

**Bills Committee
on Companies (Amendment) Bill 2004**

**Follow-up Actions Arising from the Discussion
at the Meeting on 24 February 2005**

PURPOSE

At the Bills Committee meeting held on 24 February 2005, Members invited the Administration to consider the views on the possible impact of the Companies (Amendment) Bill 2004 (the Bill) on the development of the asset-securitization market in Hong Kong given by some of the industry members and academics, and to respond to further submissions from them on the subject.

2. The Administration's earlier papers entitled respectively "Follow-up Actions Arising from the Discussion at the Meeting on 16 December 2004" (LC Paper No. CB(1)668/04-05(03)) and "Impact of the Bill on the Asset Securitization Market in Hong Kong" (LC Paper No. CB(1)938/04-05(09)) have set out the Administration's views on the matter. To be considered alongside these papers, this paper aims at clarifying some key issues and responding to the following submissions -

- (a) the submission dated 18 February 2005 from Ms. Ann Rutledge;
- (b) the submission dated 14 March 2005 from the Hong Kong Mortgage Corporation Limited (HKMC);
- (c) the submission dated 16 March 2005 from Professor Kalok Chan of the Hong Kong University of Science and Technology; and
- (d) the submission dated 17 March 2005 from Professor Raymond So of the Chinese University of Hong Kong.

THE ADMINISTRATION'S VIEWS

(a) *“Control” Exercised over Securitization SPEs*

3. The submission of HKMC demonstrates that a special-purpose entity (SPE) set up by a transferor of a securitization transaction may likely be controlled by the transferor by way of, *inter alia*, the transferor's right to give directions with respect to the operating and financial policies of the SPE, unless the transaction is so structured that “the transferor would effectively have no specific role other than as a seller / buyer counterparty and all the typical securitization options would have to be outsourced to or obtained from third party service providers”. Professor Kalok Chan also points out that most SPEs might be subject to the control of the transferor in substance, albeit not necessarily in form.

4. This line of arguments in fact highlights the need for financial reporting requirements to be developed to cater for the underlying economic reality of different types of transactions including securitization transactions. As we have reiterated, the crux of the matter in relation to the proposed definition of “subsidiary” in the Bill lies with whether the parent company retains control over another undertaking, be it named a SPE or otherwise. Where **the SPE's financial and operating policy is directed by the transferor**, it is indeed necessary, from the financial reporting point of view, to consolidate the SPE **as a member of the group** because the fundamental purpose of group accounts is, precisely, to present the results and the state of affairs of the group as a whole. Alternatively, *if* the control is extinguished right away by structured transactions (for example, “true sale” of assets), such transactions would result in the relevant assets and liabilities from being removed from the balance sheet of the transferor, as confirmed by the HKICPA.

5. The difference of the financial reporting treatment reflects what a “true and fair view” means in practice, by reporting the substance of the transactions truly and fairly according to the underlying nature of the transactions.

(b) International Accounting Standards Board (IASB)'s Position

6. It was said at the meeting on 24 February 2005 that the IASB might further revise the “control-based” definition of “subsidiary” in IAS 27, to which the proposed definition of “subsidiary” under the Bill is closely aligned. In addition, Ms. Ann Rultedge suggests that “*IAS is in flux*” in her submission.

7. We note that, while the IASB is embarking on a project to review IAS 27, the Board “*initially intended that the output from the project would be a single IFRS on consolidation to replace IAS 27 Consolidated and Separate Financial Statements and SIC-12 Consolidation – Special Purpose Entities*”.¹ The IASB has reaffirmed that “*consolidation should be based on the notion of control*” and that “*control of an entity is the ability to direct the strategic financing and operating policies of an entity*”.² The IASB has also stressed that there “*should be no specific exemptions from consolidation on the basis of transaction types (such as for certain types of securitization)*”³.

8. We have also communicated with Mr. Kevin Stevenson, Director of Technical Activities, to seek clarification. We have been advised that the Secretariat of the IASB is not empowered to speak on the Board’s behalf. However, we have been drawn to some personal observations by Mr. Stevenson. According to Mr. Stevenson, the existing review confirms the suitability of the control-based approach and is primarily focussed on its development to assist current requirements. This is far from a global project “to develop a new model for accounting for securitization transactions”, as mentioned in HKMC’s submissions dated 11 January 2005. He has also advised us that there is no intention about carving securitizations out of IAS 27.

(c) Carve-out Would Undermine the Financial Reporting Regime

9. As a key to the underpinning of investors’ confidence,

¹ A paper – *Consolidation (including special purpose entities)*, issued by the IASB on 23 November 2004 to reflect the decisions up to and including the November 2004 Board meeting.

² Same as footnote 1.

³ A paper – *Consolidation (including special purpose entities)*, issued by the IASB on 31 May 2004 to reflect the decisions up to and including the May 2004 Board meeting.

quality financial reporting promotes the transparency, integrity and efficiency of our financial markets and business environment. A set of consistent, clear and comprehensive financial reporting standards is of utmost importance in accomplishing this objective. The Listing Rules, issued by the Stock Exchange of Hong Kong and approved by the Securities and Futures Commission, already require corporations primarily listed in Hong Kong to prepare financial statements in conformity with either the HKFRSs or IFRSs.

10. We consider that any proposed carve-out would lead to an inconsistent approach in preparation of group accounts among companies incorporated in Hong Kong and otherwise. We have not found any good reasons as to why some SPEs, being set up by Hong Kong-incorporated companies and indeed falling within the proposed definition of “subsidiary”, in the asset-securitization industry alone, should not be subject to the same approach in determining a “parent and subsidiary” relationship. Indeed, no other jurisdictions following IFRSs have adopted a carve-out in relation to the securitization industry.

11. The HKICPA is also concerned that the a carve-out – where one could be accused of “cherry picking” standards that we like – would cause Hong Kong more harm than good in terms of its international reputation as a well regulated financial centre. Moreover, the IASB strongly recommends against any carve-out, which may undermine the financial reporting regime to the extent that the accounts subject to a carve-out do not show a true and fair view.

(d) The Development of Securitization Market in Hong Kong

12. As we have reiterated, asset securitization is a useful financial tool. There are a host of factors contributing to the development of asset-securitization market. The “off-balance-sheet” accounting treatment should not be equated to be the “oxygen” to the asset-securitization market. It is a matter of fact that IFRSs (including IAS 27) have been adopted in many places, including Singapore, Australia and European Union (for listed companies), and that there is no evidence showing that the securitization markets there have been adversely affected as a result.

CONCLUSION

13. Members are invited to note and support the Administration's views set out in this paper.

Financial Services and the Treasury Bureau
April 2005