

**Information provided in response to letter of 22 December 2008 from
the Clerk to Subcommittee to Study Issues Arising from Lehman
Brothers-related Minibonds and Structured Financial Products**

Background

In the letter dated 22 December 2008 to the Financial Services and the Treasury Bureau (FSTB), the Clerk to Subcommittee to Study Issues Arising from Lehman Brothers-related Minibonds and Structured Financial Products requested written information on a list of 11 issues. While FSTB considers that the Hong Kong Monetary Authority and/or the Securities and Futures Commission are in a better position to respond to these issues, we note that the Subcommittee has requested, inter alia, an account of the initiatives taken and the new financial products offered to investors following the announcement of the Government's intention to attract more financial product issuers to Hong Kong in the 2002-2003 Budget Speech.

Information Provided by FSTB

2. The Government and relevant regulators have all along attached great importance to the development of Hong Kong as an international financial centre. In response to the Subcommittee's request, we provide herewith the following documents (at Annex) which help illustrate efforts made to promote the issuance of bonds in Hong Kong before and after the announcement of the 2002-2003 Budget Speech, with reference to products that had been offered to investors –

- (a) the Secretary for Financial Services' reply to Hon Ambrose Lau's question on "Developing Hong Kong into a Bond Issuing Centre" at the LegCo sitting of 5 December 2001;
- (b) the Secretary for Financial Services' reply to Hon Sin Chung Kai's question on "Promoting Development of Retail Bond Market" at the LegCo sitting of 5 December 2001;
- (c) paper on "Development of the Retail Debt Market in Hong Kong" for the meeting of the LegCo Panel on Financial Affairs on 7 January 2002;

- (d) the Secretary for Financial Services and the Treasury's reply to Hon Ambrose Lau's question on "Development of Bond Market in Hong Kong" at the LegCo sitting of 12 November 2003; and
- (e) the Secretary for Financial Services and the Treasury's reply to Hon Ambrose Lau's question on "Retail Bonds" at the LegCo sitting of 12 May 2004.

Financial Services and the Treasury Bureau
January 2009

Developing Hong Kong into a Bond Issuing Centre

3. MR AMBROSE LAU (in Cantonese): *Madam President, given that the Financial Secretary has indicated to the media that Hong Kong possesses the conditions for developing into a bond issuance centre in Asia, will the Government inform this Council of the measures it has taken and will take to promote Hong Kong's development in this direction?*

SECRETARY FOR FINANCIAL SERVICES (in Cantonese): Madam President, the Hong Kong Monetary Authority (HKMA) has taken the following measures in promoting the development of Hong Kong as a bond centre.

Over the past decade, the HKMA has been developing the infrastructure for bond market development in Hong Kong. It includes the establishment of a Central Moneymarkets Unit (CMU) which provides an efficient and safe means of electronic clearing of Exchange Fund Bills and Notes and other Hong Kong-dollar or non-Hong Kong-dollar denominated bonds. Through its linkage with other overseas clearing systems, the demand for Hong Kong dollar debts from overseas investors would increase and the base of foreign investors expand. We have further launched the Hong Kong Dollar Clearing System and US Dollar Clearing System. Through linking the CMU with these clearing systems, the trading of Hong Kong dollar and US dollar bonds can be settled in an efficient manner and achieve real-time or day-end delivery versus payment. In addition, the US Dollar and Hong Kong Dollar Clearing Systems allow foreign exchange transactions between US Dollar and Hong Kong Dollar to be settled in real time, thereby eliminating settlement risks which could arise when the settlement occurs across time zones.

At the same time, we have established a reliable Hong Kong dollar Benchmark Yield Curve, which provides benchmarking and hedging tool for bonds issued by private corporations. To ensure the liquidity of Exchange Fund Bills and Notes in the primary and secondary markets, we have also put in place a system of appointing Recognised Dealers and Market Makers to trade in Exchange Fund Bills and Notes.

To encourage more multilateral agencies to issue bonds in Hong Kong, we have since 1996 put in place a tax exemption scheme for qualified bonds. At present, there are already 10 multinational corporations whose bonds are

qualified for profits tax exemption. That is, interest income and trading profits derived from their bonds are exempt from profits tax. For income derived from qualified bonds issued by statutory corporations and government-owned corporations, there is a concessionary profits tax rate equivalent to 50% of the standard rate.

To proceed in tandem with the rapid market development, we are taking steps to simplify the procedures and requirements of bond issuance in Hong Kong in order to strike a balance between facilitating market development and protecting investors. For instance, the Securities and Futures Commission (SFC) has implemented since May this year a class exemption which allows split language prospectuses to be issued; and simplified the requirements for information on valuation of operational leases in the prospectuses. In addition, the SFC also exempted the requirements for prospectus contents in respect of retail bonds recently issued by the Hong Kong Mortgage Corporation. We are now conducting a comprehensive review of the Companies Ordinance and related legislation in aspects of prospectus requirements and offers of investment. We aim to simplify the procedures and enhance the regulatory flexibility to facilitate market development.

Over the past decade, we have accumulated valuable experience and expertise in bond issuance and trading. In addition to our first-class financial infrastructure, all these will enhance Hong Kong's status as a regional bond centre and attract overseas issuers and investors to Hong Kong.

Looking ahead, we will further develop the depth and width of our bond market. We are forging the bilateral linkage with Euroclear with a view to promoting cross-boundary custody and clearing of Hong Kong and overseas bonds, and at the same time expanding the base of investors, thereby stimulating the growth of both local and regional bond markets. We will also develop our CMU into an international clearing house, so that Hong Kong will become the central clearing house in Asia. This will strengthen our status as an international financial centre.

The HKMA is now studying the feasibility of establishing real-time settlement system in other currencies (such as Euro settlement system). The aim is to provide clearing and settlement services for the trading of bonds denominated in other currencies, thus attracting more of such business to Hong Kong. We will also continue to develop further the local retail bond market.

MR AMBROSE LAU (in Cantonese): *Madam President, in the fourth paragraph of the main reply the Secretary said that to encourage more multinational agencies to issue bonds in Hong Kong, we have put in place a tax exemption scheme and at present there are already 10 multinational corporations whose bonds are qualified for profits tax exemption. Furthermore, for income derived from qualified bonds issued by statutory corporations and government-owned corporations, there is a concessionaire profits tax rate equivalent to 50% of the standard rate. In a bid to enable Hong Kong to become a bond issuance centre, will the Government inform this Council whether it intends to give a concessionary profits tax rate to quality bonds issued by statutory corporations and government-owned corporations in Hong Kong, or even local corporations?*

SECRETARY FOR FINANCIAL SERVICES (in Cantonese): *Madam President, I thank the Honourable Ambrose LAU for his supplementary question. Indeed, we are studying the issue and are considering ways to develop Hong Kong into a centre for bond issuance. The issue of tax is one of the items we will be studying.*

MR HUI CHEUNG-CHING (in Cantonese): *Madam President, in his main reply the Secretary said that the Administration has adopted and will adopt numerous measures to develop Hong Kong into a regional bond centre. However, since the "September 11 incident", institutional rating personnel indicated that the incident would pose definite obstacles to the issuance of bonds. Will the Secretary inform this Council whether the Administration has conducted any assessment on the impact of the incident?*

SECRETARY FOR FINANCIAL SERVICES (in Cantonese): *Madam President, I think the decision to issue bonds by a company is determined by its need for capital. For a company in general, the cost of issuing bonds is high, and especially in the retail bond market, the cost is even higher. Earlier, I indicated that we had a working group to study this aspect, for instance, to consider providing the tax concession just mentioned and to adopt other measures to encourage relevant companies to continue with the issuance of more bonds despite the "September 11 incident".*

MR JAMES TIEN (in Cantonese): *Madam President, at a Panel meeting in this Council yesterday, the Financial Secretary mentioned that the economic growth of the Mainland might reach 7% next year, a rather high rate in the region. Will the Secretary inform this Council whether in the future, state-owned enterprises (SOEs) from the Mainland may enjoy concessionary tax rates as those 10 multinational corporations? Moreover, in the last paragraph of his main reply, the Secretary spoke about the feasibility of trading of bonds denominated in other currencies in future. Does that include the Renminbi?*

SECRETARY FOR FINANCIAL SERVICES (in Cantonese): Madam President, I am sorry. I could not get the second part of the supplementary question.

MR JAMES TIEN (in Cantonese): *Madam President, excuse me. The second part of my supplementary question is about the last paragraph of the main reply, in which the Secretary said the aim was to provide clearing and settlement services for the trading of bonds denominated in other currencies. By currencies, it is meant Euro and US dollars. Will the Renminbi be included in future?*

SECRETARY FOR FINANCIAL SERVICES (in Cantonese): Madam President, I thank Mr TIEN for his supplementary question.

Let me deal with the first part of the supplementary question. The 10 multinational corporations in fact do not refer to SOEs or individual companies. They are some multinational organizations such the Asian Development Bank and the World Bank, so they do not include SOEs. However, as I said in reply to a supplementary question from Mr LAU, our overall consideration is on tax issues and ways to attract more companies to issue bonds in Hong Kong.

The second part of the supplementary question is about bonds denominated in Renminbi. This is of course an issue involving state policies. As far as infrastructure is concerned, our CMU is a very good settlement system and in the Mainland, there is the GSBS. We are negotiating with the Mainland to find out if the networks can be linked, which, if successful, may also encourage the trading of bonds.

DR TANG SIU-TONG (in Cantonese): *Madam President, in the sixth paragraph of the main reply, the Secretary said that Hong Kong has accumulated a decade of experience in bond issuance. Will the Secretary inform this Council whether the Government has data to show the scale and position of the Hong Kong bonds market in comparison with other financial markets in Asia?*

SECRETARY FOR FINANCIAL SERVICES (in Cantonese): *Madam President, I thank Dr TANG for his supplementary question. I believe the Government knew 10 years ago that Members would be very concerned about this. So, much work started 10 years ago. Compared with other Asian countries, Hong Kong has a settlement system in US dollars, which other countries in the region lack. In terms of infrastructure, Hong Kong has definitely reached world standards. Moreover, we have the expertise and related facilities as support, including large investment banks, and accounting and legal professionals have all gathered in Hong Kong. Thus, Hong Kong has what it takes to be a bond issuance centre. The number of issued bonds is significant. If I remember correctly, Hong Kong has issued bonds in the worth of HK\$500 billion and US\$10 billion-odd. These figures will enable Hong Kong to top the list in Asia.*

MR ABRAHAM SHEK: *Madam President, in the last paragraph of the main reply, the Secretary said that the Hong Kong Monetary Authority is studying the feasibility of establishing real-time settlement system in other currencies. My question is: What other currencies will be considered, apart from Euro; and when will the feasibility study be completed?*

SECRETARY FOR FINANCIAL SERVICES (in Cantonese): *Madam President, I thank Mr SHEK for his supplementary question. I think what could be studied is the Japanese yen, in addition to Euro. The HKMA is conducting the study and is hoping to complete the same by next year.*

PRESIDENT (in Cantonese): *Fourth question.*

Promoting Development of Retail Bond Market

4. MR SIN CHUNG-KAI (in Cantonese): *Madam President, regarding the development and management of the retail bond market open to the public, will the Government inform this Council:*

- (a) *in view of the keen response from the public to the last few issues offered by the Hong Kong Mortgage Corporation Limited (HKMCL), whether it knows if the Kowloon-Canton Railway Corporation (KCRC), the MTR Corporation Limited (MTRCL), the Airport Authority (AA) and the Hong Kong Monetary Authority (HKMA) have plans to issue retail bonds;*
- (b) *whether it plans to review the legislation governing the issuance of retail bonds with a view to reducing the costs of private companies in issuing retail bonds; and*
- (c) *of the measures in place to promote the development of the retail bond market and to increase the turnover of retail bonds in the secondary market?*

SECRETARY FOR FINANCIAL SERVICES (in Cantonese): Madam President,

- (a) The HKMA has issued Exchange Fund Notes (EFN) that carry a minimum denomination of HK\$50,000 to facilitate investment by retail investors. Such highly liquid paper can be purchased by retail investors either in the secondary market, or in the primary market through the recognized dealers appointed by the HKMA. These EFNs are also listed on the Hong Kong Exchange to attract investment at the retail level.

As to other individual statutory corporations such as the KCRC, the MTRCL and the AA, they have issued Hong Kong-dollar notes in the past. For example, the MTRCL has issued Hong Kong dollar notes under the HKMA's Notes Issuance Programme. The AA also has eight notes issued under the same programme. Such notes are denominated at a minimum of HK\$50,000 that facilitate

investors' buying. These statutory corporations will, according to commercial principles, take into account their own and market demand and cost-effectiveness in considering whether to issue bonds, and their denominations, to meet their financing needs.

- (b) Existing legislation, in particular the Companies Ordinance, contain very stringent requirements over the disclosure of information for the retail offer of debentures and shares. Preparation of prospectuses and marketing materials under this stringent framework entails substantial financial and time costs. In view of the rapid development of the markets, the Government and the regulatory bodies are taking steps to streamline the procedures and requirements, so as to strike the right balance between facilitating market development and protecting investors.

Pursuant to sections 38A and 342A of the Companies Ordinance, if the Securities and Futures Commission (SFC) considers that the disclosure requirements concerned are either irrelevant or unduly burdensome to issuers, it can give exemptions to certain class of companies or prospectuses. For instance, in March 2001, the SFC gazetted a class exemption notice, which came into force on 11 May 2001, that allows split language prospectuses to be issued and reduces the information required to be disclosed for valuation of operating leases. Furthermore, the SFC has also exempted retail bonds issued by the HKMCL from certain prospectus content requirements. The SFC will consider publishing on SFC's website information as to the types of exemption granted by the SFC in the past and other information considered to be useful to other applicants. The public will be able to access such information, which will ensure the transparency and consistency of SFC's decision. The SFC is reviewing the Companies Ordinance and all other legislation relating to the offers of investment and prospectus requirements. We will consider the experience of overseas markets in this regard, with a view to simplifying the procedures and increasing the flexibility of our regulatory regime in order to meet market development needs.

- (c) The HKMA has taken a number of steps to promote the development of the retail bond market. For instance, EFNs are

exempt from stamp duty and profits tax; the minimum denomination of the notes is set at HK\$50,000; and the listing of notes to facilitate trading by investors.

In terms of market infrastructure, since the introduction of the Third Generation Automatic Order Matching and Execution System (AMS/3) in October 2000 by the Hong Kong Exchange and Clearing Limited (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 fixed-rate products.

The HKEx will further enhance its trading system by developing automated market-making facilities to facilitate the trading of derivative warrants, National Association of Securities Dealers Automated Quotations (NASDAQ) stocks, Exchange Traded Funds and bonds. The system enhancements are expected to be implemented in the second quarter of 2002.

Meanwhile, we have successfully 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, we would further enhance transaction channels through on-line banking and brokerage services, thereby promoting the retail trading of bonds.

We are equally aware of the importance of improving investors' knowledge about debt products. The SFC has included information on bond investment in its Electronic Investor Resources Centre and investment booklets. The SFC also publishes frequent articles in newspapers and launches promotional campaigns on special themes to increase investors' understanding on various types of investment products. The HKMA has been conducting briefing sessions about new services and promoting education on bonds for retail investors through the media.

MR SIN CHUNG-KAI (in Cantonese): *Madam President, in part (b) of his main reply, the Secretary said that the three public organizations have all issued*

notes in the past. I would like to ask did the notes issued account for a comparatively high proportion of their total amount of borrowings? In the past, the need for issuing notes was not so strong as there was no zero interest rate, but now the interest rate is almost zero and the need would have been stronger. Has the Government conducted any study to identify the motif for those almost government wholly-owned corporations to increase the ratio of retail bonds being issued?

SECRETARY FOR FINANCIAL SERVICES (in Cantonese): Madam President, I would like to thank Mr SIN for his supplementary. Concerning the ratio between the notes issued by those corporations and the total amount of borrowings, I do not have the figures at hand. If necessary, I could provide an answer to Mr SIN in writing. (Annex II) However, I would like to point out that those corporations operate on commercial principles. As a result, whenever there is a need for financing, they will certainly take the cost into account and see whether consortium loan or the issuance of notes should be more cost-effective, then they will make the choice and determine the denomination of \$50,000 or less and so on. I believe all of them have to follow the prevailing market condition and make decision on commercial principles. Actually, with regard to today's condition, the interest of the public in retail bonds has increased significantly, therefore these corporations, such as the AA, also have interest in the issuance of more retail bonds.

MR HENRY WU (in Cantonese): *Madam President, the Secretary mentioned in part (a) of the main reply that retail investors may purchase bonds through recognized dealers appointed by the HKMA. Will the Government inform this Council of the number of recognized dealers appointed by the HKMA, of the appointment mechanism that the authority adheres to, and whether dealers are openly appointed; if not, the reasons for not appointing them openly?*

SECRETARY FOR FINANCIAL SERVICES (in Cantonese): Madam President, in respect of number, there should be over 140 traders, they are mainly recognized institutions such as banks or investment banks. In fact, as far as bonds issued via the HKMA are concerned, many of them are listed on the HKEx, therefore the public may also purchase the bonds through brokerage houses.

PRESIDENT (in Cantonese): Mr Henry WU, has your supplementary not been answered?

MR HENRY WU (in Cantonese): *Yes, Madam President, the Secretary has not answered my supplementary. I have just asked whether the dealers openly appointed by the Government; if not, the reasons for not appointing them openly?*

SECRETARY FOR FINANCIAL SERVICES (in Cantonese): Madam President, I think institutions interested in the dealings are all recognized institutions, all of these 147 recognized dealers and 27 market-makers are mainly recognized institutions. I believe that their status as recognized traders is an important factor for us to make a decision.

DR YEUNG SUM (in Cantonese): *Madam President, now that bank deposit rate is almost as low as zero, and the Secretary has mentioned earlier that the demand and interest of the public in retail bonds have increased significantly, there are still potential risks. Will the Government make greater efforts in educating the public in this respect, so as to steer the public clear of the same old disastrous course of taking risk in making investment ventures?*

SECRETARY FOR FINANCIAL SERVICES (in Cantonese): Madam President, I would like to thank Dr the Honourable YEUNG Sum for his supplementary. I fully agree that we should make more efforts to educate the public, notwithstanding that investors in the present time are more investment-conscious than we are. Besides, they know more varieties of bonds than we do, as there are dozens of retail bonds for them to choose once they step into any bank in town. As a result, I agree with Dr YEUNG that educating the investors is very important. In that respect, irrespective of the the HKMA, HKEx, the SFC or the Hong Kong Capital Markets Association, all of them provide websites, brochures, pamphlets and on-line information. Nevertheless, I agree that we should exert more efforts in this respect.

MR SIN CHUNG-KAI (in Cantonese): *Madam President, since those corporations operate on commercial principles, has the Government made a*

comparison between the cost of making consortium loan and that of retail bonds, and found the cost of the former higher than the latter? Although local market demand on retail bonds is seemingly strong, the supply seems inadequate. Will the Government conduct more study in that respect, especially aiming at those almost government wholly-owned and quasi-government corporations, with a view to making out why the borrowing ratio is still that low?

SECRETARY FOR FINANCIAL SERVICES (in Cantonese): Madam President, as I have actually explained earlier, whether or not these corporations issue debt products really depends on the cost, that is to say, the market condition. If the market rate is very low, then why should they issue bonds and pay investors up to a yearly interest of 4%? Furthermore, those corporations have to take into account the capital and time needed, such as long-term and short-term needs. Hence, I believe that commercial principles should really be taken into consideration. The Government should not be used the reason that it owns those corporations to order the issuance of more retail bonds by those corporations to facilitate the promotion of the retail bond market without taking the cost-effectiveness into account. On the contrary, those corporations should take into account the cost-effectiveness of various financing channels before making any decision based on commercial principles. However, I have mentioned in my main reply that we encourage those corporations to issue more retail bonds mainly because the current interest rate is on the low side and there are demands on the market. I have also explained that those corporations are in fact interested in the issuance of more retail bonds and the like.

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)								
20-Oct-98	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	118	8.14%	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.

Financial Services Bureau

January 2002

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Development of Bond Market in Hong Kong

4. MR AMBROSE LAU (in Cantonese): *Madam President, it has been reported that the Central Government supports the development of a bond market in Hong Kong, and our country has chosen Hong Kong to be the first stop of the international tour to promote this year's global issuance of foreign currency national bonds amounting to US\$1 billion and 500 million Euro. In October this year, the Vice-Minister of Finance came to Hong Kong to promote the bonds to local officials and over 200 fund managers. This batch of national bonds will be put up for off-market listing in the Hong Kong Exchanges and Clearing Limited. Moreover, the low interest environment has also generated a great demand for bonds in the market. In this connection, will the Government inform this Council:*

- (a) of the progress in streamlining bond issuance procedures; whether the authorities have plans to introduce measures for enhancing the work in this respect; if they have, of the details;*
- (b) of the incentives and related measures to attract local and overseas institutions and enterprises to issue bonds in Hong Kong; and*
- (c) whether it has plans or measures to develop Hong Kong into a centre for China's foreign currency national bonds and for mainland enterprises to issue foreign currency bonds; if it has, of the details?*

SECRETARY FOR FINANCIAL SERVICES AND THE TREASURY (in Cantonese): Madam President, in a bid to further strengthen Hong Kong's status as an international financial centre, the Government has taken a number of measures to promote the development of Hong Kong's financial markets. Of these efforts, the promotion of the development of the bond market is a priority item. From a macro perspective, the development of the bond market would give public and private sectors an additional channel for long-term capital raising, distinct from bank loans and the stock market. It would also help attract overseas companies in need of fund raising. Diversification of investment products would also make it easier to attract overseas investment. To an individual, a more developed bond market would offer him more investment choices that might suit his investment needs and risk appetite. For Hong Kong as a whole, the promotion of the bond market would thus be conducive to the development of the financial industry and its employment and hence the economic well-being of Hong Kong.

The Government has done a lot in relation to the promotion of the bond market, including providing the necessary financial infrastructure, simplifying the issuance process and offering tax incentives. All these should help create a favourable environment that is conducive to the development of the bond market.

- (a) In respect of simplification of the issuance process, the Government plans to overhaul the existing regime of offer of shares and debentures in three phases.

The Securities and Futures Commission (SFC) has implemented the first phase in February 2003, including the issue of the following three Guidelines:

(1) Guidelines on awareness advertisements

In the past, awareness advertisements made by issuers might be regarded as prospectuses and thus these advertisements would have to comply with relevant requirements under the Companies Ordinance. In other words, issuers had to supply voluminous information and documents and register the prospectuses in accordance with relevant procedures. With the issue of the guidelines by the SFC, an issuer may now, in accordance with the guidelines, issue awareness advertisements prior to a public offer of

shares or debentures without being subject to prospectus-related requirements. Awareness advertisements allow potential investors more time to arrange their own finance, thereby facilitating greater retail investor participation.

(2) *Guidelines on "dual prospectus"*

In the past, if an issuer offered shares or debentures on a continuous or repeated basis, it had to prepare and register a comprehensive prospectus before each offering. The prospectus included basic information about the company which did not require frequent updating. After the introduction of the "dual prospectus" mechanism, an issuer may register a "programme prospectus" which contains information on the issuer's business, financial and other basic information. In its subsequent offerings of shares or debentures, an issuer does not have to prepare the comprehensive "programme prospectus". Instead, it will only have to register an "issue prospectus" which contains offer-specific information such as interest rate and settlement matters. This arrangement significantly reduces the burden of registering and issuing prospectuses, and shortens the lead time required for preparing an offer of shares or debentures.

(3) *Guidelines on relaxation of procedural requirements for registration of prospectuses*

In the past, an issuer had to submit to the SFC the definitive prospectus (the version that is to be distributed to the public) together with the original of any expert's consent letter for registration purposes. However, an issuer might have engaged an overseas-based expert in some cases and it would take more time to get hold of the original of the expert's consent letter. With the introduction of the new guidelines by the SFC, an issuer may submit to the SFC a faxed copy of expert's consent letter for registration purposes. This measure has facilitated issuers in offering shares or debentures.

Members may be aware that, since the SFC issued the guidelines in February this year, a number of companies have issued retail bonds

in the past few months in Hong Kong which have in turn offered more choices for investors and further facilitated the development of the bond market.

In addition, we have gazetted the Companies Ordinance (Exemption of Companies and Prospectuses from Compliance with Provisions) (Amendment) Notice 2003 in March this year to exempt the issuer of bonds from providing information that is unnecessary to investors and/or that will impose an unnecessary burden on the issuer in the prospectus.

In the second phase, legislative amendments relating to prospectuses are proposed in the Companies (Amendment) Bill 2003 mainly in response to specific requests from market participants. Among other things, the proposals aim at simplifying the procedures for the registration and issue of prospectuses, thereby fostering the development of retail bonds and other financial products. The Bill was introduced to the Legislative Council in June 2003 and is being examined by the Bills Committee.

As regards the third phase, the SFC will conduct a comprehensive review of all local laws and procedures governing public offers of securities with reference to regulatory reforms introduced in other leading international financial centres, with a view to putting in place a framework that provides the most efficient, competitive and fair environment for issuers and investors alike. The SFC has commenced the review and aims to put forward proposals for public consultation by September 2004.

- (b) In respect of tax incentives, the Government proposed in the 2003-04 Budget speech to increase the tax concessions on trading profits and interest incomes derived from qualified debt instruments (QDIs). The new measure will reduce the eligible maturity period of QDIs for 50% tax concession from not less than five years to not less than three years; and will increase the tax concession for QDIs of not less than seven-year maturity period from 50% to 100%. This proposal has the support of the financial sector and was passed into law by the Legislative Council on 5 November. The increased tax concessions for QDIs should be conducive to the supply and

trading of medium- and long-term debt instruments, thereby facilitating the overall development of the bond market.

- (c) In fact, among Asian countries, Hong Kong is well-positioned to become a bond centre. Our sound legal system, free flow of information, simple and low tax regime, open capital markets and first-class human resources inspire confidence in companies and investors. Apart from these fundamental factors, the Government also plays an active role in establishing a bond clearing and settlement system. For example, to further reduce settlement risk, the Central Moneymarkets Unit (CMU) operated by the Hong Kong Monetary Authority (HKMA) has established linkages with Hong Kong's payment systems for the Hong Kong Dollar, the US dollar and the Euro. This enables simultaneous settlement of funds and bonds to be carried out during Hong Kong hours, thus removing settlement risk arising from time difference. These measures would help Hong Kong gradually develop into a bond centre for this region not only for China.

Madam President, since taking up office, I have been encouraging the public corporations to take the lead in launching debt issuance programmes, including Hong Kong Dollar bonds with longer maturity periods and particularly at the retail level. Last year, we saw Hong Kong Dollar bonds, including retail bonds, with maturities ranging from seven to 15 years issued by the Airport Authority, the MTR Corporation Limited and the Kowloon-Canton Railway Corporation (KCRC). The response from investors has been good. These bonds provide benchmark yield curves for the reference of the market and offer additional choices for investors. As at the end of September 2003, the outstanding amount of Hong Kong Dollar bonds, including the Exchange Fund Bills issued by the HKMA, amounted to \$556 billion. The Government will continue with its multi-pronged approach to developing the bond market. We will keep up our efforts by, among other things, encouraging the public sector to issue bonds, in particular retail bonds; promoting bond investment education; and exchanging views with the financial services industry on how to stimulate the development of the market. Apart from promotional efforts buttressed by government policies, I also hope we can count on the support and participation of both the

markets and the media. Let us work together to develop Hong Kong's bond market and strengthen our status as an international financial centre.

MR AMBROSE LAU (in Cantonese): *Madam President, the Secretary mentioned in the main reply that in respect of the simplification of the issuance process, the Government planned to overhaul the existing regime of offer of shares and debentures in three phases — the exercise would be carried out in three phases. The measure in the first phase was to issue three Guidelines. In this connection, may I ask the Secretary if market participants had been consulted before these three Guidelines were issued; if they had been, which of their views were not adopted by the Government; and if they had not been consulted, then why?*

SECRETARY FOR FINANCIAL SERVICES AND THE TREASURY (in Cantonese): *Madam President, a working group was set up under the then Secretary for Financial Services to examine the development of the bond market. Apart from members of the SFC, this working group was also comprised of market participants. Therefore, before introducing these measures, the views of market participants had been fully considered and we had heard and taken on board many views from the market before making the decisions. I also meet frequently with members of the Hong Kong Capital Markets Association to understand in what areas they think the Government can do more to develop the bond market. Therefore, the exercise is ongoing and will not stop after the work has been completed.*

MR ALBERT CHAN (in Cantonese): *Madam President, when the airport was to be built in 1990, we already suggested to the Government then that the capital could be raised by issuing bonds. A number of Financial Secretaries in office said that this would be examined. However, so far we cannot see any actual result. The Secretary has touched on many areas and given explanations on a number of cases, but the most important thing is the outcome. Can the Secretary tell us when the Government will use the issuance of bonds as a principal means of financing large-scale infrastructural projects, that is, when this will be implemented and should bonds be issued to raise capital, can bonds of smaller denomination be issued so that the general public can purchase them as a way of saving?*

PRESIDENT (in Cantonese): Mr Albert CHAN, the subject of this question is the issuance of bonds by the Government, that is, the simplification of the issuance process for bonds, however, you are asking the Government when it is going to issue bonds, am I right? What is the relationship between the two?

MR ALBERT CHAN (in Cantonese): *Madam President, when things are simplified, naturally things can be done faster. In other words, can the Secretary comment on when the process will be simplified to such an extent that this can be done as soon as possible?*

SECRETARY FOR FINANCIAL SERVICES AND THE TREASURY (in Cantonese): Madam President, the relevant process is already very simplified and although the relationship between simplification and the timing of bond issuance is rather remote, still I will try to tackle Mr Albert CHAN's supplementary. The Financial Secretary mentioned in the Legislative Council meeting on 22 October that insofar as the issuance of bonds to fund investments in infrastructural projects is concerned, the Government would adopt a proactive approach. In this regard, I can assure Members that the Government will frequently review this matter and will do the appropriate thing at the appropriate time. I have also mentioned in the main reply that, although so far the present Administration has not issued any bonds, as Members all know, we very much encourage public corporations such as the KCRC and the Airport Authority, which are organizations wholly owned by the Government, to issue bonds, in particular retail bonds. These organizations have worked on this area with great success. Therefore, although the Government itself has not issued any bonds so far, these public organizations have made investments in infrastructural projects and issued bonds that were well-received by the market.

MR HUI CHEUNG-CHING (in Cantonese): *Madam President, the Secretary mentioned in part (a) of the main reply that an issuer may issue awareness advertisements so long as the relevant guidelines are complied with. In this connection, may I ask the Secretary if information such as the fundamental risks involved in buying bonds or the charges to be borne by the buyer are prescribed in the guidelines, so that retail investors can grasp the basic information before they make investments?*

SECRETARY FOR FINANCIAL SERVICES AND THE TREASURY (in Cantonese): Madam President, as far as I can remember, when the Airport Authority issued bonds, it placed an advertisement in the newspapers setting out the interest rates, the term of bonds, and so on. At present, generally speaking, information in many areas, such as the ratings of retail bonds, have to be made public. We believe that in this regard, plenty of information is already available to the public in purchasing bonds. Furthermore, the SFC will also step up its monitoring in this area.

DR TANG SIU-TONG (in Cantonese): *Madam President, the Secretary mentioned in the last paragraph of the main reply that the Government will continue to promote the development of the bond market, in particular that for retail bonds. Will the Government impose restrictions on the issuance of debentures and establish a rating system in Hong Kong, so that debentures rated as junk will not be offered at the retail level in Hong Kong?*

SECRETARY FOR FINANCIAL SERVICES AND THE TREASURY (in Cantonese): Madam President, the issuance of bonds is a market activity. However, concerning the tax incentives I have mentioned, for example, when institutional investors buy bonds from us, if the bonds are of a poor rating, as Dr TANG Siu-tong has said, they would not be entitled to any tax incentives. Moreover, when issuing bonds, especially retail bonds, the financial institution responsible for issuance has to explain the rating to investors. However, we always hope that the public will understand that the purchase of bonds carries risks, that is, a great deal of risk is involved as far as the rating is concerned. Therefore, we must not merely look at the interest rate but also the rating of the company concerned when purchasing bonds. That was what I meant when I said in my main reply that we hoped the SFC and various institutions concerned would step up publicity and education on bond investment. We should not think that buying bonds is definitely risk-free. The ratings of some bonds may change or be downgraded and there is some risk. Of course, there will not be any problem in buying bonds issued by the Hong Kong Government. *(Laughter)*

DR TANG SIU-TONG (in Cantonese): *Madam President, I wish to seek elucidation on one point. The Secretary said just now that the ratings of some bonds would render them ineligible for tax incentive. May I know if the rating criteria are spelt out clearly?*

PRESIDENT (in Cantonese): Dr TANG Siu-tong, I am sorry, this is not a follow-up but a supplementary. I do not think you will have any chance of raising any further questions today, since 19 minutes have been spent on this question. I will now allow the last supplementary.

MR HENRY WU (in Cantonese): *Madam President, I would like to thank the Secretary for coming before us and introducing the many areas of work done by the Government. I also hope that the Secretary can give an account on how, although this is not the subject of the question today, more small and medium brokerages can be allowed to take part directly in the sale of bonds in future, albeit this is another subject. More importantly, in the entire main reply, the Government tells us that it has done a lot and the time for making preparations has been shortened with regard to awareness advertisements, dual prospectus and other areas. May I ask the Secretary if, after all this work, he knows the length of lead time shortened compared with the past?*

SECRETARY FOR FINANCIAL SERVICES AND THE TREASURY (in Cantonese): Madam President, I believe Mr Henry WU will understand that the lead time in each case is different because many details are involved, so we cannot say that three months were needed in the past, whereas only one month is now required. However, I can share with Members some of my personal experience. Take the issuance of retail bonds by the KCRC as an example, at that time the Board of Directors was also a bit worried. I would say that the lead time, which was measured in terms of months, would be somewhere between one month or two months. It turned out it only took us 10 days on that occasion to give the approval. I am aware that recently, some issuers of bonds have sung high praises of the efficiency of Hong Kong, that is, of the SFC.

PRESIDENT (in Cantonese): Last oral question.

Retail Bonds

2. MR AMBROSE LAU (in Cantonese): *Madam President, regarding the Hong Kong Link 2004 Limited Retail Bonds, will the Government inform this Council:*

- (a) *of the experience gained in the first issuance of such bonds; and*
- (b) *whether it will continue to issue government bonds of this type; if so, of the details and how it will proceed with future issuance work by reference to the above experience; if not, the reasons for that?*

SECRETARY FOR FINANCIAL SERVICES AND THE TREASURY (in Cantonese): Madam President,

- (a) The Government is committed to developing the local bond market to consolidate Hong Kong's position as an international financial centre. The offering of \$6 billion securitization bonds backed by revenues to be generated by government-owned toll tunnels and bridges has turned a new page of the development of our financial industry by being not only the first securitization bond offering by the Government, but also the largest securitization bond offering ever in Hong Kong, and amongst the largest in the region. In addition, it is the first securitization bond offering to local retail investors, with the retail bonds being distributed through the largest

retail distribution network ever established for a bond issue in Hong Kong. Over 800 branches of 23 placing banks were involved, along with 89 brokers who participated via the Central Clearing and Settlement System (CCASS) of the Hong Kong Stock Exchange.

The Government has gained invaluable experience from this offering, including:

- (1) Hong Kong investors in general are very interested in retail bonds and their oversubscription by more than two times reflects the significant development potential of the local retail bond market. This has important implications for the Government and other public and private entities when deciding their future financing plans.
- (2) Retail investors have demonstrated that they are adequately familiar with the investment risk (interest rate risk in particular) through their participation in this offering. Their relatively greater demand for bonds of shorter maturity reflected their consideration of future interest rate movements on the bond price. Indeed, the Government and other concerned parties, such as the Hong Kong Capital Markets Association, have put in a lot of effort in educating our investors in the past. I have explained bond market development in my regular column and also reminded the public that they should pay attention to the interest rate risk and credit rating of the bond issuer. In my speech at the launching ceremony of this offering, I also reminded investors that they should seek advice from their financial adviser before making any investment decision. In addition, we also organized several educational seminars on bond investment for Chairmen and Vice Chairmen of the District Councils as well as other local participants with the goal of enhancing public knowledge of bond investment.
- (3) About 5% of the subscription amount was received from brokers through CCASS, as part of our wide distribution network. This has laid down a good foundation for further participation of brokers in future retail bond offerings.

- (4) Response from institutional investors to this offering was overwhelming and the notes were oversubscribed by three times, indicating their demand for this type of bonds.
- (b) We have no immediate plan to issue another securitization bond. Our focus now is to plan for the issue of government bonds within 2004-05. We will certainly build on the invaluable experience just mentioned to ensure that we can successfully implement the plan to issue government bonds and further widen the distribution network. This will further develop our bond market and encourage private entities actively to consider bond issuance as a funding alternative. Ultimately, this will propel forward the development of Hong Kong's financial industry and even our economic development as a whole.

MR AMBROSE LAU (in Cantonese): *Madam President, in the main reply, the Government mentions its "glamorous achievements", saying that the current securitization bond offering is the "No. 1" in three respects. And, the Government thus concludes that there are great development potentials for the local retail bond market, and this will carry important implications for future financing plans. But then, in part (b) of the main reply, the Government says, "We have no immediate plan to issue another securitization bond." Why is it that despite the avowed success and "glamour", the Government does not plan to carry on?*

SECRETARY FOR FINANCIAL SERVICES AND THE TREASURY (in Cantonese): Madam President, I wish to thank Mr Ambrose LAU for his supplementary question. As mentioned in the main reply, our focus now is to plan for the issue of government bonds. It is hoped that after the completion of this task, we will have time to explore what other government assets can generate revenue. Such studies are required because the issue of government bonds requires much more than a simple desire on our part. The issue of securitization bonds, in particular, must be backed up by stable revenue. There must be a very high credit rating in terms of revenue stability before such bonds can be issued. Therefore, we must consider what types of government assets can fulfil such a special requirement on bond issuing. I can, however, assure Members that we will definitely keep up our efforts in this respect.

MR BERNARD CHAN (in Cantonese): *Madam President, it is mentioned in point (4) of part (a) of the main reply that the response from institutional investors was overwhelming. The insurance sector, which I represent, for example, very much welcomes the issue of such bonds. But it also hopes that there can be longer maturity in order that some hedging could be provided in respect of our liability. Bonds of longer maturity will thus be more suitable for us. May I therefore ask the Secretary whether products of longer maturity will be considered when similar securitization bonds are issued in the future?*

SECRETARY FOR FINANCIAL SERVICES AND THE TREASURY (in Cantonese): *Madam President, many thanks to Mr Bernard CHAN for his very good advice. The securitization bonds offered to institutional investors this time around are of a 12-year maturity period. But we are permitted to effect early settlement before the expiration of the 12-year period. Why is there such a structure? The reason is that we estimate that the revenue generated by the tunnels and bridges will be sufficient to enable us to effect early settlement in less than 12 years. Such a maturity period may not be very suitable for insurance companies, but we do note the voices of the insurance sector. So, with the permission of the Legislative Council, we will certainly consider this point the next time when any government bonds are to be issued.*

MR MA FUNG-KWOK (in Cantonese): *Madam President, it is mentioned in part (b) of the Government's main reply that there is no immediate plan to issue another securitization bond. But I note that the Government has recently announced the construction of Route 8 connecting the Stonecutters' Island. A total of \$2.7 billion will be spent on constructing the longest cable-stayed bridge in the world. As announced by the Government, the use of some sections of this bridge will be toll-free, but tolls will be charged for at least one section (the tunnel). This means that revenue will be generated. Since there will be revenue, why did the Government say just now that no project with revenue can be identified for the issue of securitization bonds? The fact before us is that there is a project that would generate revenue. Furthermore, if bonds have already been issued for a new project that is not yet developed, and if the bonds can sell well, it will prove that the new venture is feasible. This is actually a very important means to improve the governance of the Government.....*

PRESIDENT (in Cantonese): Mr MA Fung-kwok, I see that you have made a very good proposal. But it is the question time now, so.....

MR MA FUNG-KWOK (in Cantonese): *I just wish to ask the Government why it does not consider this readily available venture.*

PRESIDENT (in Cantonese): A straightforward question like this will be good enough.

SECRETARY FOR FINANCIAL SERVICES AND THE TREASURY (in Cantonese): Madam President, this is a very good supplementary question, one which brings us back to the reason why investors want to purchase securitization bonds. The reason is that they are certain that they will be able to recover their costs. The bridge mentioned by Mr MA Fung-kwok will be a new bridge, and no revenue has yet been generated. It is therefore impossible for us to obtain any credit rating to convince others that its revenue will be sufficient to cover its costs. The success of the "Hong Kong Link" this time around is very much due to the fact the revenue of the tunnels has been very steady over the years; the annual revenue of the "Hong Kong Link" is about \$1.5 billion. This therefore gives investors confidence. But investors may not have any confidence in a new project, and may not be sure whether there will definitely be any revenue.

As for the proposal on issuing bonds for this project, I must say that the proceeds from the \$20 billion bonds will also be used for the project. In a way, the proceeds from issuing bonds will already be used for the bridge, though we cannot say very directly that the money is raised for this particular project.

As for why bonds cannot be issued for this project, I should say that if the bridge can yield steady revenue after its completion, we will not rule out such a possibility. However, since the question is on whether there is such a plan now, we can only answer that there is no such a plan for the time being.

MR CHAN KAM-LAM (in Cantonese): *Madam President, the Secretary says that a lot of valuable experience has been gained. Since there is an oversubscription by more than two times, may I ask whether the Government has*

ever thought, while deciding on the interest rates and prices of bonds, that it should offer less to investors due to huge oversubscription?

SECRETARY FOR FINANCIAL SERVICES AND THE TREASURY (in Cantonese): Madam President, frankly speaking, the pricing of bonds is not decided by any single hard-and-fast formula, but by a variety of factors, including the credit rating of the bond-issuer (which, in this case, is quite high), the types of bonds to be issued (the prices of securitization bonds, for example, are lower than those of ordinary bonds), interest rates and the prevailing market conditions. In this respect, there can be a great difference. In the case of institutional investors, we will first ascertain the rate of oversubscription before setting down an interest rate. This time around, after announcing the price, we noticed that there was huge oversubscription, so we lowered the interest rate; this means that we will not have to pay so much in interest. This mechanism of course worked to the advantage of us as a bond-issuer because once we knew that there were so many people who wanted to purchase our bonds, we could narrow the interest rate differential. But the case of retail bonds is a bit more difficult, because under the existing mechanism of retail bonds, as soon as the issuing of bonds is announced, we have to set down an interest rate differential (which is several points above that of Exchange Fund Bills). Since the interest rate differential has to be fixed right at the beginning, there may be no purchaser if it is not set at an appropriate level; and, there may be many purchasers if it is set too high. All this required good judgement. We therefore have to count on professional experience, meaning that we have to count on the arrangers to tell us what the price should be.

We have gained some experience this time around. But we also have to admit that the pricing of retail bonds was not as flexible as that of bonds for institutional investors. This time around, we in fact narrowed the interest rate differential by many points before concluding our deals with institutional investors. There was, however, no such flexibility for retail bonds. But we are still pleased to see that most people in the market felt that we had done well in pricing.

MR JAMES TIEN (in Cantonese): *Madam President, it is mentioned in the last paragraph of the Secretary's main reply that "we have no immediate plan to issue another securitization bond" (similar to the "Hong Kong Link", that is), but that their "focus now is to plan for the issue of government bonds within 2004-05".*

Madam President, I remember that when the issuing of bonds was discussed in the Legislative Council in the middle of last year, there was the SARS outbreak, and caught in financial difficulties, the Government said that it would not be able to make ends meet without borrowing money. As recently announced by the Financial Secretary, the fiscal deficit last year has come down drastically from \$78 billion to \$40 billion. We must congratulate the Government on doing so well, on saving \$38 billion. But I wish to ask the Government whether it is still necessary to issue \$20 billion of government bonds?

SECRETARY FOR FINANCIAL SERVICES AND THE TREASURY (in Cantonese): Madam President, since there is a deficit in the Capital Account under the Budget this year, we intend to issue \$20 billion of government bonds to make up for this deficit first. So far, we have been proceeding with the scheme set down by the Financial Secretary in the Budget he announced on 10 March. As Members are aware, the formulation of the Budget was based on quite a number of assumptions, and we may not necessarily receive some of the expected revenue as scheduled. And so, judging from the current situation, the \$20 billion bonds scheme will proceed as scheduled.

DR LAW CHI-KWONG (in Cantonese): *Madam President, it is mentioned in point (1) of part (a) of the main reply that the oversubscription this time around will have important implications for the Government when deciding its future financing plans. Will the Secretary please share with Members of this Council what these implications are? Does he mean that securitization bonds will also be issued as a means of financing for long-term infrastructure projects expected to yield reasonable returns in the future?*

SECRETARY FOR FINANCIAL SERVICES AND THE TREASURY (in Cantonese): Madam President, I believe Dr LAW Chi-kwong also knows that the Government has been making great efforts to promote the bond market, especially the local bond market. The experience this time tells us that there are substantial market prospects for retail bonds in Hong Kong, and people are completely aware of the risks involved. The retail bonds issued this time amount to roughly \$2.2 billion, but a total subscription of \$7.7 billion has been received. This shows that Hong Kong people do have plenty of money and wish to look for investment opportunities.

I would also like to take this opportunity to say that retail bonds are not issued only in Hong Kong, but also in many other countries. In countries such as Canada and Japan, such an investment tool is also available to the people. Public corporations have also issued plenty of retail bonds; in fact, the Government, the Kowloon-Canton Railway Corporation, the MTR Corporation Limited and the Airport Authority have also issued retail bonds. I hope that more private institutions can make use of retail bonds as a means of raising capitals. That way, investors can be offered an additional choice, and besides turning to banks and the bonds market, bond-issuers can also have one more channel to raise capital.

DR LAW CHI-KWONG (in Cantonese): *I am sorry, but the Secretary has not answered my supplementary question. His reply is about the financing strategy of the Government and other public institutions. But my question is not about the market, but about the financing implications to the Government.*

SECRETARY FOR FINANCIAL SERVICES AND THE TREASURY (in Cantonese): Madam President, I am sorry that I could not quite catch the focus of Dr LAW's question just now. On financing strategies, with respect to the issue of \$20 billion bonds this time, the implication is that even if we try again to raise capitals in the retail bond market, there will not be any problems.

PRESIDENT (in Cantonese): The Council has spent more than 17 minutes on this question. We will now proceed to the third question.