Frozen Wall for Hong Kong Debt Capital Market: Several Questions About Further Development

by

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Frozen Wall for Hong Kong Debt Capital Market: Several Questions About Further Development[§]

Alexander Shupletsov[*] and Terence Tai-Leung Chong[**]

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Compared to its counterparts in the United States, the European Union, and the United Kingdom, Hong Kong's secondary debt market is often characterized as underdeveloped and illiquid. This situation contradicts the vision of Hong Kong as a thriving global financial hub with aspirations for further expansion and development.

The significance of addressing this issue has grown in the wake of recent geopolitical changes worldwide. In the coming years, Chinese capital markets are poised to play a substantially larger role in offering capital market services to corporations and sovereigns in Latin America (LATAM), the Middle East, Asia, and North Africa (MENA). This trend is closely intertwined with Hong Kong's role as the Chinese financial and promotional hub for the Belt and Road initiative.

While these ongoing shifts may lead to a natural gravitation toward Asian capital markets, it is imperative to consider that Hong Kong's current debt capital market regulatory framework is not adequately prepared to accommodate this transformation in supply. The failure to address this issue could jeopardize Hong Kong's leading position in the evolving market landscape.

While most market participants maintain that there is no pressing need for changes in the debt capital markets regulatory framework and practices, it is crucial to challenge this perspective and explore counterarguments. In this article, we aim to scrutinize the problem

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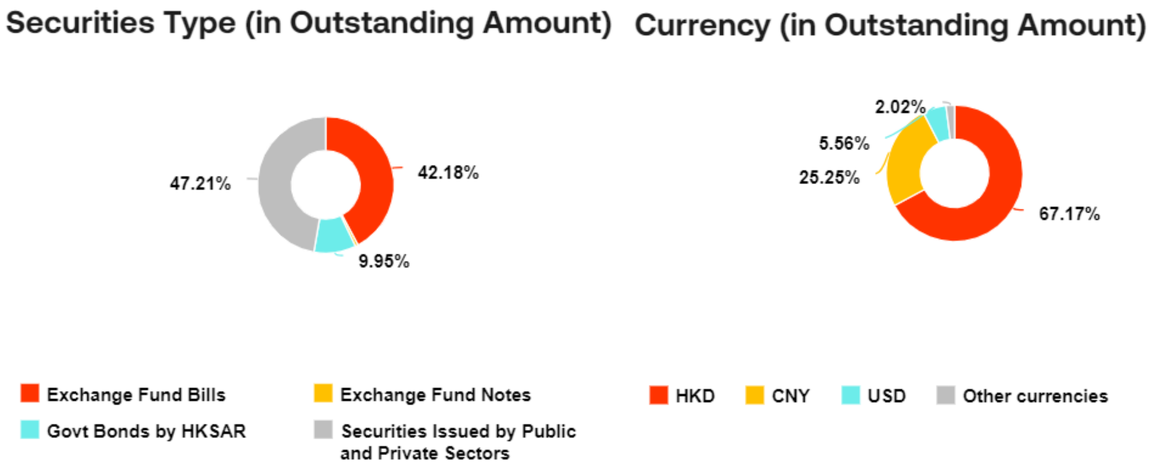
from both the demand and the supply sides. However, before delving into this analysis, let us provide a brief overview of the current market conditions.

Hong Kong Secondary DCM Wrap

In this article, we broaden the definition of the Hong Kong Secondary Market to encompass all debt securities, including those lodged with the Central Moneymarkets Unit (CMU) and those listed on the Hong Kong Stock Exchange.

Currently, there are a total of 2,036 issues lodged with CMU: It is noteworthy that over 47% of these issues originate from both the public and private sectors. Furthermore, more than 67% of these issues, totaling 882, are denominated in Hong Kong dollars (HKD).

Chart 1: Hong Kong Debt Capital Market outstanding



Source: CMU

The volume of debt securities held by the Hong Kong Central Moneymarkets Unit[1] has steadily increased over the past three years, albeit with a slight decline observed since June 2023.

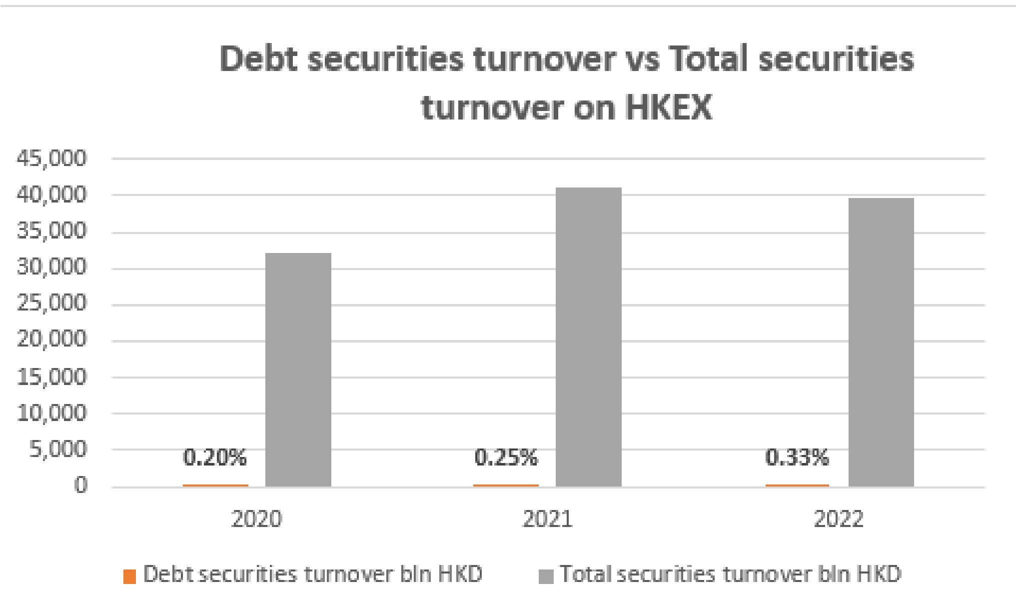
[1] The Central Moneymarkets Unit (CMU) is a central securities depository (CSD) for debt securities owned and operated by the Hong Kong Monetary Authority (HKMA).

Chart 2: Outstanding Issues of Securities Lodged with CMU 2020-2023

Source: CMU

However, the secondary debt capital market turnover on the Hong Kong Stock Exchange remains at a modest 0.33% of the total turnover, notably lower than its global counterparts.

Chart 3: HKEX Trading: Debt Securities Turnover vs Total Securities Turnover



Source: Hong Kong Stock Exchange[2]

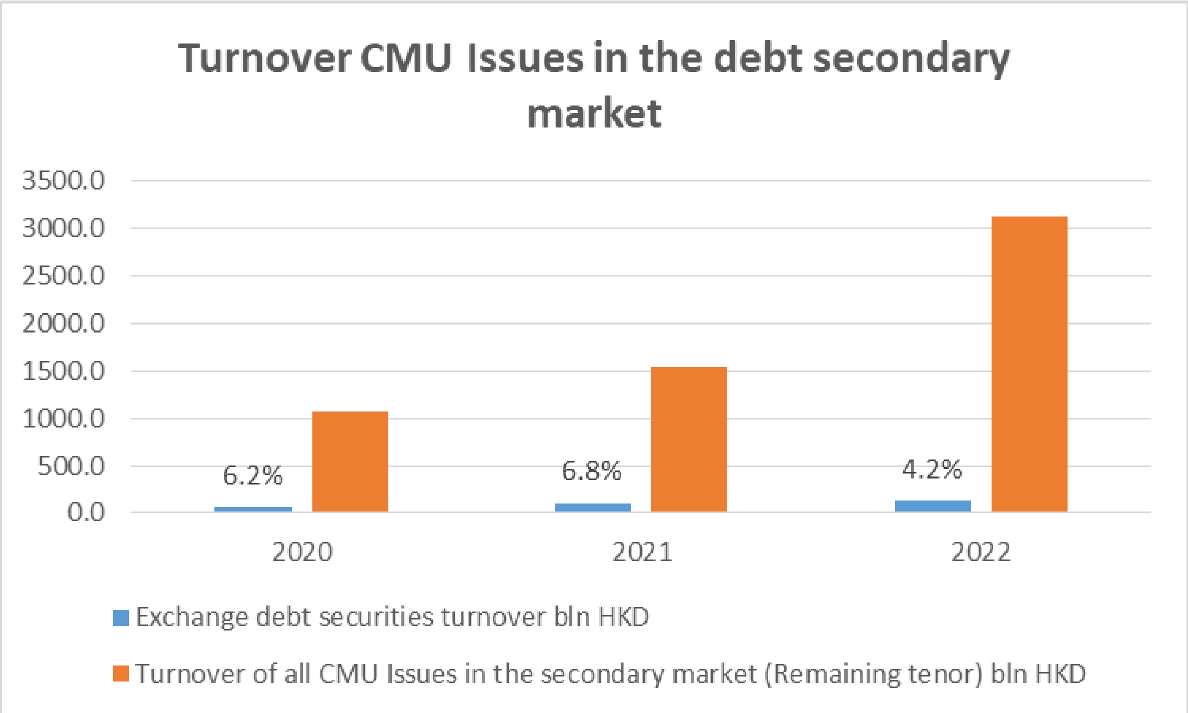
[2] https://www.hkex.com.hk/-/media/HKEX-Market/Market-Data/Statistics/Consolidated-Reports/Annual-Market-Statistics/e_2022-Market-Statistics.pdf

This lack of liquidity in the exchange-based secondary debt capital market can be attributed to several key factors.

Firstly, debt securities issued in Hong Kong typically find themselves locked away in the "hold to maturity" (HTM) portfolios rather than actively participating in secondary trading. Second, non-professional retail investors are restricted from investing in 96.5% of the listed debt instruments, effectively isolating them from both primary and secondary markets.

As of the date of this report, there are more than 1,600 debt securities listed on the Hong Kong Stock Exchange, but a mere 57 debt securities (3.5%) are available for public investment. The options are limited to Exchange Fund Notes (EFNs), two MTR bonds, three bonds issued by the Hong Kong Government, and CNH-denominated Ministry of Finance of the People's Republic of China bonds. Additionally, there is a notable absence of dedicated exchange-based market-makers for the debt capital market (DCM).

Chart 4: Debt Secondary Market Turnover 2020-2022



Source: CMU[3]

[3] https://www.hkma.gov.hk/media/eng/doc/market-data-and-statistics/monthly-statistical-bulletin/T050601.xls

In light of these challenges, it becomes apparent that the majority of bond trading occurs on the over-the-counter (OTC) market, which imposes its own set of limitations and entry barriers. According to calculations based on Bloomberg data, Hong Kong boasts the highest share of OTC bond trading globally, at 55%, with Singapore ranking second at 51%. In regions with well-established financial infrastructure, the share of OTC bond trading is significantly lower.

Table 1:Volume of Bonds in Circulation Compared Across Different Countries and Regions of the World, $ Billion USD

Region	All bonds capitalization, bln USD	Listed bons capitalization, bln USD	OTC bonds capitalization, bln USD	% of not listed bonds
HK	460,8	207,7	253,1	55%
Singapore	632,6	307,8	324,8	51%
USA	41751	40461	1290	3%
Russia	806,1	771,7	34,4	4%
UK	5359,3	5114,9	244,4	5%
EU	25897,4	24981	916,4	4%
Germany	6274,6	6128,4	146,2	2%

Source: Bloomberg

These limitations in the Hong Kong Exchange-traded DCM also extend to the absence of derivatives, such as exchange-traded futures and options for debt securities, which hinders investors' ability to efficiently manage their portfolios.

Market participants' opinions on this underdevelopment diverge into several categories: Some argue it is due to a lack of new debt securities supply, while others contend it is an issue of cost efficiency. This dilemma resembles the classic "chicken and egg problem" often observed in marketplace dynamics.

In the following analysis, we will delve deeper into both the supply and the demand sides of the Hong Kong debt capital market to identify potential areas for growth and development.

Supply Side

The Changing Landscape: Shifting Issuer Focus in Global Capital Markets

The world underwent irrevocable changes last year, prompting issuers from regions such as Latin America (LATAM), the Middle East and North Africa (MENA), and Central Asia to seek well-established and politically-neutral capital market infrastructure. They are actively seeking to broaden their investor base and diversify their sources of financing, especially in Chinese yuan. Notably, the funding cost in Chinese renminbi (CNH) has become significantly more attractive when compared to USD or EUR funding, particularly for China's primary trading partners.

The question arises: Why do issuers still predominantly concentrate on the US and EU capital markets? On the one hand, issuers enter the capital markets to raise fresh capital or refinance existing debt. On the other hand, if an issuer contemplates CNH-denominated debt securities, they must construct a robust debt profile and yield curve to effectively manage funding costs and pricing for CNH-denominated debts.

When juxtaposed with the US and EU markets, assessing the liquidity of the Hong Kong debt capital market proves challenging due to the lack of substantial turnover on the secondary market. Furthermore, the absence of a debt derivative market remains a key factor contributing to the lack of investor demand for debt securities with tenors exceeding 3 years. This is a primary reason why issuers continue to favor the US and EU markets, even with the lower CNH funding costs.

In order to stimulate primary market activity, it is imperative to first bolster the secondary market. We hope that Hong Kong policymakers will earnestly focus on developing an active secondary debt capital market. Doing so will not only accelerate the popularization of CNH but also position Hong Kong to seize upon emerging debt capital market (DCM) trends and prevent the migration of bond listings to rival markets.

Demand Side

Let us take a deeper dive into the demand-side issues, examining them from various perspectives:

Equal Investment Opportunities: We need to consider the challenges related to providing equal investment opportunities for all types of investors in Hong Kong's capital market.

Fairness: Bonds vs. Stocks: It is crucial to address the questions of fairness in allowing public investments in stocks while limiting investments in bonds.

Bank Deposits vs. Bonds: Bridging the Investment Gap: As investors seek to protect their assets in times of inflation, the disparity between bank deposits and bonds as investment options becomes increasingly significant.

OTC vs. Exchange Trading: The difference between over-the-counter (OTC) and exchange trading for Hong Kong investors.

Financial Literacy: Enhancing financial literacy is paramount, especially in a period of inflation shock. Investors require a solid understanding of the intricacies of financial markets to make informed and prudent investment decisions.

We are currently navigating an era of inflation shock, where investors are actively seeking opportunities to preserve their purchasing power. In such times, the need for financial literacy, transparency, and equal opportunities for all categories of investors cannot be overstated. These elements are critical in helping investors navigate the complex landscape of investment options and make more informed and effective choices.

Equal Opportunities Dilemma

We propose to consider this issue by answering the following question: Does HK debt market provide equal opportunities for investing in bonds issued by banks?

Suppose a Hong Kong individual investor wishes to purchase Bank of China, HSBC, Standard Chartered, or Wing Lung Bank bonds, or any other of more than 1,090 banking sector bonds in circulation, as he considers this investment to be an alternative to a deposit.

With this end in view, an investor will have to prove that he has HKD 8 million (USD 1,03 million) in assets in order to be recognized as a 'professional investor' under the statutory restrictions.[4] For calculation, the portfolio or assets, securities, deposits with banks, cash in their own accounts and in combined accounts, and shares in the business are taken into account.[5]

Going back to the Hong Kong individual investor, we would also say that in addition to the assets for the above amount, he must also have available funds of at least HKD 1,000,000 (USD 128,000),[6] as this is the average amount for buying abovementioned bonds.

It is fair to say here that these requirements did not emerge out of thin air: For many years, regulators and financial authorities, having weathered several global financial crises, have been modernizing their approaches to allowing, categorizing, and controlling investors in financial markets. However, one result of these measures has been the emergence of non-market structures such as the Hong Kong debt market, where an individual investor has little or no ability to invest in bonds.

After all, it is obvious that the financial requirements above are far removed from both qualification and financial education issues—it is only a question of equal investment market rights for individuals. In fact, the Hong Kong youth, who are just forming their savings and

[4] Securities and Futures Ordinance https://www.elegislation.gov.hk/hk/cap571!en.pdf?FROMCAPINDEX=Y at the site Hong Kong e-Legislation - Chapter Number Index https://www.elegislation.gov.hk/index/chapternumber?QS_CAP_NO=571&p0=1&TYPE=1&TYPE=2&TYPE=3&LANGUAGE=E#tag571)

[5] Qualification of professional investors https://www.ifec.org.hk/web/en/investment/investment-products/market-intermediaries/financial-market/professional-investors/qualification-of-prof-investors.page

[6] Calculations are made by author based on CMU data.

investment style, are cut off from the local bond market by these high barriers. As a result, the public is not developing a culture of investing in fixed-income instruments.

Undoubtedly, there should be limitations for an individual investor (e.g., restrictions on access to structured notes and subordinated bonds), but in this case they are completely unjustified and are another demonstration of the lack of equal investment opportunities.

Bonds vs Stocks: One Question of Fairness

At the same time, there are no such restrictions for non-professional individuals to invest in stocks. That is, a Hong Kong individual investor is allowed to invest in stocks but not in bonds. It is not about protecting public from risks: The shareholder in the event of the issuer's bankruptcy is the last in the queue of claims. So why does the regulator cut the rights of a broad of individual investors?

Investment Gap: Bank Deposit vs Bank Bond

In this section, we delve into the practical considerations for individual investors in Hong Kong who are contemplating the most efficient way to manage their available Hong Kong dollars (HKD). The central question revolves around whether to opt for a time deposit or invest in a bond/certificate of deposit (CD) issued by a bank. Under the law, bank deposits are insured up to HKD 500,000 (USD 64,000), including the body of the deposit and interest.[7] At the same time, as we have written above, the standard lot amount of OTC bonds issued in Hong Kong is about USD 120,000. So even if an investor has the necessary amount to be qualified as a ‘professional investor’ as well as enough available cash to buy the bonds, he will get a so-called investment gap: It is impossible to risk-free invest more than the amount insured. At the same time, the amount insured is not enough to buy the most part of the debt instruments.

The question arises: What is filling this gap in the market? The answer is self-evident: uninsured deposit balances and spot bond issues with a small lot. According to CMU data, there are only 74 bonds of the banking sector in the market with minimum tradable amount

[7] HK Deposit Protection Ordinance https://www.dps.org.hk/index_EN.html

equal or below the limit of the insured deposit threshold. Most of them are certificates of deposit issued by Hang Seng Bank.

But that is not all: We are also witnessing a gap in investment yields. While 3-12 months HKD deposit rates range from around 3.6%-4.5%, yields on most bond investments in Hong Kong banks within the same duration do not fall below 5%. Meanwhile, Hong Kong bond market offers much more diverse investment opportunities in bank debt in terms of duration, issuer, and currency.

OTC vs Exchange-Traded

Usually, when individual investors are deciding to make a time deposit in countries with developed debt capital markets, they compare the bond yields and the time deposit yields of the same bank with a comparable duration.

In Hong Kong, individual investors are cut off from this opportunity, as there is no debt capital market information publicly available (because it is mostly OTC).

Moreover, in the OTC market, an individual investor has no way of assessing the market itself as well. While exchange data allows for a very clear indication of the G-curve yield and spreads to the curve at any point in time (i.e., investors' expectations about future rates), OTC by definition cannot give such information to Hong Kong retail investors. This is a capability they are essentially deprived of. Because even if a Hong Kong individual investor is classified as a professional investor, he/she will not be able to estimate the yield of his/her chosen bond relative to the peer issues by duration, credit rating, and industry without access to professional information systems.

Obviously, OTC markets are less transparent than exchange-traded markets. The liquidity and bid-ask spreads are among the other concerns as they extremely inflate the cost for investors to enter and exit the market. Moreover, it is common practice for listed bonds to provide market making with a predetermined volume and bid-ask spread.

Financial Literacy: The Culture of Debt Securities Investment

Opening up the broad debt capital market to individual investors, implementing mandatory listing for all debt instruments, reducing the minimal face value of newly issued bonds, and introducing compulsory 'investor days' for each issuer are all significant steps that promise to improve financial literacy and invigorate market activity.

This comprehensive approach offers a ‘win-win’ scenario, benefiting retail investors, issuers, the Exchange, stockbrokers, and Hong Kong Special Administrative Region (HKSAR) as an international financial center. These measures are set to transform the financial landscape, fostering a more inclusive and dynamic market environment that serves the interests of all stakeholders.

Gradually Open the Debt Secondary Market

To increase the number of participants and liquidity in the debt market and consequently further develop Hong Kong's role as an Asian debt financial hub, we propose

1) modifying the monetary threshold for individual professional individual investors to attract more individual investors to Hong Kong debt secondary market;
2) introducing a rating criterion for eligible debt instruments available for public investors, e.g.,
   - for the general public, establish admission to investing on an international rating of BBB- or higher;
   - for professional investors, anything for the public plus below-rated issues;
3) establishing the maximum face value for the public available bonds at HKD 10,000 (USD 1,280);
4) providing unlimited access for foreign individual investors;
5) increasing market transparency by moving the market from an OTC to an on-exchange format. Without strengthening the role of the stock exchange, it will not be possible to improve pricing transparency and market liquidity; and
6) introducing mandatory market making for all securities available for public investors.

Conclusion

As an international financial center, Hong Kong has strengths in its banking sector, foreign exchange market, and the stock market. However, the debt market is considered a weak link of Hong Kong, as Hong Kong government enjoyed budget surplus in previous decades and did not issue enough government bond products for the market to develop. In addition, as the banking sector is mature, the issuance of the corporate bonds is replaced by lower-cost alternatives such as syndicated loans. To develop it bond market, the Hong Kong public debt capital market needs to rethink its role and perhaps fine-tune and spot-tune its current structure and regulation. This reform could establish the basis for further popularization of Chinese debt capital markets and Chinese yuan as an international reserve currency.