Euromoney Seminars
Asia Pacific Real Estate Securitisation Summit 2006
19 September 2006
Hong Kong

"Enabling the Growth of REITs and CMBS in Hong Kong: The role of the regulators"

By
Martin Wheatley
Chief Executive Officer
Securities and Futures Commission
Hong Kong

Good morning Ladies and Gentlemen:

1. I am delighted to join you at this year's Asia Pacific Real Estate Securitisation Summit today. With the boom of the Asia REIT market and the revival of CMBS [commercial mortgaged backed securities] markets in the region, this conference provides a good opportunity and platform for discussion. I shall focus in my speech on 3 areas :- (i) the prospects of the markets, (ii) opportunities and issues concerning the growth of REITs and CMBS; and (iii) their impact on the real estate market and financial industry.

2. Today, I would like to talk about the role of the Commission as a securities regulator in relation to the regulation and development of REITs in Hong Kong. I will also share with you some of the regulatory issues relating to REITs. Before talking about our role as a regulator, I would like to give you a quick overview of Hong Kong's financial markets and asset management business, and the importance of the development of the REIT market to Hong Kong.

Hong Kong as an International Financial Centre

3. Hong Kong is an international financial center (IFC) by all standards. We have a well-established and advanced banking system, a highly liquid market and an effective and transparent regulatory regime which is on a par with international standards.

4. Our financial markets provide an excellent investment and fund raising platform. Currently ranked eighth globally and second in Asia in terms of market capitalization, our stock market has come a long way in becoming a major centre for capital raising and securities trading. Last year, Hong Kong overtook Japan as Asia's number one equity fund raising platform, and ranked fifth worldwide. The momentum has continued into 2006, with a total of US$23.4 billion raised in Hong Kong in the first six months of this year, making Hong Kong the third largest fund raising centre in the world, after NYSE and London.

5. Hong Kong has also developed into a leading international asset management hub in the region, as evidenced by the sheer size and growth rate of its fund management business. According to the results of our latest Fund Management Activities Survey, the fund management business registered a 25% growth in 2005 to US$580 billion. Over 60%

of the assets are sourced from overseas, reinforcing the ability of Hong Kong to attract international funds and the capability of the professionals here to put the money into work.

6. While the four SFC-authorised REITs only accounted for around US$6.5 billion of the assets in the fund management business, the introduction of REITs was a significant milestone in the development of a new type of investment expertise and a new asset class in the continuing diversification of our financial markets. With more product choices, different investors' investment appetite and hedging needs can be catered for, thereby further increasing the attractiveness of our financial markets.

7. REITs also enhance the transparency of Hong Kong's real estate market. According to a recent survey conducted by Jones Lang La Salle, Hong Kong was rated Tier 1 for the first time and ranked sixth on the Real Estate Transparency Index, being the highest ranking jurisdiction in Asia (ex-Australia). By Tier 1, it means that the real estate market is highly transparent and highly regarded for its ability to meet global improvements in accounting standards and governance. It is recognised in the survey that Hong Kong has benefited from the introduction of the REIT Code, which has helped raise the transparency of the already transparent real estate market.[1]

8. Hong Kong's development as an IFC is premised on a number of fundamental strengths. In addition to its unique geographical position, Hong Kong has much to offer in terms of skills, experience and quality services. Hong Kong's strengths are based on a number of factors, namely :- (a) a critcal mass of professional talents with expertise developed in investments in Asia, particularly the Mainland; (b) a well-established financial infrastructure; (c) rule of law; (d) stable and free flow of currency; and (e) a low and simple tax regime. Further, Hong Kong serves as a bridge between the Mainland and the rest of the world. All these are achieved through the collective dedication of the financial regulators and the market practitioners over the years. I am sure we are committed to further enriching our financial markets and positioning Hong Kong as a vibrant and ever-growing IFC.

<u>The REIT Market in Hong Kong</u>

9. While REITs have over twenty years of history in Australia and the US, they constitute a fairly new asset class in Asia and we are likely to experience fast development in REITs in the region, both in terms of magnitude and diversification. We therefore need to remain mindful of the development of REITs in the international arena and to apply our rules in a pragmatic manner to deal with issues as they arise, while bearing in mind protection of investors' interest.

10. In June 2005, the SFC revised the REIT Code to allow investments in overseas properties. Further, to provide REITs with sufficient financial flexibility and better management of currency exposure in the case of overseas investments, the permitted gearing ratio of REITs has been raised from 35% to 45% of total assets. This gearing level has been arrived at after consultation with the public and market practitioners, as well as examination of the development of cross-border REITs in overseas jurisdictions.

11. Given the limited size of Hong Kong and the fact that most of the properties that are of investment grade are already listed on the Hong Kong Stock Exchange, the opening up of overseas investments in June significantly enhances the development prospects

[1] Ranking of some other countries: Australia (1), Singapore (10), Japan (23).

of the Hong Kong REIT market. Hong Kong can, as a result, provide a platform for the listing of REITs that invest in properties in the region, thus broadening the investment choices and attracting participation of international investors. In fact, the lifting of geographical restriction was crucial in enabling the listing in Hong Kong of the first REIT in the world with 100% exposure to Mainland properties at the end of last year.

12. Notwithstanding the relatively short history, with the first REIT only listed in November last year, the Hong Kong REIT market is picking up quickly. The listing of the Link REIT, the first REIT in Hong Kong, is so far the largest REIT IPO in the world. Currently with a total of four REITs, the capitalization of our REIT market is about US$6.5 billion. In addition to substantial interest at the time of the IPO, an active secondary market has been developed among REITs, with daily average turnover amounting to US$38 million in the first seven months of this year, exceeding the daily average turnover of US$22 million of the 13 Singapore REITs for the same period. While fears on interest rate hikes in earlier months dampened the stock market and sentiment towards IPOs, including those of REITs, market practitioners in general expect that another wave of REIT offerings will be seen in the near future, as the outlook of interest rates clarifies, thus fueling the further growth of the REIT market in Hong Kong.

Prospects for Further Growth

13. It is only in the last few years that REITs in Australia have actively embarked on cross-border investments. The size of Hong Kong is limited and Hong Kong has already got a substantial universe of listed real estate assets in the form of listed property companies. A significant part of the growth of our market will be through the process of overseas investments by REITs in Hong Kong. In the process, it is only natural that issuers of REITs will look to the Mainland for assets. It is physically close to Hong Kong; market practitioners and Hong Kong investors are familiar with the languages, culture, business practices and systems in the Mainland. Of course, not to mention the opportunites presented by the sheer size of the Mainland and its rapidly growing economy. According to one estimate[2], the size of the investment grade real estate in Hong Kong and the Mainland is worth about US$334 billion, of which 77% is yet to be listed, providing a potent source of growth to the REIT market.

14. To real estate owners in the Mainland, they are also motivated to package their assets into REITs in Hong Kong, in the absence of an equivalent regulatory framework for establishing REITs in the Mainland. Of course, recent austerity measures introduced by the Mainland government to prevent an overheated property market will increase the cost of establishing REITs and create more administrative hurdles. In the short term this will dampen the incentive to set up REITs but the longer term potential of the Mainland market is indisputable.

15. In addition to our vast hinterland of the Mainland, another strong source of growth to the Hong Kong REIT market is expected to come from elsewhere in Asia. Geographically, Hong Kong lies in the heart of Asia, which is home to half the world's population but real estate per capita is among the lowest globally. Therefore, as Asian real estate markets are opened up in the coming years due to rapid urbanization, strong economic growth and the increasing presence of foreign institutional investors, the Asian market will constitute a potent force in the development of REITs in Hong Kong. In the process, large

[2] "Global Real Estate Analyser", UBS.

scale funding has to be obtained and REITs offer an attractive means to property owners to liquidate their holdings to fund further development projects.

16. We are committed to facilitating the development of REITs with Asian real estate exposure. So far, aside from The Link REIT, all the REITs listed in Hong Kong are spin-offs of properties owned by property companies already listed in Hong Kong, and the REIT managers are seasoned local property portfolio managers. While we are encouraged to see the development of local expertise in REIT management, we very much like to see and welcome international professional asset managers to package their real estate investments into REITs for listing in Hong Kong. Our aspiration is for the Hong Kong REIT market to attract not just assets already listed in the portfolio of Hong Kong listed companies, but a new universe of quality listing grade real estate assets in the region, managed by internationally renowned houses, as in the case of the more developed REIT markets of Australia and the US.

17. A number of well-known professional portfolio managers have approached the Commission indicating their interest in launching REITs with diversified international portfolios. We very much hope and would like to see a broad range of REIT products with local, Mainland and other overseas assets coming to the Hong Kong market. This can only add to the depth and breadth of our REIT market. We believe a congregation of home-grown and international REIT managers with diverse backgrounds will facilitate transfer of technical know-how and expedite the further development of REIT management expertise in Hong Kong.

Role of the Commission

18. As a securities regulator, our job is to maintain a regulatory framework of international standards and market integrity. This, we hope, will attract investors and quality issuers, and preserve an environment that is conducive to product development, which in turn, will facilitate the growth of the market. In this regard, the Commission has to uphold a fine balance between market facilitation on the one hand, and investor protection and reputation of Hong Kong as an IFC on the other. More specifically, I would like to share with you the SFC’s role in 3 areas:

- role as a gatekeeper in assessing the acceptability of the REIT manager
- regulatory issues on the product side and disclosure issues
- investor education

19. Similar to Australian REITs, the manager of a Hong Kong REIT is required to be licensed by the SFC. In respect of the regulation of the REIT manager and its key personnel, the Commission plays an important gate-keeper role in assessing their acceptability. As the REIT managers are investing money entrusted to them by the retail public, it is of paramount importance that they are fit and proper, possess the relevant skills, experience and resources in investing in and managing the type of real estate that a REIT invests in.

20. There should be appropriate and adequate internal controls and good corporate governance systems in place to deal with the existing and potential risks and complexities pertaining to the REIT. There should be processes to manage or avoid potential or perceived conflict of interests. This is especially important in the case where the REITs are spin-offs from existing listed companies that also engage in the same and competing business.

21. In respect of the regulation of the REIT product itself, as a regulator, it is not our job to worry about the value of the assets per se; or whether the office is Grade A or Grade B office, or where it is located. Rather, the SFC would assess a REIT application on a principle-based approach to ensure its compliance with the fundamental requirements in the REIT Code.

22. A fundamental requirement is that properties must have good and marketable title, as well as control over the management of the properties. The importance of title is beyond doubt, as properties are the cornerstone of any REIT. On the issue of control over properties, since the manager of a REIT is required and expected to actively manage and enhance the value of the properties, it is important that the REIT has "majority ownership and control" in the properties at all times (albeit with certain exceptions) to enable the REIT manager to exercise control over the management and strategic development of the properties.

23. The SFC has consulted the Committee on REITs on the issue of majority ownership and concluded that different factors would be considered in assessing the presence of majority control, depending on the specific circumstances in each case. The SFC has taken a pragmatic approach in applying this requirement where the building/complex is of composite use. Of course, this majority rule will not be strictly applied in those overseas jurisdictions which have rules and regulations that prohibit majority ownership of properties by foreigners. Further, in order to provide a degree of flexibility to cater for practical situations, a REIT may own less than a majority interest in a property, subject to a limit of 10% of the net asset value of the REIT.

24. All REITs must uphold a high standard of corporate governance and transparency, as they are the collective investments of the retail public and thus have the duty to properly inform the public of any price sensitive information in a timely manner. On the disclosure side, our regime requires that there must be full and proper disclosure of the investment characteristics and potential risks in the offering documents.

25. Investment in real estate is not novel to Hong Kong public in general, but investing in real estate through a trust is new to Hong Kong investors. The most difficult part lies not in understanding the properties per se, but in assessing the financial features of the fund itself.

- SFC requires upfront and succinct disclosure of each of these features in simple layman terms, to clearly explain to investors the implications of the special features on the distributions of the REIT, and the potential risks involved.
- E.g. Interest rate swap
  - Upfront disclosure that effectively, part of the IPO proceeds will be distributed to unitholders over the life of the swap arrangement, resulting in an effective return of capital.
  - In the case of a step-up structure, interest rates on the loan will increase over the life of the swap, thus distributions to unitholders will be adversely affected in the event of deterioration in the rental market.

26. Regarding investor education, REITs is still a new product. The SFC is committed to educating the public about its nature and special characteristics. In fact, since the introduction of the REIT Code, the SFC has published brochures, Dr. Wise articles,

participated in public talks, organized TV programs, and updated its website to educate investors on the mechanism of REITs. Recently, in order to enhance the public's understanding on the distribution components of a REIT, the sources of distributions and the mechanism of complex financial structures like "step-up" interest rate swap and distribution entitlement waivers by substantial investors, the SFC issued a set of Frequently Asked Questions on the InvestEd website in May to provide more guidance for investors' information.

SFC's REIT experience

27. While talking about the role of the Commission, let me also share with you a few anecdotes of our review of REIT applications. We have prepared an application checklist, setting out the documents that have to be submitted for our vetting, in order to facilitate the preparation of REIT application. Applicants are generally "compliant", and the sheer size of the documents sent to us appears to reflect this too. However, on further perusal of the documents, we sometimes found some oddities. On one occasion we found that while the number of valuation reports tallied with the number of properties proposed to be injected into a REIT, the reports were identical and in fact were all for the one same property. We also notice that the REIT market is very transparent. In fact, we sometimes get documents of one REIT sometimes bearing the name of another REIT, probably due to oversight on the part of the draftsman when adopting provisions of another REIT into the subject REIT.

28. On another occasion, we were pleased to see a comfort letter from a professional party stating that everything was in order, until we found that the professional party had prepared the letter based on an outdated professional standard. Luckily, we have the relevant professionals in our REIT team. Where we have identified deficiencies, we politely request the re-submission of a comfort letter using the current standards or the correct property.

29. We all know that the preparation of a REIT is a dynamic process in that it is subject to swift changes based on market conditions. The timing of the listing is also of crucial importance. However, the applications can only proceed smoothly if the submission is of good quality, complete and compliant with requirements of our codes and guidelines. Substandard applications will only delay the process and are liable to be rejected. For instance, we have already adapted to the rounds of changes in the details or terms of the REITs, due to market conditions or for commercial reasons. However, we find it more difficult to adjust to the erroneous reinstatement of provisions which the applicant has previously deleted. Also, it would help if the parties involved in the REIT application draw our attention to potential issues upfront. For example, one applicant did not disclose to us potential title issues until the night we were supposed to grant our in-principle approval to the application. This not only caused delays in the review process but also raised concerns on the due diligence and quality of work of the relevant parties involved.

Taxation

30. I believe my discussion on REITs will not be complete without visiting the tax issue. While taxation is not within the remit of the SFC, I think there have been some misconceptions that the tax regime in Hong Kong is unfavourable for the development of REITs. Unlike overseas jurisdictions that have higher tax rates and thus need to grant

special tax exemptions to REITs to facilitate their growth, Hong Kong already has a simple and low tax system.

31. In so far as local properties are concerned, the provision under the REIT Code for the use of special purpose vehicles to hold properties already facilitates the adoption of tax efficient strategies for stamp duty planning. Further, unlike many tax systems overseas, at the investor level, Hong Kong has no tax on dividend income, including distributions from REITs. When REITs invest in cross border properties (e.g. Mainland properties), Hong Kong's tax regime for REITs is highly competitive. This is because the properties/entities overseas will in any event be subject to taxes in the relevant jurisdictions where the properties are located. So any tax exemptions granted by overseas jurisdictions are not relevant and will not help. In fact, when the profits are remitted to Hong Kong, the REITs here are not subject to any Hong Kong tax on any overseas sourced income or profits and investors are not subject to tax on distributions from REITs. So tax exemption is a red herring with regards to cross border REITs.

Concluding Remarks

32. I am confident that Hong Kong is well-positioned to further develop the REIT market, given its critical mass of expertise, its huge capability to raise funds on an international scale and its strategic location in Asia. While we hear occasional noises of relocation of fund managers out of Hong Kong due to air pollution in Hong Kong, we are also aware of the insistence of dominant players to remain in Hong Kong, which is where opportunities and clients are located. It is also encouraging that 57 corporations were newly granted with Type 9 (asset management) licence by the Commission in 2005. That, of course, does not mean that nothing needs to be done on the ecology side. I strongly support any initiatives to improve the air quality of Hong Kong, for the betterment of our health and the environment.

33. The REITs market has made a strong start and we for our part, are committed to meeting our objective in facilitating further development. In closing, may I wish you all a very successful conference.

-End-