FEATURE ARTICLE

The Hong Kong debt market in 2010

by Monetary Management Department

The Hong Kong dollar debt market was characterised by a shift in investor demand and a change in the mix of issuers, on the back of what was an eventful 2010 for the global debt market, and uncertainties moving into 2011. On a brighter note, the renminbi debt market in Hong Kong expanded considerably following elucidation of supervisory principles and a revised agreement for renminbi business.

Global background

The outlook for the global debt market was largely stable at the beginning of 2010 as market expectations geared towards an exit from the extraordinarily accommodative monetary policies adopted by the US Federal Reserve and other major central banks.

However, concerns over escalating government deficits and debt levels in some European economies turned into a European sovereign debt crisis in the second quarter, triggering a new wave of de-risking activities as evidenced by a flight-to-quality to US Treasuries and German Bunds, amid surging yields in the debt-stricken European economies (Chart 1).

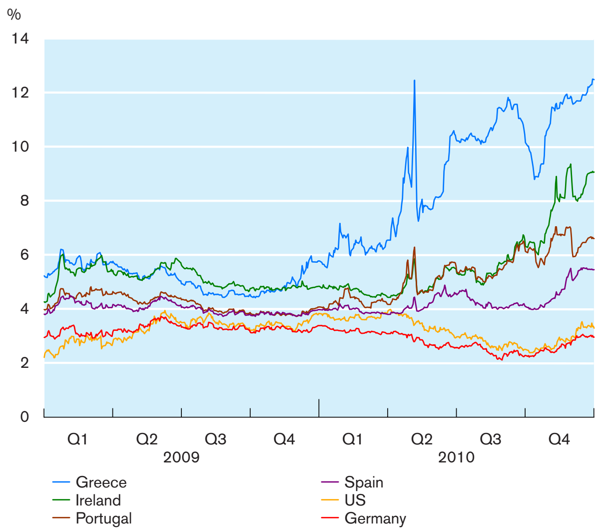
At the same time, businesses and consumers turned more cautious. The market saw increased risk of a double-dip recession and deflation as economic data turned weaker in the second quarter. In late August, the US Federal Reserve Board Chairman indicated that the Federal Open Market Committee (FOMC) was prepared to provide additional monetary accommodation through unconventional measures if necessary, prompting speculation about a new round of asset purchasing. In November, the FOMC announced the purchase of a further US$600 billion of longer-term Treasury securities on top of an existing policy to reinvest its maturing Agency debt and Mortgage Backed Securities into longer-term Treasury securities, bringing the total planned purchases to US$850 - 900 billion by the end of June 2011.

The asset purchases increased inflation expectations, driving up bond yields at the long end in the fourth quarter. As a result of the uncertainties, with rising yields as well as a weaker economic outlook, 2010 was an eventful year for the global debt market.

CHART 1

Yields of 10-year government securities of the US and selected European economies

Average 10-year yield spreads with German Bund (basis points)				
	Greece	Ireland	Portugal	Spain
2009	190	188	93	75
2010	636	298	253	150
Difference	**446**	**110**	**159**	**75**



Source: Bloomberg.

Hong Kong debt market overview

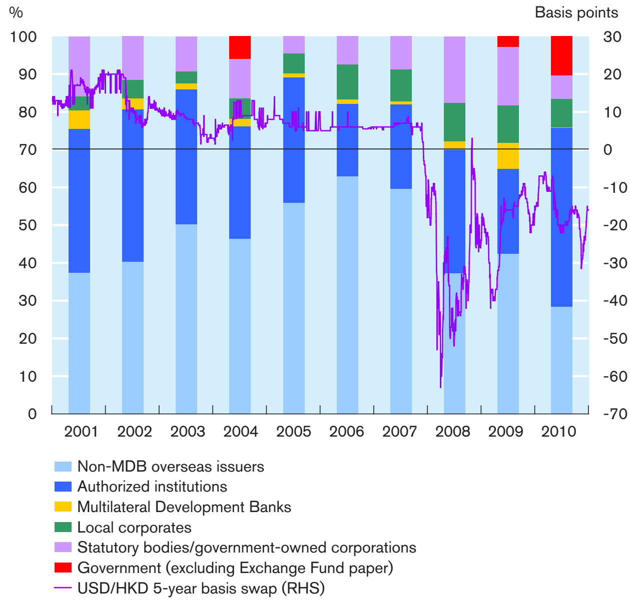
Changing issuer mix in the Hong Kong dollar market

Against this backdrop, issuance activities in the Hong Kong dollar debt market were affected somewhat. In particular, debt fundraising by overseas issuers, excluding the multilateral development banks (MDBs), contracted in 2010, while issuances by authorized institutions (AIs) expanded, leading to a change in the issuer mix (Appendix).

In the past, AIs and non-MDB overseas issuers tended to be dominant in the issuance market. The stronger growth in debt issuance by AIs in 2010 could be due to the low interest rate environment, which favoured issuances of Certificates of Deposit (CDs) by the banks for securing longer-term funding. Debt issuance by non-MDB overseas issuers, which usually seek US dollar funding, was discouraged by the continuing high hedging costs in servicing Hong Kong dollar interest payment obligations. Such hedging costs were measured by the USD/HKD basis swap rate, which had remained mostly negative since the onset of credit crunch in 2008 (Chart 2).[1] This suggested that, for those overseas issuers seeking US dollar funds, the all-in cost of funding through tapping the Hong Kong dollar market had become unattractive compared with tapping the US dollar market directly.

CHART 2

Breakdown of Hong Kong dollar debt issuers (excluding issuances made by the Exchange Fund) and the USD/HKD basis swap rate



Note: The 5-year USD/HKD basis swap is presented here as this is a tenor that closely resembles Hong Kong dollar debt fundraising activities by the non-MDB overseas issuers.

Sources: HKMA and Bloomberg.

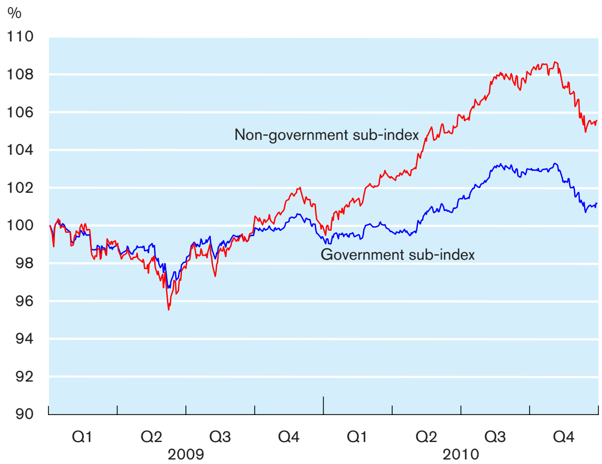
[1] An issuer can secure Hong Kong dollar cash flows for making Hong Kong dollar interest payments by entering into a USD/HKD basis swap. In short, the issuer agrees to pay LIBOR (the interbank borrowing rate of US dollars) for the duration of the swap in exchange for Hong Kong dollar cash flows based on HIBOR (the interbank borrowing rate of Hong Kong dollars). The basis swap rates are usually quoted as US dollar flat (i.e. no premium or discount to LIBOR) versus Hong Kong dollar plus or minus a spread to HIBOR. A negative USD/HKD basis swap implies that the issuer is willing to receive a lower HIBOR interest while paying flat LIBOR. This would add to the overall cost of funding to the overseas issuers.

Continuation of low absolute Hong Kong dollar yields increases attractiveness of longer-term and corporate papers

The average maturity of Hong Kong dollar fixed-rate debt issuances, excluding Exchange Fund Bills and Notes (EFBNs), lengthened to 4.6 years in 2010 from 4.3 years in 2009 (Table 1). This was particularly evident in debt fundraising by local corporates. For example, a local utility company that tapped the Hong Kong dollar market in 2009 with a 40-year bond re-tapped the market with another 40-year issuance in January 2010. A number of conglomerates and real estate companies also took the opportunity to secure long-term funding through issuing bonds of 20 and 30 years (Table 2). Associated with the lengthening of maturities was the outperformance of private sector papers relative to public sector papers, as suggested by the divergence of the government and non-government sub-indices of the HSBC Hong Kong Dollar Bond Index in 2010 (Chart 3).

CHART 3

Performance of the government and non-government sub-indices of the HSBC Hong Kong Dollar Bond Index (2 January 2009 = 100)



Source: Bloomberg.

TABLE 1

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

Issuer	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Government (excluding Exchange Fund papers)	–	–	–	5.5	–	–	–	–	3.1	5.7
Statutory bodies and Government-owned corporations	3.6	2.9	6.7	4.5	6.6	3.3	3.5	3.0	3.8	2.4
Authorized institutions	2.4	2.5	3.0	2.8	2.4	1.7	2.2	1.5	2.3	2.4
Local corporates	2.6	4.3	4.5	5.6	6.9	5.3	5.0	6.2	8.4	9.6
MDBs	4.8	5.6	7.5	8.2	7.0	2.8	4.8	-	4.4	3.0
Non-MDB overseas issuers	2.9	3.6	3.1	4.1	4.5	3.0	3.8	5.4	4.0	5.6
Total	**3.0**	**3.3**	**3.6**	**4.1**	**4.2**	**3.1**	**3.6**	**4.0**	**4.3**	**4.6**

Source: HKMA.

TABLE 2

Issuance of ultra-long-dated Hong Kong dollar bonds in 2010

Issuer	Industry classification	Month of issuance	Tenor (years)	Coupon rate (%)	Issue size (HK$ million)
HKCG (Finance) Limited	Public utility	January 2010	40	5.00	250
Hongkong Land Notes Co Limited	Real estate	March 2010	30	5.25	250
Hongkong Electric Finance Limited	Public utility	May 2010	20	3.95	470
Wharf Finance Limited	Conglomerate	June 2010	30	5.30	250
CLP Power Hong Kong Financing Limited	Public utility	September 2010	20	3.60	260
Hongkong Land Notes Co Limited	Real estate	September 2010	20	4.11	800
Swire Pacific MTN Financing Ltd	Conglomerate	November 2010	20	3.90	500
Total issue size					**2,780 (1,300 in 2009)**
Total number of ultra-long-dated bond issuers					**6 (1 in 2009)**

Note: Ultra-long-dated bonds are those that have a tenor of at least 20 years at issuance.

Sources: HKMA and Bloomberg.

These developments were largely the result of a prolonged low absolute yield environment in the Hong Kong dollar debt market. For instance, the average yield in the Hong Kong dollar public segment, represented by the government sub-index of the HSBC Hong Kong Dollar Bond Index, was around 1.71% in 2010, significantly lower than the 10-year average of 3.19% on the same index. Amid this low yield, institutional investors were more inclined to seek higher yield investments by extending the credit spectrum and moving up the yield curve. As a result, investors overweighted in instruments such as bonds issued by corporate entities and papers with longer maturities as far as permitted under their investment mandates. Overall, the Hong Kong dollar market was characterised by a shift in investor demand and hence issuer mix in 2010.

Renminbi debt market in Hong Kong

Another key development in the Hong Kong debt market over the year was a growing renminbi segment. This market started in 2007 and took off in 2010 following an elucidation of supervisory principles for renminbi business in Hong Kong provided by the HKMA, and an amendment to the Clearing Agreement for Renminbi Business (executed between the People's Bank of China (PBoC) and Bank of China (Hong Kong) Limited) (see Box 1 for milestones in the renminbi debt market development in Hong Kong). The elucidation ensured that the range of eligible issuers, the issue arrangements, and target investors could be determined in accordance with the applicable regulations and market conditions in Hong Kong. In addition, following the amendment to the Clearing Agreement, any companies, including securities firms, asset management and insurance companies, could open renminbi accounts with banks, and there would be no restriction on renminbi interbank transfers between personal and corporate accounts. As a result, the range of issuers and investors participating in the renminbi debt market in Hong Kong expanded significantly.

In 2010, 50 renminbi-denominated debt instruments were issued in Hong Kong, including bonds, CDs and equity-linked notes, involving some RMB42.7 billion. Of these, bond issuances totalled RMB36 billion, up by RMB20 billion over 2009. The issuer base also diversified from predominately the sovereign (Ministry of Finance of the Central People's Government) and Mainland banks to include Hong Kong and multinational corporations and international financial institutions.

Hong Kong is a key testing ground for promoting the external use of renminbi in the international market place. As the pool of renminbi liquidity continues to grow, the capacity for Hong Kong to meet the fundraising needs of issuers will also expand, hence an increasingly important role for Hong Kong in facilitating renminbi debt issuance offshore.

Initiatives to further promote the development of the Hong Kong debt market

The Government has been working on a number of initiatives to nurture diversified investor and issuer bases, and promote the effective functioning of the debt market as a financial intermediating platform.

Continued implementation of the Government Bond Programme

An active public debt market is instrumental to the long-term development of the Hong Kong market. In 2009, the Government introduced the Government Bond Programme (GB Programme) to expand the investor base and attract more overseas issuers. It was also aimed at promoting the sustainable development of the debt market by establishing a benchmark yield curve and providing a steady supply of public debt securities to better develop the public debt market. The HKMA is tasked by the Government to assist the implementation.

During 2010, HK$18.5 billion worth of Government Bonds (GBs) were issued to institutional investors under the GB Programme, bringing the outstanding size of bonds issued under this part of the GB Programme to HK$24 billion (Table 3). According to the published issuance plan, institutional GBs totalling HK$8.5 billion are scheduled for further issuances by August 2011.

TABLE 3

Outstanding Government Bonds issued under the Institutional Programme at the end of 2010

Tenor	Issue code	Coupon rate (%)	Outstanding size (HK$ billion)
2-year	02GB1109	0.92	3.5
2-year	02GB1203	0.70	3.5
2-year	02GB1209	0.48	3.5
5-year	05GB1411	2.07	3.5
5-year	05GB1512	1.43	2.5
10-year	10GB2001	2.93	7.5
Total outstanding size			**24**

Source: HKMA.

The timetable for the issues is designed to ensure the characteristics, such as the tenor and size, are conducive to the long-term development of the Hong Kong debt market. The HKMA constantly engages with the investment community and the Primary Dealers appointed under the institutional GB Programme to seek opinions on how the GB Programme can be implemented most effectively.

The GB Programme also consists of a retail part to promote investment in bonds by local investors. The HKMA is currently preparing for the launch of iBond, an inflation-linked bond under the retail GB Programme, following the announcement by the Financial Secretary in his 2011-12 Budget Speech.

Promoting private issuance through the Qualifying Debt Instrument Scheme

The promotion of the private segment is equally important for the debt market to serve as an effective financial intermediating platform. Hong Kong's Qualifying Debt Instrument (QDI) Scheme provides tax concessions to certain types of debt instruments issued in Hong Kong, including those denominated in Hong Kong dollars and other currencies (the QDIs), to boost the demand for such instruments.[2] The Scheme helps promote the private segment by attracting more issuers to raise funds in the Hong Kong debt market.

To further improve the QDI Scheme, the Government relaxed the maturity requirement for QDIs to include shorter-dated debt instruments with original maturity of less than three years in March 2011. The provisions concerning the "issued to the public" eligibility criterion was also clarified at the same time to provide more transparency to market participants on how this should be met.[3] The measures are expected to encourage issuers to make better use of the Hong Kong debt market platform.

---

[2] QDIs are debt instruments that meet a set of criteria. Income derived from QDIs will enjoy a tax concession at 50% of the normal profits tax rates under section 14A of the Inland Revenue Ordinance.

[3] Following the relaxation, a debt instrument issued on or after 25 March 2011 will qualify as a QDI if:

(i) it is lodged with and cleared by the Central Moneymarkets Unit operated by the HKMA;

(ii) it has an original maturity of less than seven years;

(iii) it has a minimum denomination of HK$50,000 or its equivalent in a foreign currency;

(iv) it is issued in Hong Kong to 10 or more persons, or less than 10 persons none of whom is an associate of the issuer; and

(v) it is issued by a person and has, at all relevant times, a credit rating acceptable to the HKMA from a credit rating agency recognised by the HKMA (which is currently set at minimum BBB- from Standard & Poor's).

Assisting the development of a cross-border market

The HKMA is working with other central banks, central securities depositories in the region and Euroclear in a Task Force to facilitate Asian debt market development and to enhance the attractiveness of Asian debt to foreign investors. The Task Force has developed a blueprint for a Common Platform Model in Asia (See Box 2 for further details). In essence, the model aims to adopt a set of harmonised procedures and shared technology for debt securities processing in the region in a pragmatic and gradual approach. This will be beneficial to fostering the development of the Asian bond market, including that of Hong Kong.

Way forward

The HKMA will continue to support the development of the Hong Kong debt market in 2011, devoting further effort to enhancing the financial infrastructure, encouraging both overseas issuers and investors to participate in the local market, and continuing to promote the institutional and retail markets through the GB Programme.

APPENDIX

Issuance of Hong Kong dollar debt instruments (in HK$ million)

	Exchange Fund	Government	Statutory bodies and government-owned corporations	Authorized institutions	Local corporates	MDBs	Non-MDB overseas borrowers	Total
1998	316,850	0	9,171	33,307	6,180	44,502	7,728	417,738
1999	261,443	0	8,931	70,190	24,098	15,920	34,417	414,999
2000	275,036	0	8,325	80,138	16,107	19,330	57,010	455,946
2001	237,009	0	24,075	57,787	5,600	7,462	56,865	388,798
2002	216,228	0	20,760	72,894	8,854	5,200	72,615	396,551
2003	219,648	0	15,724	60,819	5,470	2,641	85,509	389,810
2004	205,986	10,250	17,799	50,801	9,171	3,530	79,287	376,824
2005	213,761	0	8,560	62,542	9,951	1,800	105,383	401,997
2006	220,415	0	17,419	44,930	21,371	2,950	147,009	454,094
2007	223,521	0	19,368	49,645	18,678	1,700	131,875	444,787
2008	285,875	0	24,308	45,237	14,292	3,000	51,648	424,360
2009	1,047,728	5,500	29,852	43,878	19,539	13,145	82,431	1,242,073
2010	1,816,752	18,500	11,187	85,004	13,383	315	50,830	1,995,972

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

	Exchange Fund	Government	Statutory bodies and government-owned corporations	Authorized institutions	Local corporates	MDBs	Non-MDB overseas borrowers	Total
1998	97,450	0	11,366	179,353	19,950	69,402	15,622	393,143
1999	101,874	0	20,117	176,400	34,748	61,287	44,767	439,192
2000	108,602	0	20,047	166,065	38,405	57,062	81,740	471,921
2001	113,750	0	35,873	151,145	38,880	51,104	102,797	493,548
2002	117,476	0	48,212	147,763	37,567	40,834	139,145	530,998
2003	120,152	0	56,441	137,988	33,466	27,855	181,522	557,425
2004	122,579	10,250	60,186	141,458	34,708	24,735	213,988	607,904
2005	126,709	10,250	57,712	153,385	38,138	21,535	255,999	663,728
2006	131,788	7,700	56,876	147,428	52,398	19,555	332,396	748,141
2007	136,646	7,700	58,476	136,352	60,628	13,155	351,263	764,220
2008	157,653	5,000	64,618	95,053	67,015	14,253	313,017	716,608
2009	534,062	7,000	69,723	84,675	79,462	24,348	312,056	1,111,327
2010	653,138	25,500	63,672	122,307	84,700	15,513	283,988	1,248,819

Notes:

1. Statutory bodies and government-owned corporations include Bauhinia Mortgage-backed Securities Limited, The Hong Kong Mortgage Corporation, Airport Authority Hong Kong, Hong Kong Housing Authority, Hong Kong Link 2004 Limited, Kowloon-Canton Railway Corporation and MTR Corporation Limited.
2. Authorized institutions include licensed banks, restricted licence banks and deposit-taking companies.
3. Multilateral Development Banks (MDBs) refer to the Asian Development Bank, Council of Europe Social Development Fund, European Company for the Financing of Railroad Rolling Stock, European Investment Bank, European Bank for Reconstruction and Development, Inter-American Development Bank, International Bank for Reconstruction and Development, International Finance Corporation, African Development Bank and Nordic Investment Bank. Income earned on Hong Kong dollar debt securities issued by the MDBs is exempt from profits tax.
4. Figures may not add up to total because of rounding.

Source: HKMA.

BOX 1

Major milestones in renminbi debt market development in Hong Kong

June 2007

The PBoC and the National Development and Reform Commission announce that, subject to approval, financial institutions incorporated in Mainland China are allowed to issue renminbi bonds in Hong Kong. The first issuance of such bonds is offered to the public by China Development Bank in July.

July 2009

HSBC Bank (China), the Mainland subsidiary of a local bank, issues the first renminbi-denominated floating rate note outside Mainland China, with the underlying reference index based on the Shanghai Interbank Borrowing Rate.

September 2009

The Ministry of Finance conducts the first renminbi-denominated sovereign offering outside the Mainland. The issuance sets the stage for the development of benchmark interest rates on the renminbi in Hong Kong, making the pricing of other renminbi-denominated financial products more efficient.

February 2010

The HKMA provides an elucidation of supervisory principles to streamline operational arrangements for renminbi business in Hong Kong. One of the outcomes for bond issues in Hong Kong is that there is no longer a restriction on the range of eligible bond issuers, issuance arrangements or investors.

July 2010

The revision of the Settlement Agreement between the PBoC and the Bank of China (Hong Kong) Limited paves the way for an offshore renminbi debt market by permitting all companies to open renminbi bank accounts and removing the restrictions on renminbi interbank transfers between personal and corporate accounts. These changes allow for a much wider array of issuers to raise renminbi funding in Hong Kong through debt issuances.

Hopewell Highway Infrastructure Limited and CITIC Bank International Limited issue the first offshore renminbi-denominated corporate bond and Certificate of Deposit respectively in Hong Kong.

October 2010

Asian Development Bank, an international financial institution, issues a 10-year offshore renminbi bond in Hong Kong.

November 2010

The Ministry of Finance successfully issues renminbi sovereign bonds to institutional investors using the tendering platform of Hong Kong's Central Moneymarkets Unit.

BOX 2

The Pan Asian Central Securities Depositories Alliance Initiative

Inefficiencies in post-trade infrastructure coupled with market fragmentation and lack of automation and harmonisation of the post-trade processes for Asian debt securities are the major barriers to the attractiveness of the Asian bond market to international and regional investors. Against this background, a Task Force, comprising the HKMA, a group of central banks and central securities depositories (CSDs) in the Asian region, and Euroclear, was formed to facilitate the Asian bond market development and enhance the attractiveness of Asian debt securities to foreign investors through the development of a cost-effective and efficient post-trade infrastructure.

Following a series of meetings and discussions, the Task Force has reached a consensus that a Common Platform Model (CPM), which serves as a basis for co-operation among CSDs from different economies and Euroclear, is necessary, and that a gradual implementation approach is appropriate for Asia given the differences in financial, regulatory and currency regimes among Asian markets. The Task Force issued a White Paper entitled "Common Platform Model for Asian Post-trade Processing Infrastructure" on 4 June 2010.[4] It sets out the long-term blueprint for the post-trade cross-border clearing and settlement infrastructure for debt securities in Asia.

While the CPM will help address the identified needs, the introduction of harmonised processes and common systems to the ultimate Common Platform will require time and effort. It is therefore more appropriate to adopt a tactical solution by introducing a Pilot Platform to deliver early benefits of the CPM before its full implementation. The Pilot Platform will leverage the existing services and systems used by Asian CSDs and the international CSD (ICSD) to facilitate cross-border investment activities in Asia and attract more international investments into the Asian markets. The Task Force plans to launch the Pilot Platform in the first half of 2011. The HKMA, together with Bank Negara Malaysia and Euroclear, will join the Pilot Platform as early movers. By then, investors in Hong Kong and Malaysia can hold foreign securities through their local CSDs and settle cross-border transactions denominated in both local and major foreign currencies (for example, US dollars, euro and renminbi) on a delivery-versus-payment basis within the Asian time zone. Other central banks and CSDs in the region can also join the Pilot Platform and decide what securities to be put onto the Pilot Platform according to their own market development and needs. The Task Force will also continue to co-ordinate further development of the Platform and turn it into a more integrated and harmonised solution in the longer term.

[4] For further details, please refer to the White Paper and the feature article "Common Platform Model for Asia: a collaborative effort to improve the post-trade processing infrastructure for debt securities in Asia" in the September 2010 issue of the *HKMA Quarterly Bulletin*. Both are available on the HKMA website.