

**LEGISLATIVE COUNCIL
PANEL ON FINANCIAL AFFAIRS**

Development of the Retail Debt Market in Hong Kong

I. Purpose

This paper sets out the current state of and prospects for the development of the debt market in Hong Kong.

II. Government policy

2. It is the government's policy to develop the debt markets of Hong Kong and the region. The Asian financial crisis has highlighted the risks for many parts of the region that uncertain economic outlook and over-reliance on volatile short-term capital flows may result in a credit crunch. Development of the debt markets both domestically and in the region would provide more stable and flexible financing for local businesses. It would give a greater depth to our financing structure as an international financial centre.

3. In the process of developing the debt markets, we also seek to promote the participation of retail investors, which would not only enhance the investor base of the debt market but would also provide an additional investment channel for retail investors.

III. Current state of development

4. Institutional investors—such as banks, pension funds, life insurance companies and public funds, have traditionally dominated the Hong Kong debt market. Retail investors play a minor role only. Though precise data are not available, the share of retail investors is probably less than 1%.

5. However, part of institutional investment in bonds is conducted indirectly on behalf of retail investors, such as through unit trusts, bond funds and pension funds. A survey commissioned by the Hong Kong Investment Funds Association in 2000 suggested that 7.8% of the adult population in Hong

Kong held investments in unit trusts and mutual funds. Within these adult population respondents, only 26% hold bond funds (compared with 80% investing in equity funds).¹ Pension funds other than Mandatory Provident Funds (MPFs) also allocate a small portion of their assets, usually in the range of 1-2%, to Hong Kong dollar bonds, while MPFs are likely to invest a higher portion.²

6. On the demand side, the low retail participation may be explained by a number of factors. These include the usual custom of Hong Kong investors to invest in equities, which provide a potentially higher return despite greater volatility; the limited popularity of collective and contractual savings schemes; lack of familiarity with fixed income products and their risk/return profile relative to equity investments; limited transparency of the debt market; and lack of liquidity in the secondary market, with wide spreads and high transaction costs.

7. On the supply side there has been a shortage of bonds attractive to retail investors, in the sense of suitable denominations, issued by familiar enough names, and accessibility.

8. As at end-September 2001, there were 208 issues of bonds by the Exchange Fund (EF), the Hong Kong Mortgage Corporation (HKMC) and other entities (in HK\$ as well as foreign currencies), amounting to HK\$626 billion. These bonds are listed on the Hong Kong Stock Exchange (HKEx), which provides a channel for retail investors to trade (Table 1). However, the turnover of listed bonds has been modest, amounting to about HK\$27 million during the first nine months of 2001. Within the total, there has been ample supply of bonds with low minimum denomination (at HK\$50,000), across a wide maturity profile. About 69% of the bonds issued by Airport Authority, the HKMC and MTRC, amounting to about HK\$27 billion, have a minimum denomination of HK\$50,000 (Table 2).

¹ The survey covered 1,000 respondents for fund penetration, and 500 respondents for fund investor profiles. 71 percent of the respondents indicated that their total investments in funds were below HK\$0.2 million.

² An HKMA survey based on three MPF service providers with a total market share of about 25 percent indicated that about 9 percent of the MPF assets were allocated to Hong Kong dollar bonds at February 2001.

Table 1: Listed Bonds on the HKEx

	As of 30 September 2001		2001 Q1 - Q3
	No. of Issues	Outstanding Amount ¹	Turnover
		(HK\$ million)	
EFN	61	39,700	1.75
HKMC	7	3,700	23.11
Other bonds	140	583,154	1.85
TOTAL	208	626,554	26.71

¹ Nominal Value.

Source: HKMA and HKEx

**Table 2: Low denomination bonds issued by AA, HKMC, and MTRC
As of September 2001**

	Total outstanding		Of which: with minimum denomination of HKD50,000	
	HK\$ million		HK\$ million	In percent
Airport Authority	6,500		3,500	54
HKMC	23,839		22,739	95
MTRC	8,545		500	6
TOTAL	38,884		26,739	69

By Original Maturity

	Total outstanding			Of which: with minimum denomination of HKD50,000		
	Years			Years		
	0 <= 3	3 <=5	5 <=30	0 <= 3	3 <=5	5 <=30
	(HK\$ million)			(HK\$ million)		
Airport Authority	3,750	2,750	0	2,500	1,000	0
HKMC	13,480	8,521	1,839	12,480	8,421	1,839
MTRC	2,550	5,330	665	0	500	0
TOTAL	19,780	16,601	2,504	14,980	9,921	1,839

Source: HKMA

Measures taken to promote the retail bond market

9. Over the past years, Hong Kong Monetary Authority (HKMA), Securities and Futures Commission (SFC), HKEx and other market participants have taken a number of steps to promote the development of the retail bond market. Examples are as follows -

- (a) to address the shortage of bonds attractive to retail investors, HKMA has issued Exchange Fund Notes (EFNs) that carry a minimum denomination of HK\$50,000. Such highly liquid paper can be purchased by retail investors either in the secondary market, or in the primary market through Recognised Dealers appointed by HKMA. These EFNs and HKMC Notes are also listed on the HKEx to attract investment at the retail level;
- (b) on tax concessions, EFNs are exempt from stamp duty and profits tax. In addition, the minimum denomination requirement for other debt securities eligible as qualified debt securities for tax concession purposes has been lowered from HK\$500,000 to HK\$50,000 (which may encourage the issuer to provide smaller denominations even though an individual investor pays no tax anyway);
- (c) to stimulate liquidity and increase transparency in the market for EF paper, HKMA has introduced benchmark criteria for regular review of the performance of market makers and the publication of an advance quarterly issuance schedule of EF paper. Nevertheless, because of the particular role of EF paper for intra-day repos in the payments system and for accessing the discount window, it is likely to remain a class of paper which is especially attractive to banks at yields below other debt instruments, and therefore may not be able to attract significant retail interest;
- (d) in terms of market infrastructure, since the introduction of the Third Generation Automatic Order Matching and Execution System (AMS/3) in October 2000 by HKEx, investors can trade bonds on line. Furthermore, individual financial institutions have put in place electronic trading platforms for their clients to facilitate trading of bonds; and
- (e) we have achieved computerization of the clearing of bonds. At the retail level, some banks and brokerage houses have been providing on-line trading to their clients. Through market development

initiatives, transaction channels would be further enhanced through on-line banking and brokerage services, thereby promoting the retail trading of bonds. These measures serve to improve the transparency, liquidity and depth of the debt market in general, thereby directly or indirectly making bond investment more attractive and accessible to retail investors.

Some positive recent developments

10. Recent market conditions may also have been conducive to development of the retail debt market. It should be noted that market conditions and the direction of interest rate movement affect retail interest in bonds. After successive interest rate reductions by the Federal Reserve in 2001, bank deposit rates have reached record low levels, while equity markets have been depressed and volatile. Some resultant increase of retail interest in bonds has been apparent. Of course, subject to changes in market sentiment, this situation may not be sustainable.

11. A recent development is the successful debut issue of dedicated retail bonds by HKMC in October 2001, under a new mechanism.³ In four previous issues HKMC had included a target retail allocation (Table 3), but this was the first issue aimed entirely at the retail investor. Total issuance 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 HKMC. Over 1,660 investors submitted applications through the Placing Banks appointed by the HKMC⁴. This compares favourably with the 890 applications and total application amount of HK\$300 million in HKMC's preceding public offer of bonds with a retail allocation in August 2001. The prices of the two latest bonds were determined by reference to specified EFNs on 5 November 2001, which resulted in effective annualised yields of 3.44% and 4.32% for the 3-year and 5 year notes, respectively. These returns compared favourably with prevailing bank deposit rates.

³ The issuance mechanism enabled retail investors to subscribe for the bonds through banks appointed by the HKMC as its placing agents. The new mechanism also allowed the HKMC to offer bonds in different maturities under separate tranches of the same issue, with no cap specified in advance on the issuance amount. A formal market-making system was also introduced to provide liquidity in the secondary market.

⁴ The three Placing Banks are Dao Heng Bank, HSBC and Hang Seng Bank.

Table 3: HKMC's Retail Bond Issuance

Date of Issues	Total Issue Amount	Original Maturity	Coupon Rate	Original Retail Allocation	Actual Retail Allocation	Retail Subscription Amount	Effective Yield at Issuance	Saving Deposit Rate / 12-month Time Deposit Rate
(HK\$ million)								
28-Oct-99	500	2 yr	6.65%	100	100	108	6.96%	3.75% - 5.55%
13-Apr-00	500	2 yr	6.40%	100	100	136	6.86%	4.25% - 5.53%
14-Dec-00	500	2 yr	6.05%	100	100	116	6.14%	4.75% - 5.05%
29-Aug-01	500	3 yr	4.28%	100	250	300	4.42%	1.88% - 2.34%
07-Nov-01	649	3 yr / 5 yr	3.50% / 4.30%	100	649	651	3.44% / 4.32%	0.34% - 0.82%

Source: HKMA and HKMC

IV. Future development

12. Increased participation by retail investors is desirable to broaden the investor base for the bond market in the long run. Modest progress has been achieved so far by the various initiatives described above, but there should be scope for further expansion of this market. Measures which are being considered include greater efforts to promote public awareness and interest in bond investments, development of more market-making activity for listed securities; encouraging financial institutions to be more pro-active in offering bond investment services to their customers; and streamlining the documentation and listing procedures for debt issuance. Indirect retail participation in the debt market is also expected to grow as fund investment becomes more common and MPF funds expand.

13. With regard to public education on bond investment, HKMA will continue to be alert to opportunities to work with the Hong Kong Capital Markets Association (HKCMA), HKMC, the Hong Kong Investment Funds Association and the media.

14. HKCMA is planning, in co-operation with the Hong Kong Polytechnic University, to publish a book about bond investment for general readership. SFC has also included information on bond investment in its Electronic Investor Resources Centre and investment booklets and published articles in the press to explain the risks and concepts of bond investment. In addition, HKEx is planning to conduct a series of public seminars on bond investment in the second quarter of 2002.

15. As regards the rules and regulations concerning public offering of debt securities, the Government and SFC will conduct a comprehensive review on the Companies Ordinance and related regulations that stipulate requirements on prospectus and investment offerings with a view to streamlining the procedures

and matching market developments.

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