Annex I

Financial impacts on banks due to accounts consolidation of Special Purpose Entities for securitisation purposes

If the proposed account consolidation of a Special Purpose Entity ("**SPE**") is adopted, the transferor's consolidated balance sheet will have to include the securitised assets as an asset and the related mortgage-backed securities ("**MBS**", or asset-backed securities for non-mortgage loan assets) as a liability. As a result, the transferor's consolidated balance sheet will be inflated. For illustration purposes, a hypothetical case for XYZ Bank is set out in the following Table. The impact on the various ratios is dependent on the size of securitisation as a proportion of its ordinary business. In the case of XYZ Bank which carries out substantial securitisation transactions, its total assets as at 31 December 200X would have increased from HK$100 bn to HK$150 bn, while its total liabilities would have inflated from HK$85 bn to HK$135 bn. This will impact immediately on its capital adequacy ratio, unless the regulator permits XYZ Bank to calculate the ratios without taking into account the on-balance-sheet securitised assets.

The transferor, which usually acts as a servicer for the SPE in an MBS transaction by collecting the monthly instalments from the borrowers, typically receives a small servicing fee to cover its operating costs. Therefore, the ratio of return on total assets based on the inflated total assets will be smaller which would distort the transferor's true profitability.

Inclusion of the MBS as a liability in the consolidated balance sheet of the transferor will overstate its leverage ratio at group level. The increase in leverage ratio may adversely affect the transferor's ability to raise funds in the capital markets.

Once the assets and liabilities of the SPE are consolidated onto the balance sheet of XYZ Bank:

(i) the capital adequacy ratio drops from 15% to 10% in 200X;
(ii) the return on total assets drops from 2.0% to 1.3% in 200X; and
(iii) the debt-to-equity ratio increases from 5.7 to 9.0 as at 31 December 200X.

The lower capital adequacy ratio and higher debt-to-equity ratio may increase the funding costs of XYZ Bank. In addition, the accounts consolidation requirement could cast doubts on whether or not a true sale of XYZ Bank's assets has been effected to the SPE and induce a false perception that XYZ Bank is legally liable for the SPE's debts.

XYZ Bank				
(HK$bn)	**Before accounts consolidation**	**SPE**	**After accounts consolidation**	**+/-**
Total assets	100	50	150	+50
Total liabilities	85	50	135	+50
Total equity	15	-	15	-
Profit after tax	2	-	2	-
Debt-to-equity ratio	5.7		9.0	+3.3
Return on assets	2.0%		1.3%	-0.7%
Return on equity	13.3%		13.3%	-
Capital adequacy ratio	15.0%		10.0%	-5.0%