate debt

Fixed-rate debt continued to dominate new issuance in 2008, probably due to the low interest-rate environment. Excluding EFBNs, new issues of fixed-rate debt amounted to HK\$112.8 billion, accounting for 82% of the total debt issuance (excluding EFBNs), up from 75% in 2007 (Chart 3). The average maturity of newly issued fixed-rate debt, excluding EFBNs, increased to 4 years in 2008 from 3.6 years in 2007, as non-MDB overseas borrowers and local corporates tended to increase the tenor of their debt issues (Table 1).

CHART 3

### New issues of fixed-rate and floating-rate Hong Kong-dollar debt securities (including EFBNs)



<sup>3</sup> Statutory bodies and government-owned corporations include Bauhinia Mortgage-backed Securities Limited, the Hong Kong Mortgage Corporation, the Hong Kong Airport Authority, and the Hong Kong Housing Authority, Hong Kong Link 2004 Limited, the Kowloon-Canton Railway Corporation, and the MTR Corporation Limited.

TABLE 1

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

Issuer	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Government bonds	–	–	–	–	–	–	5.5	–	–	–	–
Statutory bodies/Government-owned corporations	2.9	2.0	2.0	3.6	2.9	6.7	4.5	6.6	3.3	3.5	3.0
MDBs	2.0	3.4	4.0	4.8	5.6	7.5	8.2	7.0	2.8	4.8	–
Non-MDB overseas borrowers	2.1	1.6	2.2	2.9	3.7	3.1	4.0	4.5	3.0	3.9	5.4
Als	3.5	2.0	2.1	2.4	2.4	3.0	3.0	2.4	1.7	2.2	1.5
Local corporates	0.2	2.4	3.3	2.6	4.3	4.5	5.6	6.9	5.3	5.0	6.2
<b>Total</b>	<b>2.3</b>	<b>2.2</b>	<b>2.5</b>	<b>3.0</b>	<b>3.3</b>	<b>3.6</b>	<b>4.1</b>	<b>4.2</b>	<b>3.1</b>	<b>3.6</b>	<b>4.0</b>

## Exchange Fund Bills and Notes Programme

An electronic trading platform (ETP), one of the recommendations arising from the first phase of the debt-market review, was launched and completed its first full year of operation in 2008. The ETP is primarily for the trading of EFBNs to improve price transparency and streamline trading. The daily turnover of EFBNs using the ETP increased steadily to reach 40% of the market total by the end of 2008. To encourage market makers (MMs) to use the platform, refinements were made to the compilation of the MMs league tables in June 2008, taking into account their trading activities conducted through the ETP.

Separately, the HKMA continued its efforts to fine-tune the maturity mix of the EFBN portfolio, with increased issuance of five-year, 10-year and 15-year Exchange Fund Notes. At the same time, HK\$18 billion worth of additional three-month Exchange Fund Bills were issued to address banks' strong demand for short-dated Exchange Fund paper for liquidity management purposes, which was reflected in the very low yield of Exchange Fund Bills.<sup>4</sup>

## Phase two of the debt-market review

Following completion of the first phase of the debt-market review, which focused on refining the EFBN programme, the HKMA initiated the second phase to promote the overall development of Hong Kong's debt market. The review was completed in 2008 and identified a number of recommendations associated with the regulatory process, the use of investment benchmarks and tax treatments to attract more issuers and broaden the investor base. These recommendations, endorsed by the Council of Financial Regulators in early 2008, are being followed up by the HKMA and other relevant authorities.

<sup>4</sup> The additional issuance is consistent with the Currency Board principles and the three refinements to the Linked Exchange Rate System introduced in May 2005. The Monetary Base remains fully backed by foreign exchange reserves.

## Islamic bond market

The development of an Islamic bond (or sukuk) market in Hong Kong has been identified as a key part of the policy initiatives of the HKSAR Government to promote financial market development. Islamic finance offers huge opportunities and potential on the global financial scene. Its introduction in Hong Kong will add to the depth and breadth of the local market and reinforce Hong Kong's position as an international financial centre. In support of the government initiative, the HKMA has adopted a four-part approach to promoting the development of an Islamic bond market in Hong Kong:

### 1. Facilitating infrastructure development:

The HKMA undertook a study to assess the market potential and identify existing hurdles in developing the market, by reference to the tax and regulatory regimes in other Islamic financial centres and the advice of Islamic financial experts who are members of the Treasury Markets Association (TMA). The findings suggest that Hong Kong's existing legal and regulatory infrastructure can readily support the development of an Islamic bond market. However, suitable changes and clarifications are needed to Hong Kong's tax laws to level the playing field for the issuance and trading of Islamic bonds vis-à-vis conventional bonds. These include the treatment of stamp duty, profits tax and periodic payments arising from the complex structure of Islamic bonds to adhere to shariah principles. Based on these findings and recommendations, the HKMA is further supporting the work of the Government in pursuing technical modifications to the tax regime to deal with the additional tax obligations and liabilities arising from the issuance and trading of Islamic bonds in Hong Kong.

In addition, the HKMA introduced a number of enhancements to the clearing and settlement systems in September and November 2008 to cater for banks' processing of Islamic financial transactions. These included activation of a payment code specifically for Islamic-related payment,

provision of additional settlement accounts in the US dollar and euro Real Time Gross Settlement (RTGS) systems for segregation of Islamic-related funds from other funds, and improvements to the Central Moneymarkets Unit (CMU) for custodian, clearing and settlement services for Islamic bonds in Hong Kong.

### 2. Raising Hong Kong's international profile:

The HKMA has been pursuing strategic partnerships with other Islamic financial centres and strengthening the international profile of Hong Kong in the areas of Islamic finance by initiating co-operation and participation in international forums. For example, a memorandum of understanding was signed between the HKMA and the Dubai International Financial Centre Authority in May 2008 to strengthen co-operation in promoting the development of Islamic financial products in both jurisdictions. The HKMA also organised road shows to the United Arab Emirates and Jordan in May 2008 to present seminars on Hong Kong's financial platform, which were well received by participants. In addition, the HKMA's participation in a number of key industry forums locally and internationally helped project and consolidate Hong Kong's profile as an emerging centre for Islamic finance.

**3. Raising market awareness:** In a bid to promote market awareness and nurture a larger talent pool in the Islamic finance field in Hong Kong, the HKMA co-operated with the TMA to organise a series of Islamic finance education seminars and workshops for local industry players, government officials and regulators. The workshops covered a wide range of topics dealing with Islamic finance, including exchangeable sukuk, Islamic equity funds and indices, tax and accounting treatment of Islamic financial transactions, and Islamic banking developments.

**4. Encouraging product development:** To promote the development of Islamic financial products in Hong Kong, the HKMA has been liaising with the private sector and government agencies to resolve any tax and regulatory issues involved, and to pave the way for new product launches. A range of

shariah-compliant financial services and products has already been introduced in Hong Kong, such as exchangeable sukuk, an Islamic equity index featuring Mainland companies listed in Hong Kong, Islamic equity funds, Islamic loan syndication and Islamic banking windows. These product launches signal the readiness of Hong Kong's financial market platform to accommodate Islamic finance.

## Conclusion

As investor appetite for debt securities waned because of the deepening global financial crisis, the Hong Kong-dollar debt market contracted slightly in 2008. The contraction in debt issuance activity was concentrated in the private sector, while the public sector continued to register some growth. In particular, the issuance of Exchange Fund paper increased markedly during the year to meet banks' strong demand for short-dated paper for the purpose of liquidity management.

Although debt issuance was affected in 2008 by investors' concerns over the credit-worthiness of private sector issuers (especially financial institutions), there have been initial signs of a revival in the issuance volume in the early part of 2009, as governments in major overseas markets introduce various programmes to guarantee their financial institutions' debt issuance. These initiatives have helped relieve investors' concerns over credit risk and have encouraged issuance in Hong Kong.

As part of its continuing efforts to promote Hong Kong's debt-market development, the HKMA has been pursuing the recommendations from the first and second phases of the debt-market review. Significant efforts have also been made to facilitate the development of an Islamic bond market in Hong Kong. Going forward, the HKMA will continue to work closely with the Government and market participants to promote the local debt market to reinforce Hong Kong's position as an international financial centre.

## 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
2007	223,521	19,368	0	1,700	131,875	49,645	18,678	444,787
2008	285,875	24,308	0	3,000	51,648	45,237	14,292	424,360

### Outstanding amount of 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
2007	136,646	58,476	7,700	13,155	351,263	136,352	60,628	764,220
2008	157,653	64,618	5,000	14,253	313,017	95,053	67,015	716,608

\* Includes government-owned corporations

Source: HKMA.