



14 February 2005

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

I am honored to be invited to give my views on the impact of the Companies (Amendment) Bill on the asset securitization market in Hong Kong. Before I give my opinion, it is useful to have an overview of the securitization structure and the role of "Special Purpose Entity", which is the subject of discussion in the Bill.

Securitization Structure

Appendix I contains a diagrammatic illustration of a typical securitization structure. In its simplest form, securitization is a method of funding receivables such as mortgage debts, leases, loans, or credit card balances through creating marketable securities backed by these assets. A typical securitization structure consists of a transferor (or originator) whose business gives rise to the receivables for collateralization. The receivables are transferred to "Special Purpose Entity" (SPE), which issues asset-backed securities (ABS) that are purchased by investors. As cash flows from the assets are collected, they are used by the SPE to make principal and interest payments to the investors.

The SPE is established for the specific purpose of facilitating the financing with very limited scope of operations so that its own business and financial risks are limited. The SPE typically has no office, independent management or employees. The collection of receivable is mostly done by the transferor, whose familiarity with the receivables and the obligors makes it the preferred party to service the receivables. A trustee is also featured in the securitization structure to safeguard the investors' interest in the SPE, and their primary responsibility is to receive cash from the servicer and distribute them in accordance with the terms of contracts.

One key aspect of a securitization transaction relates to the ability to legally isolate the assets transferred to the SPE from bankruptcy risks associated with the transferor itself. This essentially requires a true sale to be achieved in the transfer of assets to the SPE so that it has a perfected, first priority ownership in the assets. To qualify for a true sale, the assets must be beyond the reach of the transferor's creditors so that the SPE is bankruptcy



remote. Besides being unaffected by the transferor's bankruptcy, it is imperative that the SPE be remote from its own bankruptcy. This is accomplished by restricting the scope of operations of the SPE with limited intervention from the transferor. Furthermore, when the SPE issues ABS and transfers the proceeds to the transferor by way of purchase price for the receivables, the purchase proceeds are normally less than the face value of the receivables, with some residual risk on the receivables being retained by the transferor as a form of "credit enhancement" for the ABS issue. The transferor will therefore retain rights to receive from the SPE any profit realized on the receivables after repayment of the ABS issue.

Debates in Securitization Accounting

There have been ongoing debates about the treatment of the SPE as a subsidiary of the transferor or as an independent non-consolidated entity. In a true sale whereby the assets are beyond the reach of the transferor or transferor's creditors (even though the transferor retains servicing and residual interests in the assets), an argument could be made that the assets and liabilities of the SPE do not need to be consolidated into the financial statements of the transferor. But under the proposed legislative amendments to the definition of "subsidiary", it is unlikely that the SPE could be treated as a non-consolidated entity. Basically, the legislative amendments follow the SIC-12 whereby the subsidiary definition includes entities that are directed or operate on autopilot so long as the sponsoring company realizes benefits from them. Because most securitizations require some method for extracting residual income from the SPE back to the sponsoring company, the SPE will be treated as subsidiary and needs to be recognized on the balance sheet under IAS39.

There is clearly a fundamental weakness to the IASB approach if assets and liabilities of the securitization SPE are recognized fully on the balance sheet, as this fails to recognize that substantial risks and rewards have already been transferred from the transferor to the SPE with limited recourse. A securitization is much more than a funding transaction, and reflects at least a partial sale. By retaining the assets securitized on the balance sheet in their original form, this fails to recognize that the transferor no longer has the full benefit of ownership.

Impact of the Proposed Bill on the Asset Securitization Market in Hong Kong

A frequent argument put forth by accounting standard setters is that accounting rules do not and should not affect the rationale for undertaking transactions, and therefore the consolidation of SPEs should not have any adverse impact on the asset securitization industry. It is true that some of the motives for securitization are unaffected by different accounting treatment of securitization SPEs. For example, a key benefit of securitization is that the transferor can gain access to a source of funds less expensive than would otherwise be available. In addition, by issuing in the ABS market, this enables the transferor to access a new base of investors and transfers unwanted risks to them. Clearly, these benefits still prevail even if SPEs are consolidated in the financial



statement presentation.

Nevertheless, the consolidation of the assets and liabilities of SPEs is likely to affect the key financial ratios in the balance sheet of the sponsoring company, so that this would have a negative impact on its ability to manage financial covenants. A major motive for securitization is that the transferor is effectively exchanging assets for cash, and enables the transferor to either pay down existing debt, or to reinvest the proceeds in new assets that will improve profitability. In either situation, the sponsoring company can improve its balance sheet ratio – in the former, by reducing its gearing, and in the latter, by increasing its net cash flow (thus improving its debt service and interest coverage). If the securitized assets remain on balance sheet following consolidation, then the company's balance sheet will increase in size to reflect the new assets (cash) as well as the new liabilities issued by the SPE. The gearing of the company is likely to increase by the size of the debt in the deal against assets in the deal. Although the reinvestment in new assets will benefit total income, total debt service will also increase, due to the inclusion of the securitized debt.

It is oversimplifying to assume that 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. If this is the case, we should not see so much debates on the off-balance treatment of SPEs. If one could arrive at deconsolidated figures based on consolidated financial statements, the reverse is true whereby one arrives at consolidated figures based on off-balance sheet notes. In reality, most of the investors pay attention to the key balance sheet items, and therefore the question of whether assets and liabilities of SPEs should be recognized or derecognized is not a trivial pursuit. Even for regulators who could determine their own capital regulatory requirements and not follow the standard accounting treatment, they would be concerned if there is a significant deviation of regulatory capital measurement from audited financial statements. The consolidation of SPEs probably should have the least impact on the credit rating of the sponsoring company, as rating agencies should have considered the economic risks being taken by the company in connection with the SPEs. However, this is based on the assumption that rating agencies are able to derecognize the securitized assets and liabilities based on consolidated financial statements. To summarize, the consolidation of SPEs can have potential negative effects on debt capacity, capital adequacy ratio and credit ratings of the sponsoring company, reducing the incentives for securitization.

As a result, the proposed entrenchment of the definition of “subsidiary” in the Companies Ordinance, which basically consolidates securitization SPEs, is likely to have an adverse impact on the securitization market in Hong Kong. Nevertheless, it should be pointed out that even under the current accounting treatment of SPEs, the local securitization market is relatively thin and utilized by only a limited number of issuers. In fact, the securitization market would be even smaller if there is not active participation of the Hong Kong SAR Government. The Hong Kong Mortgage Corporation, which is a government-owned corporation, has been the most significant issuer, and the majority of securitization transactions are from government related entities. Clearly, more concerted



efforts are needed to develop the local securitization market even if the securitization SPEs can receive off-balance sheet treatment.

Final Thoughts

There is no dispute that the primary objective of financial reporting is to show the true and fair view of the company's results and state of affairs. The proposed amendment to the definition of "subsidiary" simply follows the new development of accounting standards to address the issues raised by Enron financial scandal. Inside the scandal, Enron has manipulated financial statements by hiding significant liabilities in the SPEs so that they were omitted from the balance sheet of Enron. Clearly, their financial statements did not reflect a true and fair view of the assets and liabilities of the company. However, for the current discussion of securitization SPEs, we should distinguish them from Enron's SPEs. Enron's structured deals did not involve the true sale of assets and their SPEs are not securitization SPEs. The financial statement manipulation performed by Enron is irrelevant to the discussion of securitization SPEs.

Despite all the concerns that I have raised regarding consolidating securitization SPEs, I fully endorse the appeal that in order for Hong Kong to become a major player in international settings, it is important that it should converge to international accounting standards like those set by the IASB. It will be ironic and also confusing if the definition of "subsidiary" in Hong Kong deviates from that of IASB when Hong Kong is supposed to be within its jurisdiction. One may wish that IASB will relax the control definition for the securitization structure so as to report the SPEs in a more appropriate context. But it appears that the IAS amendment, if any, will not take effect until 2007. While it is important for Hong Kong to converge to international accounting standards as early as possible, any proposed legislation should also take into consideration any possible changes to the concept of "control" made by the IASB in the future.

Yours truly,

Kalok Chan
Head and Professor

Appendix I

Typical Securitization Structure

