

listed in Hong Kong in 1995 were not Hong Kong incorporated companies.³⁵ This phenomenon has mainly occurred since the early 1980s. In 1984 only 5% of companies listed in Hong Kong were not incorporated in the territory. Apparently this situation came about mainly as a result of companies feeling more comfortable redomiciling themselves in a jurisdiction which was not soon to revert to Communist Chinese sovereignty.

Between 1984–1994, 31% of the companies which were already listed on the SEHK moved their domicile out of Hong Kong.³⁶ Furthermore, a growing number of companies listing on the Exchange in the past few years have been incorporated outside Hong Kong (90% of those listed in Hong Kong in 1995, which were not mainland connected were registered outside Hong Kong).³⁷ Most of those companies listed in Hong Kong which are incorporated offshore (and excluding those registered in the PRC) are registered in Bermuda with a small percentage in the Cayman Islands.³⁸ The reason that such companies choose these particular locations is that their Companies Ordinances are sufficiently similar to that of Hong Kong for the Exchange to permit the arrangement. These locations have been approved by the SEHK as acceptable domiciles for Hong Kong listed companies (along with the Cook Islands).³⁹ Furthermore, in these locations capital tax exemption on new share issues may be obtained.⁴⁰

Spin-off listings

While all the characteristics outlined above have been longer term phenomena in this market there is one relatively new development which began in the mid 1990s. In late 1993, Hopewell Holdings, a local engineering company active in power station construction in China and the Asia Pacific region, spun off its power-generating assets into a separately listed subsidiary, Consolidated Electric Power Asia or CEPA. This began a trend which, over the ensuing three years, has seen many of the major local property companies spin off their China related infrastructure businesses into separately listed subsidiaries, raising funds for their China activities. The new spin-off companies included Henderson China Holdings, New World Infrastructure and Cheung Kong Infrastructure. As with all new market fashions the Exchange was anxious to ensure that this one did not lead to losses

35. SFC Annual Report, 1995.

36. *Asian Wall St Journal*, 15 May 1996, p 6, 'Boltholes for Hong Kong Business' David Newman, Lingnan College and David Weimer, University of Rochester, NY.

37. *Ibid.*

38. SFC Annual Report 1995.

39. *International Corporate Law*, Issue 24, May 1993, p 27, 'Transferring Hong Kong Corporate Domicile'.

40. Tim Lewis, *Practitioners Guide to the Listing Rules*, Accountants' Reports, 1994, ISI Publications.

for investors. In September 1996, as many smaller companies began to come forward with applications for separate listing of subsidiaries with discreet businesses, the Exchange announced that it would be reconsidering the rules governing such listings and possibly impose a minimum listing period for the parent company before spin-offs were permitted.⁴¹ The project companies take advantage of a provision in the Listing Rules which permit them to list without a three-year track record.⁴²

Steps in the listing process in Hong Kong

Decision to list: Why do companies list their shares?

There are generally five reasons why companies choose to list their shares on a stock exchange, rather than attempting to sell equity in their company privately.

- (1) It can enable a company to raise more funds than would be available otherwise.
- (2) It opens up greater alternatives for future fundraisings such as convertible bonds and rights issues.
- (3) It is a way of establishing a price for the shares and a market value for the company. This may be of particular use to a company interested in merging with other businesses or acquiring other businesses using its own shares rather than cash.
- (4) It is considered to give a company greater prestige.
- (5) It enables the existing owners of the company to partly 'cash out' of the company, releasing funds for other purposes.

In different markets the importance of these factors varies. While the importance of establishing a market price for shares for takeover purposes may be a major consideration for US companies, in the Hong Kong market the single biggest consideration is probably the ability to easily 'cash out' a part of one's stake in a family company. As mentioned above, Hong Kong listed companies appear to have been particularly successful in doing this with a minimum loss of management control.

In addition to the above considerations, the Chinese state enterprises listed as 'H' shares in Hong Kong, have probably been listed, as much as anything, for purposes of introducing market discipline to the management of such companies.

Before listing

Before the decision to list is made a company must make an even more fundamental decision. Should it finance its growth through debt

41. *SCMP*, Business Post, 14 September 1996.

42. Listing Rules, Chap 8, para 5.

These steps are undertaken in the four following transactions:

- (1) Matching. Ensuring that the records of buyer and seller reflect the same terms of the deal. This can be done by the companies themselves or through a central agency.
- (2) Clearing. Determining who owes what to whom. Can be netted or done on a deal-by-deal basis.
- (3) Settlement. Delivery versus payment of the shares. Entering in the book of each party a reduction/increase in share ownership with a matching increase/reduction in funds. The time from the matching to this settlement taking place is known as the settlement period and this period differs markedly for each market.
- (4) Transfer and registration. This takes place usually after the settlement and involves new share certificates being issued and new ownership being registered on the central registry (previously 21 days in Hong Kong).

This whole process was revolutionised in Hong Kong in 1992 and 1993 with the introduction of AMS and CCASS.

Central Clearing and Settlement System (CCASS)

In May 1989, the Hong Kong Securities Clearing Company Limited (the Clearing Company) was incorporated. The Clearing Company is guaranteed 50% by the Exchange and 50% by five major banks. The Clearing Company was set up to provide securities clearing, settlement and share registration services. In June 1992, the Clearing Company established CCASS.

CCASS is a computerised book-entry clearing, settlement and custodian system which can settle and record trades of any listed share or warrant in Hong Kong. It also allows for the lending and borrowing of shares among its members. Securities are kept in a central depository and all trades are recorded in members' CCASS accounts while corresponding debit and credit entries are made to their designated bank accounts. The Exchange estimated that approximately 24% of all shares of listed companies by value were held in the depository by July 1996¹²² (in New York the number is estimated to be about 35%). 75% of listed securities are entered in the CCASS system. Two sorts of trades can be settled on CCASS. Exchange trades between members of the Exchange in eligible securities (those entered in the system) are settled entirely by computer and over 99% of all trades in this category were settled on CCASS in 1995. The second type of trade is settlement instruction transaction involving matters such as stock lending or broker custodian transactions.

122. SEHK.

After the end of each trading day participants receive statements of all accounts. On T + 1 all final clearing statements of trades are transmitted to the parties for confirmation and reconciliation and on T + 2 electronic debit and credit of stock accounts occurs and electronic money transfer is effected.

In 1994 the Listing Rules were amended to make it obligatory for all new shares to be entered on the CCASS system. The purpose of the CCASS system was to provide both efficient settlement and security for investors, aims which it has largely achieved. However, theft of shares has continued, albeit at a much lower rate, since the system was introduced. In 1995 a theft of over \$260 million of shares was reported, while in October 1996 the press reported that approximately \$40 million worth of shares had been stolen in 12 different incidents over the year.¹²³ The management of the CCASS system points out that these thefts are not due to faults in the system itself but to members not following the security procedures laid down. One cause of thefts has been unscrupulous individual brokers taking their clients' shares. In an attempt to prevent these occurrences it was announced, in January 1997, that CCASS would be able to offer low cost individual accounts by mid-1998, so that investors' shares would be kept securely in their own accounts rather than those of their brokers.¹²⁴

Automatic Order Matching and Execution System (AMS) and the Over-The-Counter (OTC) market

Once the CCASS computerised settlement and clearing system was in place it was finally possible to introduce computer-based trading. AMS was introduced in November 1993 and while it does not require all market participants to do computerised trading it was a first step towards a fully computerised trading system. Prior to that time the trading system in Hong Kong (since 1986 when the exchanges were physically unified) was a computer assisted floor trading system, meaning that brokers input information on their bid/ask price for a particular stock into the teletext system without details of the amount to be traded. Based upon the information displayed the actual trade would take place face to face or on the telephone on the Exchange floor, with the trade to be recorded within 15 minutes of the transaction.

With the introduction of the AMS, a two-track trading system came into existence. All shares would now be 'traded' through AMS meaning that trades would be recorded on the system, however, the AMS would continue to allow the old system to operate, with face to face or telephone trades continuing. However, all shares settled under CCASS were, over a two-year period, gradually fed into the AMS

123. SCMP, Business Post, 12 September 1995 and 19 October 1996.

124. SCMP, Business Post, 3 January 1997.

premium which must be paid by corporate issuers to overcome their disadvantages versus the HKEF paper.

Much to the disappointment of the financial community, when the Sino British agreement on the airport finally came, both the Airport Authority and the MTRC had very much more limited public funding needs than expected. Under the agreement both bodies were to obtain a majority of their new funding requirement from an equity injection by the government. For the MTRC a total of \$35 billion of planned expenditure is to be financed almost 70% by equity injected by the government, with just over \$11 billion dollars to be raised in the debt market. The additional liquidity in the HK\$ loan markets in the 1994–1996 period is often attributed to this reduction in the borrowing requirement for the airport and its related projects.

The Airport Authority (established as the Provisional Airport Authority in 1989) which was long expected to become a borrower to rival the MTRC in the Hong Kong market has turned out to be rather a non-event as a borrower. The airport agreement saw the airport authority received the majority of its funds in government injected equity with just over \$11 billion to be raised in the debt markets. In the event, a majority of this funding was raised not in the bond market but the syndicated loan market.

Government of the People's Republic of China as borrower

As of July 1997 the true sovereign borrower in the Hong Kong market is the PRC. In preparation for the handover of power to the PRC, and in line with Beijing's increased interest in the international financial markets, the financial authorities in Beijing and Hong Kong were in discussion on the subject of PRC bond issues in Hong Kong from at least 1994. Various PRC government owned banks have raised funds in the Hong Kong debt markets and the PRC itself has done a Dragon Bond issue with a dual listing in Hong Kong and Singapore. However, as of 1997, the PRC itself has not directly entered the HK\$ bond market. Nevertheless, the Ministry of Finance in Beijing and the People's Bank of China have publicly stated on several occasions their intention to support the development of the Hong Kong bond markets and to issue paper in this market, both in HK\$ and foreign currencies 'when conditions are right'.⁵²

52. SCMP, Business Post, 1 June 1996, 19 May 1995.

Corporate Bond Market and the NCD Market

Negotiable Certificate of Deposit (NCD) Market

The private sector HK\$ bond market is, in fact, largely not a corporate bond market at all but a market of unlisted bank NCD issues (while the fixed rate non-government market is actually dominated by the supranationals as discussed on pages 198–203). Issues of HK\$ NCDs represented over 69% of all outstanding HK\$ debt other than Exchange Fund bills and notes as of the end of 1996.⁵³ The NCD market, after falling slightly from 1990 to 1991 then grew dramatically from a total size of about \$23 billion in issue in 1991 and to over \$131 billion at the end of 1996, an increase of more than 5½ times. As market practitioners like to point out, if the bond market definition includes unlisted NCD issues then the volume of bond issues in HK\$ over the past ten years has, in fact, made it one of the top ten most active issue currencies worldwide in every year but one.⁵⁴

In most markets around the world, NCDs make up a part of the money markets with maturities of under one year. However, in Hong Kong the average life of NCDs has traditionally been between 1½ to 3 years, with the majority of issuing activity in the 3–5 years range as can be seen from Table 3.4 below.

The NCD issues fall into two categories, the fixed rate CDs issued mainly by local branches of foreign banks and the floating rate CDs issued largely by local banks ('FRCs'). (See Table 3.4 for breakdown.) The very first fixed rate NCD was issued by a local investment bank named Slater Walker Hutchison in 1973, however, the market really began to take off in 1977 when Wardley Limited (the merchant banking subsidiary of Hong Kong Bank, now HSBC Markets) issued a \$50 million fixed rate CD.⁵⁵ The first floating rate CD in HK\$ was issued by Chase Manhattan in 1977⁵⁶ and the market quickly took off. While the foreign banks do much of their funding in the inter-bank market the fixed rate NCD market provides a longer-term funding source, better matched to the tenors of the banks' loan portfolios.

The fixed rate NCD market has been able to take off in a way in which the local corporate bond market has been unable to do because the foreign banks which largely issue the fixed rate NCDs are explicitly, or, most often, implicitly, using their high quality Head Office credit ratings to raise money in the HK\$ market. As mentioned, until 1993 the only local Hong Kong corporate with a credit rating was the

53. HKMA, Monthly Statistical Bulletins, February 1997.

54. P Thomas, Oakreed Financial Services Limited, op cit.

55. B Julian Beecham, *The Monetary and Financial System in Hong Kong*, HK Institute of Bankers, 1996.

56. Ibid.

Japanese lenders in driving loan pricing since the early 1990s have been altogether more cautious on the pricing front, despite their anxiousness to obtain more Asian loan assets.

VI. SECONDARY MARKET IN LOANS AND LOAN SECURITISATION

Asset sales

From the mid 1980s, many major participants in the syndicated loan markets began to feel that they could no longer afford to keep the majority of their loan participations on their books. Even before BIS capital adequacy rules were introduced such banks began to be concerned about the opportunity costs of keeping large loans on their balance sheets for long periods. From this time 'asset sales' became an important part of the syndicated loan business for major banks in the market. 'Asset sales' refers to banks selling their participation in a loan to other banks. Prior to the mid 1980s most borrowers would not permit the sale of their loans among banks.

The basic *raison d'être* of this market is that there are large banks in the syndicated loan market which wish to continue arranging syndicated loans, but do not have the appetite to hold the loans on their books for the full tenor. Being in the syndicated loan business is good for banks' overall business relationships with their major clients. Furthermore, for lead managers and arrangers, relatively attractive fees can be generated. To keep the full participation of past syndicated loans on their books would prevent such banks from enjoying new syndication opportunities. Selling past loans to second banks allows these banks to re-enter the market for new transactions.²⁵

On the other side of the market there are smaller banks with representative offices in Hong Kong and an appetite for Asian assets, but no Asian client base, or an insufficient client base of their own.

While the sale of loans in the secondary market is now a well established phenomenon, the level of the activity is lower than might have been expected in the early 1990s. The biggest reason for this has probably been the reduction of interest among the smaller banks which were the traditional buyers of the assets. In the mid 1990s most banks with a presence in the territory expect to be included in the primary syndication of a loan and therefore have less appetite for the secondary market loan assets being sold.

There are three methods which can be used for the transfer of loans between banks. From the mid 1980s when this was a relatively new phenomenon the assets were sold in one of two ways: sub-

25. Banks rarely sell out their entire loan participation, however, as this is generally considered to put too great a strain on the relationship with the borrowers.

participation or assignment. By the early 1990s the transferable loan certificate (TLC) had become a common structure, partially replacing the other two. However, the number of transactions in the local market done on a TLC basis has dropped since the early 1990s, indicating something of a slowdown in the secondary market (see Chart 4.1).

Sub-participation

Under a sub-participation, the original lenders sell their rights to receive repayment of principal and interest from the borrower in exchange for payment of the original principal amount from the sub-participant. A bank's original participation in a loan may be divided into several smaller amounts for sub-participation purposes.

The agreement between original lender and sub-participant bank(s) outlines the financial terms of the deal and the obligations of both parties. It passes on all obligations of the original borrower to the sub-participant and may state the circumstances under which the sub-participant may require the original lender to act on its behalf, for example in calling an event of default. The sub-participant may not pursue the original lender for repayment if the borrower defaults. The original lender will have liability to the sub-participant only to the extent that the original lender is guilty of gross negligence in its duties. In other words, the loan is sold 'non-recourse' to the original lender. However, the original lender always stands between borrower and new lender and there is no direct relationship between the two.

Such an agreement has the advantage for the original lender that the sale will not be known to the borrower. Thus the bank maintains its relationship with its client. At the same time, if the lender sells to the sub-participant with no recourse to itself, the sale can remove the asset from the seller's balance sheet.

In the early days of asset sales it was often possible for the original lender to keep a small skim on the loan, passing through to the sub-participant a smaller loan spread than paid on the original loan. However, as the market became more efficient and the loan pricing more closely reflected the appetite of the ultimate lenders this arbitrage opportunity generally disappeared. With a very liquid loan market, borrowers which find they can borrow more cheaply in the present market than under existing loans will tend to pre-pay old loans and refinance. Nevertheless, the original lender is generally able to keep most of the fees on the original loan.

To the buyer of a loan in the secondary market a sub-participation agreement would generally be the least attractive method of purchase. Sub-participant banks are often banks with newly established representative offices in Hong Kong anxious to 'put on assets' in Asia to cover overheads. Through this arrangement they are able to receive an income earning asset quickly, but, they are gaining no relationship benefits, as the borrower is unaware of their existence.

in exploration of oil/gas fields and pipelines as well as marketing natural resources such as minerals and timber, because of some tax advantages, which they enjoy in the US. However, this vehicle is not authorised under the current laws of Hong Kong.

Body corporate

This is the most popular structure for projects and it bestows a distinct legal personality on the project entity, independent of its sponsors/shareholders. Therefore it can acquire, hold and dispose of the project's assets in its own name. It also becomes fully responsible for the project's debts and other liabilities so that the members' (ie shareholders') risk is limited to the extent of unpaid amounts, if any, on their shareholdings and/or any guarantees given for the debts of the project corporation. This is an ideal vehicle for project financing on the classical non-recourse model. However as already discussed, currently, most projects are financed on 'with recourse' basis.

In theory, the project itself can also be incorporated with unlimited liability of its members (shareholders) but in practice this is hardly ever done. It is more customary for sponsors/shareholders and some other stakeholders to assume personal recourse for the project's liabilities, in varying degrees. This aspect will be covered in the subsequent section on 'Securities for external stakeholders', in detail.

The following are the two most commonly used variants of the body corporate structure for a project:

Limited liability company

A project entity can be set up as a limited liability company, under the Companies Ordinance (Cap 32) of Hong Kong, with all the above characteristics of an incorporated body. In this connection, it is worth noting that although the advantage of limited liability is also available for limited liability partnerships, the latter structure is hamstrung by the restrictions on the number of partners and on the participation of limited partners in the business affairs. Furthermore, unlike a corporation, in Hong Kong there is no scope for a limited partnership to raise funds through the stock exchange.

Apart from equity contributed by the sponsors, a publicly quoted limited company can raise capital from the general public. Either by private placements or via local and overseas stock markets, it can float ordinary or preferential shares as well as various types of debt instruments. This topic has been covered in depth in the earlier Chapters 2 and 3.

Usually a new company is incorporated for launching and managing a specific project. Typically the day-to-day business is carried out by professional managers, although some sponsors/equity holders will

specialist expertise may also be involved in it. Generally, the latter are represented on the board of directors, so as to control the policy and decision making processes. To ensure their continued control over the project, usually, the sponsors prohibit any one amongst them to transfer/sell its shareholdings and contingent liabilities to third parties, without the collective group consent.

So far as the lending institutions are concerned, they often insist that one or more of the sponsors must assume direct exposure regarding the project's liabilities on a 'recourse' basis. In other words, sponsors cannot simply be 'shell companies' without committing individual material assets to the project.

Statutory corporation

Instead of being incorporated under the Companies Ordinance, a statutory corporation is incorporated by a special enactment of the Legislative Council. All over the world such corporations are formed for projects which are of national interest and importance. Normally they also have a massive capital base.

Thus the Mass Transit Railways Corporation (MTRC) was incorporated under the Mass Transit Railway Corporation Ordinance (Cap 270) to construct and operate the underground railway system of Hong Kong. Likewise, the Airport Authority was set up under the Airport Authority Ordinance (Cap 483), to build and run the new state-of-the-art airport in Chek Lap Kok.

The legal, accounting and taxation positions of all commercial corporations in Hong Kong are the same, whether or not they are incorporated by registering under the Companies Ordinance or by a special enactment in the Legislative Council.¹⁷ However, the importance and elevated status of a statutory corporation is reinforced by the very fact that a piece of legislation is specifically passed for its incorporation.

It is also common for the host government of the country/territory to take a stake in statutory corporations, either by direct investments or by back-up guarantees. This will be taken up later in the chapter, in both the sections on 'Sources of funds' and 'Securities for external stakeholders'. Moreover, these corporations are normally set up as monopolies to run essential services such as public utilities. As a result, the general public is compelled to buy their outputs at prices set up unilaterally without any fear of competition. Therefore, their revenues can be freely increased to some degree, thereby strengthening the project's cashflow potential.

17. However, the Governor-in-Council can specially exempt a statutory corporation from its profits tax liability, under s 87 of the Inland Revenue Ordinance (Cap 112).

The explosive growth of the financial derivatives markets around the world from the 1980s can be largely attributed to the following factors.

- (1) The increased presence of sophisticated institutional investors looking to hedge major portfolios of investments made on behalf of clients.¹²
- (2) This trend has been reinforced by the technological advances which have made it possible for investors to obtain and act on market information very much more quickly than in the past.
- (3) Over this same period the greater integration of financial markets internationally caused by relaxation of national capital controls, as well as technology, has increased the demand for products which help investors hedge their increased international exposure.
- (4) Borrowers attempting to exploit their comparative advantage in different debt markets and arbitraging inefficiencies between the debt markets to which they have access, have largely fuelled the growth in the interest rate swap market.
- (5) Finally, a more erratic interest rate environment worldwide, as governments and central banks use interest rates to protect exchange rates and to achieve domestic economic goals, has made it more necessary for investors to explore all available hedging tools.

In Hong Kong, as in all major financial markets around the world, international institutional investors are becoming the predominant participants. Institutional investors now account for over 60%¹³ of all investment activity in the Hong Kong stock market. These investors can, and often do, 'make or break' the markets in which they invest. In order to attract and maintain the interest of such investors in their markets, regulators in Hong Kong, as elsewhere in the world, have been keen to encourage the introduction of derivatives instruments to provide the hedging tools the major institutional investors require.

Offsetting this enthusiasm for growth in the derivatives business is the concern over controlling the well publicised but poorly understood risks of derivatives trading. The subject of market regulation will be discussed later in the chapter.

A further concern is that derivatives products attract 'speculators' and encourage 'speculation' which, by implication, is bad. Indeed, most derivatives products allow market participants to leverage their position, that is, to obtain large financial gain (or loss) from a small initial investment. Derivatives do, therefore, lend themselves to use by those who wish to make a 'quick profit'.

12. As discussed in Chap 3 this development, in turn, is due to increased levels of insurance premiums and pension fund contributions to be invested, as well as greater numbers of mutual funds and unit trusts.

13. SEHK, Members Transaction Survey, 1995.

Speculators and arbitraguers, or market participants without an underlying position to hedge, account for the vast majority of activity on the organised exchanges. Approximately 80% of the HSI Futures (Hang Seng Index) trades, the most active exchange traded contract in Hong Kong, are being done by market participants without any underlying position to hedge.¹⁴ For the HSI options contract those without any underlying position to hedge account for about 65% of users.¹⁵ Thus 'speculators' have played a significant role in fuelling growth of the exchange trade market in Hong Kong. (This is probably true for other markets but not all exchanges canvass users on the purpose of trades, SIMEX for example is unable to provide a breakdown on purpose of trades.)

The speculators have also played a key role in providing liquidity in the market. As in all securities markets, liquidity is essential for a successful and enduring derivative securities market. A liquid market ensures that instruments can be sold quickly with the lowest possible transaction costs. Liquidity also means that a market is fairer, because the less liquid a market the greater the bid/offer spread on transactions and the greater the relative advantage will be for the stronger party in each transaction. The liquidity required by institutional investors who use the futures and options markets to hedge their investments is largely supplied by the 'speculators', or those who do not necessarily have an underlying position in the cash market which they are hedging. In reality, the institutional investors themselves also use the derivatives markets for purposes other than hedging. Derivatives instruments are used by institutional investors to enhance the yield on their portfolios.¹⁶

The heavy involvement of retail investors in trading activity on the Hong Kong Futures Exchange (HKFE) undoubtedly accounts in part for the heavy use of instruments for speculation. While retail investors are generally conservative with new products they appear to take a more aggressive approach than institutions in dealing with established instruments. In the Hang Seng Index (HSI) futures contract over 40% of market participants are local retail investors, while in the HSI options contract between 15–20% of the market is accounted for by local retail investors.¹⁷ This level of retail involvement is high by the standards of other major derivatives markets around the world. On SIMEX, for example, 83% of trades are from international

14. HKFE 'Market Statistics', various monthly issues 1996, 'purpose of use' stated either as 'trading' or 'arbitrage'.

15. *Ibid.*

16. While only 20% of the HSI futures trades are done for hedging purposes, over 40% of all trades are done by local and international institutional investors. *Ibid.* In other words, half the trades in HSI futures by institutional investors were not for hedging purposes.

17. *Ibid.*

Table 7.1

Direct Foreign Investment in China (Including Loans)			
(In US\$ million)			
Year	Total	From Hong Kong	Percentage of Total
1988(*)	10,226.39	3,109.44	30.4%
1989(*)	10,059.15	2,912.78	28.9%
1990(*)	10,289.39	2,431.68	23.6%
1991	11,554.17	2,831.75	24.5%
1992	19,202.33	8,416.53	43.8%
1993	38,959.72	18,892.97	48.5%
1994	43,212.84	19,835.68	45.9%

Source: *Statistical Year Book of China*, various years.

(*) Figures for 1988–1990 (three years), include investments from Macau, as well.

accorded to foreign investors in China, huge internal funds from China are sent to Hong Kong only to be channelled back as overseas investments.

There may also be substantial tax advantages for foreign corporations to route loans to China through Hong Kong. Offshore loans negotiated and funded outside Hong Kong are tax-exempt, while offshore loans negotiated by outside institutions but funded by Hong Kong institutions are only 50% taxable. Likewise, offshore loans negotiated by Hong Kong institutions but funded offshore are also 50% taxable.⁸

Therefore, no doubt a significant part of the loan funds included in the figures of Table 7.1, actually originated in overseas financial centres all over the world but were merely booked (or 'garaged') here, to take tax advantage arising from the above provisions. However, even after allowing for such possible distortions, the dominant role played by Hong Kong in direct foreign investments in China cannot be overemphasised. In any case, the local merchant banks are always gainfully involved in this process, independent of the origin of funds.

So far as the reverse traffic is concerned, China is also supposedly the largest investor in Hong Kong. However, as the official statistics on capital accounts of Hong Kong are not published, this assumption cannot be empirically proven. In any case, part of these funds are likely to be book entries only, as we have discussed above.

8. See Departmental Interpretation and Practice Note No 21 s 24 of the Inland Revenue Department of Hong Kong, dated November 1992.

Table 7.2

China's Estimated Cumulative Investment in Hong Kong	
(In US\$ billion)	
Year	Amount
1984	6.0
1989	10.0
1991	10.0–12.0
1992	12.0–20.0
1993	20.0
1995	25.0

Source: KC Fung, see footnote 9.

Be that as it may, according to a reliable study⁹ based on various indirect sources, China's investments in Hong Kong reached an impressive US\$25 billion in 1995, as detailed in Table 7.2. It was estimated that more than 90% of the investments were in non-manufacturing sectors. Chinese investment in Hong Kong's property market was put at approximately 16.7%, which is, no doubt, a contributory factor in the spiralling real estate prices of the territory.

The spin-offs from this large two-way investment flows have surely benefitted the banking sector. Apart from their crucial intermediary role in capital investments, merchant banks also have a relatively important input in trade financing, especially in arranging for the relevant short to medium-term funds and taking part in the resultant forex transactions.

In this connection it should be noted that in recent years China has also emerged as the territory's main trading partner in all sectors. So far as imports are concerned, China's dominant position is obvious in the figures of Table 7.3. Whereas China's share has been consistent around 37% over the years, that of the distant second (Japan) and third (Taiwan) places has been marginally decreasing.

Even in domestic exports, China has now overtaken Hong Kong's traditional leading partner, viz the USA. In 1996, 29% of the territory's domestic export was destined for China, against 25.4% for the US. Similarly, for re-exports too, as a destination China (accounting for 35.2% of the total) is now head and shoulders ahead of the USA (20.4%) and Japan (6.8%).

Here again there may be some distorting factors affecting the figures. For example, a considerable part of exports to China may represent unfinished goods for processing pending eventual export. A more

9. KC Fung, 'Mainland Chinese Investment in Hong Kong', in *Journal of Asian Business*, Vol 12, No 2, 1996, pp 21–37.