GLOBALISATION OF THE FINANCE AND CAPITAL MARKETS

Hong Kong and the Asian Capital Markets

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THE REGIONAL FINANCIAL TURMOIL

It is deeply ironic that any consideration of the Asian finance and capital markets today must begin by considering the current regional financial turmoil. It was only five years ago that the World Bank issued its famous study of economic growth in East Asia called *The East Asian Miracle*, a title which expressed the sentiments of the great majority of economists, financial market participants and commentators worldwide at that time. In 1996 Jim Rohwer, the Chief Economist for Asia of CS First Boston published an acclaimed book called *Asia Rising*, a phenomenon he described as *the greatest and most thrilling event of the last half of the century*. Yet one year later Mr Yen, Dr Sakibara of the Japanese Ministry of Finance, was describing developments in Asia as a *crisis of global capitalism*. What happened and how has it impacted on the Hong Kong market in particular?

The regional financial turmoil started off in Thailand in the middle of 1997 and quickly swept through to the rest of South East Asia. In late May 1997, the Thai baht came under severe speculative attack. Selling pressure was also felt in the Philippine peso and Malaysian ringgit. On 2 July 1997, the Bank of Thailand announced the adoption of a *managed float* regime for the Thai baht. The value of the baht immediately fell by more than 10%. In the two weeks that followed, the authorities in the Philippines allowed the peso to float and the Indonesian and Malaysian authorities allowed the rupiah and ringgit to depreciate.

In August 1997, the second wave of speculative attacks took place. All ASEAN currencies subsequently fell, with the baht, rupiah and ringgit depreciating more sharply than in July 1997. Major corrections set in across regional stock markets.

During this time, the Hong Kong dollar remained unaffected. The stock market, however, experienced a significant fall as a consequence of the tumbling of other regional markets, partly due to the general atmosphere and partly because Hong Kong remained the most liquid market in the region. This allowed fund managers to liquidate their positions in order to meet demands for redemption on regional funds. By 15 October 1997, the Hang Seng index had fallen by 20% from its historical high in early August 1997, closing at 13,384.

On 20 October 1997, the New Taiwan dollar depreciated by 5.8%, as a result of the Taiwanese government's announcement that it would allow the currency to float. This sparked off speculation on the resolve of the Hong Kong authorities to maintain the linked exchange rate with the US

dollar. On the same day, Morgan Stanley published the recommendation of one of its analysts to unload Asian stock holdings, including Hong Kong shares.

On 21 and 22 October 1997, the Hong Kong dollar was under heavy speculative attack. There was massive short selling as well as hedging in the forward market. With the ensuing liquidity squeeze and interest rate hike (the overnight interbank rate surged to a record high of 280% on 23 October), coupled with the market's reaction to the Morgan Stanley recommendation, the Hang Seng index plunged 10.4% on 23 October 1997 and at one point was as low as 9,766 (16% down). Daily turnover totalled HK$34 billion compared with an average daily turnover of HK$12.63 billion in the first half of 1997.

The Hang Seng index rebounded strongly by 718 points (6.9%) on 24 October, mainly encouraged by an easing of the pressure on the dollar peg and interest rate adjustments. Turnover remained high at HK$30 billion. The market continued to remain highly volatile in the following couple of days. Led by the fall of the Hang Seng index, the Dow Jones Industrial Average plunged by a record 554 points (7.2%) on 27 October 1997, which in turn triggered the largest single day fall of the Hang Seng index on 28 October by 1,438 points (13.7%). Following the rebound of the Dow Jones on 28 October, the Hang Seng index also opened high on 29 October and closed with its largest single day gain of 1,705 points (18.8%). This period of high volatility and high turnover continued up to 4 November.

In the months that have followed, the turmoil has continued in the region. As is well known, the resulting problems have had the most severe repercussions in Indonesia and South Korea. However, in all the affected economies, the most conspicuous features of the turmoil were dramatic falls in the stock markets, an upsurge in interest rates and, with the exception of the Hong Kong dollar, highly volatile exchange rates. The general business climate has deteriorated markedly, with increased stringency in the banking sector on account of falling collateral values and deteriorating loan qualities. This in turn has led to a widespread liquidity squeeze. The knock-on effects have been evidenced in reduced investment and consumer spending, reduced economic growth and an increase in unemployment. Hong Kong could not, of course, stay immune to the regional contagion. Whilst the Hong Kong dollar has remained stable and the effects on interest rates and stock market prices in Hong Kong have been reasonably contained, the effect of the regional economic crisis on financial markets' activity in and out of Hong Kong has been very significant.

HONG KONG MARKET ACTIVITY

Pre-October 1997

A period of exceptional buoyancy in the Hong Kong economy from 1995 onwards created a highly bullish outlook which drove stock and property markets to excessive heights. For example, residential property prices rose on average by as much as 80% to a peak in October 1997 in under two years. The Hang Seng index grew by 140% to its record high in August 1997 in two and a half years. In this environment, there was a tremendous surge in equity issues, with the P/E ratios for H shares (PRC State-owned companies listed on the Hong Kong stock exchange) averaging 30 times and those for Hong Kong blue chips averaging 17 times. In retrospect, while the fundamentals of the Hong Kong economy at that time remained generally sound, asset prices had escalated to unsustainable levels well above the underlying fundamentals.

Capital markets activity in Hong Kong was also buoyant during this period, principally with relatively vanilla FRCD, FRN and MTN programmes for Hong Kong banks and corporates. As of October 1997 the total size of the Hong Kong dollar debt market was HK$346 billion (US$45 billion).

The domestic bond market was developing, although more slowly than one might have expected for an international financial centre like Hong Kong. Reasons for the underdeveloped bond market included:

(a) the majority of domestic bonds were effectively short-term syndicated loans (with the bank syndicate buying the debt and holding it to maturity);

(b) little active trading;

(c) lack of a proper sovereign yield curve or government benchmark against which corporate bonds could be priced. For some time the Hong Kong Government has run substantial budget surpluses so there has been no need to launch debt programmes;

(d) lack of a large pool of pension funds which would provide longer term investors;

(e) the attitude of local issuers who were traditionally adverse to long-term debt.

Securitisation activity increased in Hong Kong, and the Asian markets generally, during the year ending 30 June 1997. The majority of the Asian asset-backed securities were issued in the Euromarket, with a small number of issues privately placed in the US 144A market. However, the securitisation of the Hong Kong Telecom staff residential mortgage loan portfolio, which closed in June 1997 and was arranged by Societe Generale, represented an encouraging development in the local capital market as it was denominated in Hong Kong dollars and tapped the local investor base. Most of these Asian securitisation transactions featured credit enhancement in the form of financial guarantees provided by US or regional monoline insurers.

The Hong Kong Monetary Authority established the Hong Kong Mortgage Corporation in March 1997. It obtained public sector entity status in July 1997 and by October 1997 had fully paid up capital of HK$1 billion. In October 1997 it had signed master agreements with eight approved banks and in November 1997 it purchased its first block of mortgages from four sellers.

The general role of the HKMC is to improve banking and monetary stability, develop the local debt market and promote home ownership. It does this by way of purchasing mortgages from local banks and holding them in a retained portfolio which backs the debt securities it issues in the local market to fund itself. Approved sellers are able to securitise assets quickly, utilising a regular source of liquidity. Unlike the private sector securitisation participants, the HKMC is able to purchase small size transactions, although it is generally more expensive than a more structured private sector transaction. Its documentation is highly standardised along vanilla securitisation lines, which has obvious advantages and disadvantages.

Post October 1997

Since the regional economic turmoil hit Hong Kong in October 1997 there has been minimal capital markets activity in, or out of, Hong Kong. The Japanese banks, in particular, appear to have largely withdrawn from the Asian capital markets altogether. In an interesting reversal of the disintermediation which is normally a feature of developed financial markets, there has been a very strong move in the Hong Kong market in the past six months back to relationship banking and straight-forward syndicated loans. This has led to an aggressive culling of credit lines by a number of banks and sharply higher pricing on roll-overs and new facilities. It has also resulted in much greater focus on the market disturbance and repricing provisions in syndicated loan documentation than has been the norm in the Hong Kong market in the past.

Mortgage-backed issues in the Hong Kong market have been on hold since the October 1997 turmoil. This was primarily due to the inversion of the Hong Kong dollar yield curve which began in October 1997 due to market fears of a sudden liquidity squeeze resulting from attacks on the dollar. One month HIBOR shot up to a high of 45% on 23 October 1997. Although it eased significantly over the next two months it remained well above the Hong Kong prime rate on which interest rates for Hong Kong residential mortgages are based. This made it extremely difficult to price the HIBOR/Prime swap for mortgage-backed deals and, where possible to do so, very expensive. The Hong Kong Mortgage Corporation has also been quiet during this period, largely due to pricing difficulties. In a disturbing development for securitisation in the region, Asia's only specialised financial guarantor – Asian Securitisation and Infrastructure Assurance (ASIA) – had its rating cut by six notches to junk in January.

The corporate banking market in Hong Kong, let alone elsewhere in the region, remains very tough indeed. This is an environment in which asset deflation has severed most corporate issuers' ability to raise equity capital. Not surprisingly, there is a great deal of work-out and restructuring work going on in Hong Kong and the regional markets and, unfortunately, a fair amount of insolvency work. To date, the two highest profile defaults in Hong Kong in the wake of the regional economic turmoil have resulted in the appointment of liquidators to the Peregrine Group, one of the largest local investment groups, and CA Pacific Group, whose difficulties primarily related to liabilities incurred in margin trading activities by a finance company subsidiary.

The regional debt restructuring initiatives are to be considered in a session later today and for now I would like to focus on two specific transactional areas in which there have been some interesting developments since October 1997 – export future flow securitisations and project bonds.

EXPORT FUTURE FLOW SECURITISATION

One significant product of this regional economic turmoil has been the severe limitations which it has imposed on the options available to regional corporates looking to raise capital. With the bond and equity markets largely illiquid and currency devaluation making normal debt service problematic in many cases, there has been increasing interest in securitisation structures which can mitigate transfer risk (essentially, the risk of declaration of a moratorium on debt repayment making it illegal for borrowers to service debt) and convertibility risk (legal or practical restrictions on access to foreign exchange due to a shortage of foreign currency or efforts to maintain an exchange rate system).

Export future flow structures were first developed after the Mexican peso devaluation and used successfully for top quality Latin American corporates that could not otherwise access the international capital markets at that time.

The first securitisation deal done in South East Asia since the regional crisis is an export future flow transaction arranged by Daiwa Securities for Wongpaitoon, a sports shoe manufacturer in Thailand. Wongpaitoon, which supplies 10 to 15% of all Reebok's shoes, raised US$100,000,000 in May 1998 by selling forward all its rights to its export receivables for the next five years to a Cayman Islands special purpose vehicle. This entity raised the US$100,000,000 by issuing debt securities into the US private placement market. It is understood that Wongpaitoon's customers (principally Reebok) have agreed to make payments due directly to a trust account in the United States administered by a trustee for the benefit of the holders of the debt securities issued by the SPV. Payments on these debt securities are made with funds from this trust account.

There are a number of securitisation deals of this nature in the pipeline, particularly in Thailand at present. An advantage of an export future flow structure is that by re-directing the company's hard currency cash flow offshore it can enable a company to achieve investment grade financing even though it is located in a non-investment grade country. This circumvents the so-called sovereign ceiling which the international rating agencies impose which means that a corporate credit rating cannot exceed the sovereign rating of the jurisdiction in which it is located.

There are, however, a number of risks inherent in export future flow structures. The first is operating or performance risk – will the manufacturer/exporter discharge its obligations so as to generate the receivables which are to be paid into the offshore trust account. The more brutal methods of addressing this risk include significant cash flow over collateralisation and debt service reserve accounts in amounts equal to at least 6 months debt service. Of course, the rating agencies also seek to conduct detailed analysis of the relevant company, management capability, liquidity, industry trends, competition, etc.

The second major risk is that the company or the government of the country in which it is located will subsequently seek to direct the foreign customers to make payments to the company or the central bank rather than to the offshore trust. This risk is usually mitigated, to the rating agencies' satisfaction, by the company giving irrevocable sale notices and payment directions to the

customers and by the SPV obtaining from them irrevocable contractual undertakings to make payment directly to the nominated trust account.

Price risk may be addressed by a fixed price or price formula with a fixed minimum price. The rating agencies will usually require stringent base case debt service coverage ratios. Of course, where appropriate, price risk may also be addressed by commodity price swaps, options and other hedging contracts.

PROJECT BONDS

Prior to last year's market meltdown the use of project finance bonds to fund Asian infrastructure projects had been growing apace after a relatively slow start in 1995. For example, a number of issues were done in the first half of 1997 on strategic highway projects in the PRC, including the Beijing ring road. Whilst I do not propose to dwell here on the general structure for secured bond issues for project financing (many of you will be very familiar with this) I would like to look quickly at a few features of a China project bond issue launched recently.

The fact that the first project bond issue after the recent Asian markets turmoil should be backed by a PRC project is no surprise. The PRC is an enormous emerging market with a huge appetite for infrastructure funding and, during a period when almost every other Asian country has experienced alarming turmoil China has, so far, emerged relatively unscathed.

The deal, which was arranged by Merrill Lynch, does however represent a major achievement given current market circumstances and the fact that investors take real project risk (which has not been common in Asian deals).

The issuer is a British Virgin Islands company, Traffic Stream (BVI) International Ltd, which is 21% owned by China Non-Ferrous Metals. Traffic Stream is the controlling shareholder in a number of Sino-foreign incorporated joint ventures which hold concessions to, and operate, toll roads in Guangdong and Shandong provinces. The US$119,000,000 bond issue was launched last month with an 8 year tenor and is listed in Luxembourg as a Euro 144A with registration rights. Rated BB-/Ba3 the issue is also callable in year five at 108%, in year six at 105% and in year seven at 102%, with a semi-annual coupon of 14.25%.

Security was taken over all Traffic Stream's interests in the relevant toll road concession rights and related joint venture assets but no recourse was provided to Traffic Stream's shareholders. Requirements under the bond indenture include:

(a) debt service coverage of 1.75 times net revenues received from the joint ventures;

(b) a debt service reserve funded up to US$30,000,000 by payments to a sinking fund;

(c) a fully funded interest reserve equal to 6 months interest cover;

(d) no distributions unless, amongst other restrictions:

    (i) all projects are fully completed, with operational electronic toll systems;

    (ii) actual debt service coverage ratio is at least 2.25;

    (iii) the debt service reserve account is fully funded;

    (iv) at least 365 days of interest cover is held in the blocked interest reserve account.

The relevant provincial governments have undertaken to ensure sufficient US dollars are available to convert toll road incomes from Renminbi into US dollars for payment through to Traffic Stream.

Whilst the structure of this deal is not novel in project finance terms it does represent a step forward in the prevailing Asian markets and we may well see more bond issues structured along similar lines used to fund infrastructure projects in China in particular. To set this in context, the Asian Development Bank has estimated that as much as US$1.5 trillion will be needed to fund physical infrastructure development in Asia in the next ten years. It is estimated that at least 30% of this demand will be generated by China. The reality at present, however, is that whilst the sponsors of a number of prospective Asian infrastructure projects are busy in the market, financiers are extremely cautious – and, for good reasons, likely to remain so for some time yet.