LC Paper No. CB(1)735/03-04(01)

財 經 事 務 及 庫 務 局
(庫 務 科)

香 港 下 亞 厘 畢 道
中 區 政 府 合 署

FINANCIAL SERVICES AND THE TREASURY BUREAU
(The Treasury Branch)
Central Government Offices,
Lower Albert Road,
Hong Kong

傳真號碼 Fax No. : 2801 7126
電話號碼 Tel. No. : 2810 3743
本函檔號 Our Ref. : FIN CR 1/4651/01
來函檔號 Your Ref. :

BY FAX

8 January 2004

Clerk to Panel on Financial Affairs
Legislative Council Secretariat
(Attn: Ms. Salumi Chan)

(Fax No. 2869 6794)

Dear Ms. Chan,

Panel on Financial Affairs
Follow-up to meeting on 5 January 2004

On the questions raised by Members at the FA panel on 5 January, including those set out in item 2(a) and 2(b) of your letter of 6 January 2004, please find attached at the Annex relevant information provided by Government's Financial Adviser. It has also addressed the questions raised in Hon Henry Wu's letter of 6 January 2004. I should be grateful if you would distribute it to the Panel Chairman and Members for reference.

Yours sincerely,

(Tommy Yuen)
for Secretary for Financial Services
and the Treasury

<u>Annex</u>

Securitization of revenue from Government bridge and tunnels

1. Securitisation - Background

A securitisation involves the issuance of notes or other financial instruments (***Securitised Bonds*** or ***Asset Backed Securities***) backed by cash-flows from particular assets, such as Toll Roads. The global market for Securitised Bonds is very large, robust and liquid, with over US$1,500 billion in issuance annually.

Governments and public bodies in several developed countries around the world, including the USA, the UK, Australia, Japan, France, Italy, Portugal, other European countries and certain Latin American countries, have successfully completed securitisations of a similar nature. In fact, Toll Revenue securitisation is a common method for Governments and other public bodies to fund infrastructure development through the capital markets, and thus to address their fiscal positions. Such transactions are, therefore, very familiar to international and domestic investors.

In the securitisation proposed by Government, Securitised Bonds will be issued via a newly created, Government-owned company, whose only purpose of existence is to facilitate the securitisation. Interest yield and principal repayment of such Securitized Bonds will be met by the net toll revenues (***Toll Revenues***) collected from the subject Government-owned Tunnels and Bridge (***Toll Roads***).

The Securitised Bonds will be rated by international credit rating agencies, such as Standard & Poor's or Moody's, at a high investment-grade level, such as A+ or AA-, which is the same as that of the Government. The credit rating addresses the likelihood of full interest and principal repayment on the Securitised Bonds. For example, at the AA- level of rating, the likelihood of full repayment is considered very high, and the likelihood of default, very low. The credit rating assessment of the Securitised Bonds undertaken by the credit rating agencies is based mainly on the stability and credit quality of the expected future revenue from the Toll Roads.

It is important to note that under the securitisation structure proposed, ownership of the Toll Roads themselves, including control over the arrangements with operators and the rights to set toll rates (***Toll Rates***), will be retained by the Government. Only the net Toll Revenues are securitized, and then only for a limited period. Once the Securitised Bonds are fully repaid or redeemed, 100% of the net Toll Revenues will continue to be received by the Government.

The Securitised Bonds will be offered and sold to retail and professional institutional investors, in the same manner as retail bonds offered by the MTRC, KCRC, Airport Authority and the Hong Kong Mortgage Corporation (***HKMC***); or securitised bonds offered by the HKMC.

The issuance of Securitised Bonds is very different to the issuance of shares or other equity instruments. Investors in bonds are only entitled to the fixed interest return and the repayment of principal on the maturity of the Bonds. Any revenues generated in excess of the amount required to give investors their fixed returns will belong to the Government. Government could, for example, use this extra Toll Revenue to repay some of the Securitized Bonds earlier, and therefore shorten the period of the Securitisation. Alternatively, or in addition, such revenue could be paid into a fund to give added security to investors for future payments. Once the Securitized Bonds are fully repaid, Government will continue to retain all net Toll Revenues.

2. How are Asset Backed Securities or Securitised Bonds different from a Government Bond?

The Securitised Bonds will not be direct financial obligations of the Government, and will not be guaranteed by the Government. Their interest returns and repayment are directly linked only to the amount of net Toll Revenues generated from the Toll Roads, and as such the risk assumed by investors is that of the volume of traffic (***Traffic Volume***) that will pass through the Toll Roads over the period of the Securitisation. However, as noted above, the high credit ratings expected for the Securitised Bonds support the fact that this is a relatively low risk given the strong track record of historic and expected future performance from the subject Toll Roads.

Investors in Securitised Bonds of a similar nature are very familiar with such concepts and risks, as evidenced by the size of the Securitisation market globally (over US$1,500 billion of issuance annually) and the number of toll revenue securitisations completed around the world each year.

(a) Investors' Perspective

There are many features which will be built into the structure of the proposed Securitisation to protect Investors from other risks, such as potential changes in Toll Rates or unanticipated closure of the Toll Roads, whilst at the same time offering an attractive rate of return on the investment in the Securitised Bonds. Investors will also receive regular detailed reports updating them on the performance of the Toll Roads and on the security of their investments. The high credit ratings of such instruments, as well as the diversification effect of such instruments in an investor's overall investment portfolio make such Securitized Bonds an attractive investment opportunity. The Securitised Bonds, therefore, represent an investment alternative commonly available in other sophisticated capital markets but less frequently available in Hong Kong.

A significant proportion of the target investors for the Securitised Bonds will be professional institutional investors based in Hong Kong and internationally. Many of the professional institutional investors are specialized funds which have a different profile to the investors which would typically purchase conventional Government Bonds. As such, the Securitised Bonds will offer an investment opportunity to a different investor base than would normally participate in a conventional Government Bond offering.

By expanding the investor base and range of investment instruments available from Hong Kong issuers, the proposed issue of Securitised Bonds will also support the development of Hong Kong's capital markets and establishment of Hong Kong as an international financial centre. This will build on the efforts of the HKMC to widen investor opportunity in Hong Kong through its mortgage securitisation programme, and will act as a useful precursor to possible future issues by other Government and non-Government entities.

(b) Government's Perspective

From the Government's perspective, the Securitised Bonds are quite different from more conventional Government Bond issuance in that the interest returns and repayment on such Securitised Bonds are backed solely by the net Toll Revenue collected from the Toll Roads, as opposed to a general financial obligation of the Government. Nor will Government directly guarantee the fixed interest return and ultimate repayment of the Securitised Bonds.

The Securitisation will also be designed to offer the Government the flexibility to redeem the Securitised Bonds earlier in the event that Toll Revenues prove to be substantially higher than expected or projected at the outset. This offers Government greater flexibility in managing its fiscal position and future transport policy.

Financial obligations of the Government arising under the proposed Securitisation are contingent on certain unlikely events taking place (such as the long-term closure of a tunnel or bridge due to unforeseen circumstances), and will not be triggered unless those pre-defined events occur. Furthermore, these contingent obligations are no different in concept to the obligations that the Government currently assumes in ownership and maintenance of the Toll Roads.

3. Impact of Changing Traffic Volume

In order to illustrate the implications to investors and to the Government of changes in the amount of traffic flowing through the Toll Roads, it is useful to consider the following scenarios:

(a) if Traffic Volume **<u>increases</u>**, total Toll Revenue from the Toll Roads will also increase (assuming no change in Toll Rates):

   i. <u>Investors</u> will receive the same fixed amount of interest return and principal repayment, but potentially over a shorter period of time.

   ii. <u>Government</u> will receive the "upside" from the extra revenue at the end of the securitisation, and the securitisation may be repaid over a shorter period. This enables the Government to have greater flexibility over the management of its fiscal policies.

(b) if Traffic Volume **<u>decreases</u>**, total Toll Revenue from the Toll Roads will also decrease (assuming no change in Toll Rates):

i. Investors will receive the same fixed amount of interest return and principal repayment, although for investors in some of the longer tenor instruments the principal repayment may take place over a slightly longer period of time, while remaining within the predetermined legal maturity date of the bond.

ii. No impact on Government. The Securitisation may be repaid over a slightly longer period. However, the Government would also retain the right to early redeem the Securitisation, should that be required or deemed appropriate.

A small decrease in traffic volume will not affect the repayment of principal and interest return on the Securitised Bonds, as the credit rating agencies would have taken into account potential decreases in traffic volume in assigning the relevant credit ratings and there will be a considerable margin between the projected revenue from the Toll Roads and the amount required to service the Securitised Bonds.

(c) In the unlikely event that Traffic Volume **decreases drastically**, total Toll Revenue from the Toll Roads may decrease significantly:

i. Investors may no longer receive full repayment of principal and/or the fixed interest return expected on the Securitised Bonds when due, as it is likely that repayment would not have taken place before the predetermined legal maturity date of the Securitised Bonds.

ii. No impact on Government. Under the Securitisation, Traffic Volume risk is borne by investors and not by Government. As such, Government is not under any obligation to repay investors should Traffic Volumes decrease.

The risk of Traffic Volume falling drastically is considered remote, given the stable historic performance of the Toll Roads, the fact that some are operating at maximum capacity, the increasing population of Hong Kong and its demand for transport services and routes. This credit strength will be reflected in the predicted high credit ratings for the Securitisation. However, as noted above, such risk concepts are well understood and accepted by investors in Securitised Bonds globally.

4. Impact of Changing Tariff / Toll Rates

The Government will retain ownership of the Toll Roads, and will continue to exercise control over the selection and management of arrangements with operators, the right to set Toll Rates and all other policy matters. Since investors will not have any say in the application of Government policy it is appropriate that investors be protected financially in the event that changes in Government policy have an adverse impact on the Securitised Bonds. Should changes in the Government's transport policy require a change in Toll Rates, the following scenarios illustrate the implications for both investors and the Government:

(a) If Toll Rates are changed by the Government, leading to an overall **increase** in total net Toll Revenue from the Toll Roads:

  i. Investors will receive the same fixed amount of interest return and principal repayment, but potentially over a shorter period of time.

  ii. Government will receive the "upside" from the extra revenue at the end of the securitisation, and the Securitised Bonds may be repaid over a shorter period.

(b) If Toll Rates are changed by the Government, leading to an overall **decrease** in total net Toll Revenue from the Toll Roads:

  i. If the decrease is greater than a pre-agreed threshold level, Government may be required to make certain compensating payments to the Issuer, for the benefit of the investors. The Government will discuss with its appointed Arranger and credit rating agencies the extent of the risk it will accept in relation to future toll adjustment, and therefore the exact level of the threshold referred to above, will be determined once the Arranger has been appointed and detailed discussions with credit rating agencies undertaken.

  ii. Investors will receive the same amount of fixed interest return and principal repayment, since the effect of an overall reduction in total net Toll Revenue would be addressed through the compensating payments from the Government.

Therefore, Government's rights and autonomy in respect of the setting or adjustment of Toll Rates will not be affected by the Securitisation.

5. Redemption Features / Rights of the Government

It is proposed that the Securitisation will incorporate structural features to allow the Government the option to partially or fully prepay or redeem the Securitised Bonds after an agreed period or to remove a facility from the Securitisation and make compensatory payments to the Issuer. Such features will give the Government flexibility, for example, to extract any particular Tunnel or Bridge from the Securitisation at any time after the initial agreed period of, say 5 years. This is designed to afford the Government maximum flexibility in future management of its transport and fiscal policies, whilst assuring fair treatment of the investors.

6. What would happen in the event of a major disaster or terrorism event?

The Government's current practice is to "self-insure" the Toll Roads. It is proposed that under the Securitisation, should certain *force majeure* business interruption events occur, rendering the Toll Road inoperable for a sustained period of time (say, greater than 3 months), the Issuer will receive compensating payments from the Government. Therefore, investors will be protected from the risk of such an event. Government's position would be similar to the present day, in that under current circumstances, such a *force majeure* event would also result in a loss of revenue to the Government and potential costs of maintenance or renewal.

7. Inclusion of Lantau Link

The inclusion of Lantau Link will significantly enhance the attractiveness and appeal of the Securitised Bonds to all investors, in particular overseas investors, given its status as an internationally recognized landmark of Hong Kong. Traffic Volume is expected to rise in future on Lantau Link with the further development of Lantau Island, the increase in air traffic at Hong Kong International Airport, the opening of the Disney Theme Park and the construction of a HK-Zhuhai-Macau Bridge.

Investors in the Securitised Bonds will not, however, receive any "upside" from the inclusion of Lantau Link as they will only be entitled to fixed interest returns and principal repayments. The upside benefits of including Lantau Link (including the rise in future revenue from Lantau Link) will flow to the Government in the form of extra revenue at the end of securitisation and the repayment of the securitisation over a shorter period.

This will facilitate greater flexibility for the Government in relation to the implementation of its fiscal policies.

8. Details of Successful Securitisations in other Jurisdictions

There are many examples of securitisations of Government assets in general, and toll road revenues in particular, which have been successfully completed in other jurisdictions. Governments in several developed countries around the world, including the USA, the UK, Australia, Japan, France, Italy, Portugal, other European countries and certain Latin American countries (for example, Mexico and Chile), have successfully completed securitisations of a similar nature. In fact, toll revenue securitisation is a common method for Governments and other public bodies to fund infrastructure development through the capital markets, and thus to address their fiscal positions.

The following is a small sample of similar successful securitisation transactions:

- Securitisation Bonds issued by Lane Cove Tunnel Finance, a special purchase issuer, backed by toll revenues from the Lane Cove Tunnel in Sydney, Australia
- Securitisation Bonds issued by Atami Beach Line Funding, a special purpose issuer, backed by toll revenues from the Atami Beach Line toll road located in Atami City, Shizuoka Prefecture in Japan
- Securitisation Bonds issued by the Triborough Bridge and Tunnel Authority, backed by net toll revenues collected on various state-owned tolled tunnels and bridges in the New York Metropolitan Area of the United States of America
- Securitisation Bonds issued by the Tribasa Toll Road Trust, backed by toll revenues from the Ecatepec-Piramides and the Armaria-Manzanillo toll roads in Mexico.
- Securitisation Bonds backed by toll revenue from the M77 road project in the UK
- Securitisation Bonds issued by Toll Road Funding, a special purpose issuer, backed by toll revenues from various tolled roads in Italy, operated by Autostrade

- Securitisation Bonds issued by Alis Finance, a special purpose issuer, backed by toll revenues from the A28 toll road in France
- Securitisation by way of an IPO of Autoroute du Sud de la France, in relation to various government owned toll-road facilities in France
- Securitisation Bonds backed by toll revenues from various motorway projects in Chile
- Securitisation Bonds backed by track access charges payable in connection with use of a rail link relating to the Channel Tunnel between the UK and France
- Securitisation of Government-owned property assets in the UK, such as the Annington Homes securitisation of the UK Ministry of Defence Married Quarters Estate, comprising approximately 2,400 properties.

The above transactions have involved the issuance of several billion dollars of Securitised Bonds to a wide range of investors in the relevant domestic and international capital markets. Such securitisations are not generally offered to investors unless the level of investor demand has first been assessed and the transaction fully and appropriately structured.

The Government has undertaken a thorough and extensive "feasibility study" for the proposed Securitisation in conjunction with its Financial Advisor, which suggests that the proposed Securitisation of Toll Roads would be well received by the domestic and international capital markets and may be executed within the required time-frame.

9. Details of organization structure and operations of Government fully-owned "special purpose issuer"

The special purpose issuer (***Issuer***) will be a newly created company, incorporated under the laws of Hong Kong, and wholly owned by the Government through the Financial Secretary Inc. The operations of the Issuer will be strictly limited to entering into the proposed Securitisation, the issue of the Securitised Bonds to investors, and the distribution of net Toll Revenues from the Toll Roads for the repayment of interest and principal on the Securitised Bonds. The Issuer will also subscribe to the back-to-back note from the Government (as described in the Legislative Council Brief). The Issuer will not, and may not, enter into any other transactions with any other parties.

Directors of the Issuer will be appointed by the Government. The Issuer will not have any employees. Certain of the affairs of the Issuer (including the preparation of the necessary books of account and records and certain other corporate, secretarial and administrative services) will be managed by an independent agent (***Transaction Administrator***) appointed by the Government. The Issuer will appoint an accredited accounting firm to act as its auditors and the Transaction Administrator will be responsible for preparing annual audited financial statements. The above arrangement for the Issuer is commonly employed in most securitisation transactions.

The Issuer will not have any engagement with any other authority, since Government will continue to directly retain the ownership of the Toll Roads as well as all existing arrangements with operators and Government authorities and departments.

10. Details of Target Investors

A significant percentage of the Securitised Bonds is expected to be offered to Retail investors in Hong Kong. The balance of the Securitised Bonds will be offered to professional institutional investors in Hong Kong and internationally.

Members of the financial services industry in Hong Kong (including placing banks and brokerage firms) will be offered the opportunity to participate as Placing Institutions for distribution of the Securitised Bonds to Retail investors, provided they are able to meet the relevant legal, regulatory and operational requirements typical to the offering of Retail Bonds in the Hong Kong market. This will ensure that the retail offering is implemented through a wide and direct distribution network, accessing the broadest possible investor base, whilst enabling the participation of the widest possible distribution channel.

A Global Coordinator / Arranger will be appointed by the Government to coordinate the distribution of the Securitised Bonds to all investors (including Retail) by the different Placing Institutions.

11. Details of possible "recourse arrangements" by the investing public on "obligations of Government"

As highlighted by the Honourable Member, Retail investors would wish to have a simple and quick arrangement for access to the obligations of the Government where it has been agreed that certain risks be retained by the Government. The mechanism for such "recourse arrangements" will be set out clearly in the Securitisation documents, and offering documents and informational materials available to all investors, whether Retail or Institutional. Access to these arrangements will not require individual Retail investors to bring any action against the Government. As part of the Securitisation, an independent and reputable financial institution will be appointed to act in the capacity of trustee (***Trustee***), whose fiduciary duty will be to protect the interests of all investors, including Retail investors. The Trustee will be responsible, amongst other matters, for exercising the rights of the Issuer in relation to any "recourse arrangements" to the Government on behalf of all investors.

12. Ancillary Expenses & Annual Incidental Costs

Although the ancillary expenses and annual incidental costs associated with the implementation of the Securitisation may not be finalized until an Arranger is appointed by the Government, and competitive terms proposed by all parties supporting the Securitisation, the following is an estimate of such items:

(a) Ancillary Expenses: Between HK$10 to 15 million plus Arrangement Fees, which will usually be expressed as a % of proceeds and subject to competitive bidding process by the short-listed banks.

These expenses are typical of those required for securitisations and other bond offerings (including retail bond offerings) for a transaction of this size, and include the fees and expenses of legal advisers, credit rating agencies, accounting and tax advisers, Transaction Administrator and Trustee, and other parties required to execute the Securitisation.

(b) Annual Incidental Costs: Approximately HK$1.5 million per year, payable to the Trustee acting in the interests of investors, to the Issuer's accountants, auditors and the Transaction Administrator, and to the credit rating agencies for their annual reviews and monitoring of the Securitisation for the benefit of investors.

*****