

80/F Two International Finance Centre  
8 Finance Street Central Hong Kong  
Telephone (852) 2536 0018  
Facsimile (852) 2536 0090



**James H. Lau Jr. JP** 劉怡翔  
Chief Executive Officer 總裁

22 December 2004

The Hon. Audrey Eu, SC, JP  
Chairwoman  
Bills Committee on Companies (Amendment) Bill 2004  
The Legislative Council  
Legislative Council Building  
8 Jackson Road  
Central  
Hong Kong

Dear Ms. Eu,

**Companies (Amendment) Bill 2004**  
**Proposed legislative amendments to the definition of “subsidiary”**

Our Corporation was very honoured to have been invited to the Bills Committee meeting on 16 December 2004 that considered the above Bill. We are very pleased to have been given an opportunity to explain how the Bill would adversely affect the fledgling securitisation industry in Hong Kong.

The two-hour meeting was very fruitful as the Bills Committee’s open-minded approach enabled us to have a useful exchange of views with the Administration and the Hong Kong Institute of Certified Public Accountants (“HKICPA”). We were of course pleased that Members present were sympathetic to the points we raised. We were particularly encouraged by your questions which very rightly focussed on the key issues of (a) the extent to which the Administration, and to an extent the HKICPA, had taken account of the concerns expressed by the securitisation industry and (b) how the Bill would affect the competitiveness of Hong Kong’s securitisation industry, particularly vis-à-vis jurisdictions that do not implement the International Accounting Standards.

Your comment that the Administration should be wary of being too hasty in implementing international standards without a proper understanding and analysis of the impact on the economy and the financial sector hit the nail right on its head. We agree with you that implementing international standards should not become an end in itself and that the Administration should not be obsessed with the objective of “overtaking the UK and surpassing the US”. This was precisely why we requested the HKICPA and the Administration to explain how they arrived at the view that the

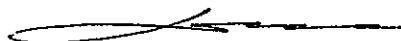
negative impact should not be a matter of concern. As we explained in our submission dated 9 December 2004 (LC Paper No. CB(1)453/04-05(02)), there are several options that can be used to mitigate the adverse impact on the industry. We would respectfully request the Bills Committee to consider the adoption of our suggestions or other approaches that would address the concerns of the industry.

Both the Hong Kong Capital Markets Association (“HKCMA”) and the Asian Securitisation Network (“ASN”) agree with our submissions and they too consider that the legislative changes will be extremely detrimental to Hong Kong’s ambition to develop itself as a regional centre for securitisation business. There would prove to be a great handicap to Hong Kong if it wishes to secure a larger role for Hong Kong’s securitisation industry in developing and tapping the vast market opportunity in the Mainland for asset securitisation. The HKCMA is an industry association founded by a group of financial institutions active in the Hong Kong market to help promote the development of the local and regional debt capital markets and the ASN is an association whose membership comprises over 200 leading securitisation practitioners from investment banks, accountants, law firms and rating agencies.

We enclose for your reference a table which we are sending to the Bills Committee to recapitulate the main arguments on a number of key issues raised at the hearing. In addition, we are in the process of preparing further briefing material on securitisation practices and market activities in other jurisdictions in the region for the consideration of the Bills Committee and would be happy to attend before the Committee again on 13 January 2005 to elaborate further.

Once again, thank you for your interest in this matter and we look forward to your continued support so that the Committee could agree on an amended Bill that would both provide for a justified need for transparency and disclosure and allow room for Hong Kong to develop its securitisation industry. We believe these are not mutually exclusive objectives and look forward to contributing further views at the next hearing on this Bill.

Yours sincerely,



cc: Ms. Emma Lau, Deputy Secretary for Financial Services and the  
Treasury (Financial Services)

**Table of HKMC's Comments to  
Key issues raised at the Bills Committee Meeting on 16 December 2004**

	Administration's Position	HKMC's Comments
1.	<p><b>International accounting standards/international financial reporting standards ("IAS/IFRS") are accepted internationally</b></p>	
	<p>IAS/IFRS are international standards and have been adopted and implemented in over 90 jurisdictions worldwide. The amendments are to align the Companies Ordinance ("CO") definition more closely with the IAS 27 definition.</p>	<p>Some major jurisdictions still do not subscribe to IAS/IFRS e.g. USA, Japan, Korea. Indeed, these jurisdictions have legislation and accounting standards that promote securitisation instead of inhibiting it. The securitisation industry in these jurisdictions is well developed and annual issuances equals a substantial portion of GDP. Contrast Hong Kong's infant industry and the unsympathetic accounting framework.</p> <p>In the European Union, the adoption of IAS/IFRS is subject to carve-outs to address the concerns of the industry e.g. there are two carve-outs from IAS 39. The carve-outs were proposed as a result of extensive consultation to take account of strong concerns raised by some sectors. On the other hand, consultation in Hong Kong was very limited and did not attempt to address the concerns expressed in the submissions of the HKMC and the securitisation industry.</p> <p>On the treatment of special purpose entities, the International Accounting Standards Board ("IASB") is currently carrying out a project on Consolidation of Special Purpose Entities and an exposure draft is expected to be issued in mid-2005.</p>

	<b>Administration's Position</b>	<b>HKMC's Comments</b>
		Moreover, the American, Australian and European Securitisation Forums have been making representations to IASB about the effect of IAS/IFRS on the securitisation industry with a view towards developing a framework which will allow off-balance sheet treatment for genuine securitisation transactions.
<b>2.</b>	<b>Interaction between IAS 39 and IAS 27</b>	
	IAS 39 is about the recognition and measurement of financial assets, not consolidation of accounts. HKICPA advises that IAS 39 is not particularly relevant to the proposed amendments.	We respectfully disagree. The decision tree for the application of HKAS 39 (the Hong Kong equivalent of IAS 39) (annexed to this table as Annex A) clearly sets out the requirement to consider the need to consolidate all "subsidiaries" which would have to be interpreted in accordance with the new definition derived from IAS 27.
<b>3.</b>	<b>TFV override provides effective means to deal with any future discrepancy between CO and IAS/IFRS</b>	
	The new TFV override requires directors to supplement or depart from the disclosure requirements of the Tenth Schedule to the CO in the event compliance is inconsistent with the obligation to give a true and fair view.	As admitted by the Administration, the application of the TFV override is limited to the Tenth Schedule to the CO and other matters required to be disclosed in accounts. Thus the TFV override would not allow a company to disregard other sections of the CO e.g. definitions. However, the proposed legislative amendments to the definition of subsidiary will be made by amending the definition and by way of amendment to the Tenth Schedule. Accordingly, if the IAS/IFRS definition of subsidiary

	<b>Administration's Position</b>	<b>HKMC's Comments</b>
		<p>was amended in a manner which was inconsistent with the entrenched definition of subsidiary, the company will not be able to make use of the TFV override.</p> <p>This puts Hong Kong at a disadvantage compared to Australia and Singapore as they do not entrench the definition of "subsidiary" in their legislation.</p>
<b>4.</b>	<b>Consolidation of SPEs: presentational issue or one of substance?</b>	
	<p>Consolidation of SPEs is just a matter of presentation and users of accounts can refer to the notes to arrive at deconsolidated figures for the group.</p>	<p>Consolidation of the assets and liabilities of SPEs into group accounts will distort the key financial ratios of the consolidating entity which are used by investors and financial analysts to assess the state of affairs of the reporting entity. This would have consequences in the capital markets and for a company's financial covenants which could be breached due to distortion of gearing and other ratios as a result of the inclusion of assets/liabilities of any deemed subsidiary.</p> <p>The example previously given by the HKMC in its submission dated 9 November 2004 (Annex 5 (I)) demonstrates the substantial deterioration in various ratios, such as the debt-to-equity ratio, return on assets and the capital adequacy ratio, caused by the bringing back onto the balance sheet of securitised assets and liabilities. Similar deterioration can be noted for the example provided by the Administration and the HKICPA at Annex B to LC Paper No. CB(1)453/04-05(16).</p>

	<b>Administration's Position</b>	<b>HKMC's Comments</b>
5.	<b>Greater transparency?</b>	
	<p>The Bill will enhance the quality of financial reporting for Hong Kong incorporated companies and thus their corporate governance. Financial reporting is fundamentally about presenting a true and fair view of a company's financial performance.</p>	<p>The HKMC supports the aim of greater transparency but argues that consideration should be given to the effect of the amendments on genuine securitisation transactions. The HKMC does not object to adequate disclosure about the effect of securitisation SPEs in company accounts. What it does object to is the consolidation of such SPEs in the accounts when such consolidation will affect the key financial ratios of a company and not give a true view of the assets, liabilities and risks for which the company is actually responsible. Accordingly, some regulators (the Australian Prudential Regulation Authority and the HKMA) have decided to retain the existing regime for the treatment of securitisation assets for Capital-Adequacy Ratio purposes. But this treatment in Hong Kong only applies to authorized institutions regulated by the HKMA, and not to the HKMC and other firms/corporates engaged in securitisation.</p> <p>There is a danger that by adopting these new amendments that Hong Kong is pursuing transparency merely for the sake of transparency without regard to the fact that consolidated accounts under the new HKAS would not reflect the true picture of the state of health of companies engaged in securitisation.</p>

	<b>Administration's Position</b>	<b>HKMC's Comments</b>
<b>6.</b>	<b>Adverse impact on competitiveness?</b>	
	<p>The amendments will not lead to any competitive disadvantage vis-à-vis Australia and Singapore as they have in effect adopted the IAS/IFRS definition of subsidiary.</p>	<p>Australia and Singapore's companies legislation requires companies to prepare their accounts in accordance with accounting standards. Therefore the current IAS/IFRS definition of subsidiary applies in Australia and Singapore at all times. If the definition changes then Australia and Singapore may easily adapt to the change. On the other hand, Hong Kong will have entrenched a specific definition into the CO which cannot be overcome by the TFV override. Accordingly, in the event of an IAS/IFRS change, Hong Kong's legislation will lag behind and the industry cannot react as quickly as Australia and Singapore to implement changes to accounting standards.</p>
<b>7.</b>	<b>Carve-out option</b>	
	<p>The Administration does not see the need to propose a carve-out as this is not the intention of IASB nor has this approach been adopted in other jurisdictions which have adopted IAS/IFRS. Moreover, IAS/IFRS are quite different from US accounting standards and HKICPA is not aware of any other jurisdiction adopting IAS/IFRS which will apply the concept of the Qualifying Special Purpose Entity in their own local accounting standards.</p>	<p>The HKMC appreciates the suggestion of a carve-out for the HKMC but this would not help the plight of the securitisation industry as a whole.</p> <p>There are a number of jurisdictions which have legislation or accounting standards which specifically provide special treatment to securitisation activities. In 2003, issuance volumes in the United States for asset-backed securities amounted to US\$1,461 billion (total outstanding amount of asset-backed securities in the United States as at 30 June 2004 was US\$7.1 trillion). In Korea and Japan, the recent enactment of</p>

	<b>Administration's Position</b>	<b>HKMC's Comments</b>
	The HKICPA opposes a general carve-out from the provisions but if a carve-out is to be made they would support it on the basis that it was limited to the HKMC only.	securitisation laws has enabled their markets to develop substantial volumes of issuances in 2003 (US\$7.2 billion and US\$36 billion respectively), which is well ahead of Hong Kong's fledgling industry (US\$762 million in 2003, representing only 0.48% of GDP). On the basis of a conservative assumption that issuance volumes can reach levels of 5-10% of GDP when compared to developed markets, Hong Kong's market could grow to between US\$8-16 billion annually (source Citicorp and HSBC).
8.	<b>"Linked-presentation"</b>	
	Linked-presentation is unique to UK accounting standards and is not part of IAS/IFRS. The HKICPA does not consider it appropriate to deviate from international norms. In any event, as from 1 January 2005, listed companies will not be able to use linked-presentation in their accounts.	Various securitisation trade forums are developing a submission to IASB which will propose amendments to IAS/IFRS to accommodate securitisation activities using a linked-presentation approach.  Notwithstanding adoption of IAS/IFRS in the UK from 1 January 2005, non-listed companies will still have the option to use Financial Reporting Standard 5 for off-balance sheet presentation.
9.	<b>"Wait and see"</b>	
	Not appropriate to withhold the Bill given that the "control-based" definition of subsidiary has been adopted by IASB since 1990 and has been adopted by many jurisdictions following	The IASB is currently carrying out a project on Consolidation (including special purpose entities), the objectives of which are "(a) to develop a comprehensive definition of "control" that is to be used as the basis for



	<b>Administration's Position</b>	<b>HKMC's Comments</b>
	IAS/IFRS since the last decade. Indeed, IASB has affirmed that the consolidation principles it develops will apply to all entities, including SPEs.	consolidation by all entities; (b) to consider the circumstances in which SPEs should be consolidated based on the concept of control developed and (c) to address both consolidation policy and procedures." The exposure draft is expected to be issued in mid-2005. There is no urgent need for the amendments and there is no harm to wait until the exposure draft is published.

The Hong Kong Mortgage Corporation Limited  
22 December 2004

# Hong Kong Accounting Standard 39

HKAS 39 (May 2004)

## Derecognition of a Financial Asset (paragraphs 15-37)

AG36. The following flow chart illustrates the evaluation of whether and to what extent a financial asset is derecognised.

