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The Hon. Audrey Eu, SC, JP
Chairperson
Bills Committee on Companies (Amendment) Bill 2004
c/o Ms. Connie Szeto, Clerk to Bills Committee
Legislative Council Secretariat
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Dear Ms. Eu,

Thank you for your letter of 20 January 2005, in which we are invited to give views on the impact of the proposed Companies (Amendment) Bill 2004 on the asset-securitization market in Hong Kong, in particular that the Bill entrenches the definition of "subsidiary" and that this may be detrimental to the creation of Asset Backed Securities (ABS) in Hong Kong. Please find below our comments on the various matters raised in your letter.

It is useful to state the background to the issues that we are invited to comment upon. There are three accounting issues that are relevant for securitization.

IAS 27: Consolidated Financial Statements and Accounting for Investments in Subsidiaries
SIC 12: Standing Interpretation Committee on Consolidation of Special Purpose Entities
IAS 39: Financial Instruments: Recognition and Measurement.

An important concern arising out of IAS 27 and SIC 12 in the securitization industry is the requirement to consolidate Special Purpose Entities (SPE) into the parent company's financial statements. According to the regulations of consolidation in many jurisdictions, majority ownership such as more than 50 percent of the voting rights of the SPE automatically implies that it should be consolidated with its parent company. According to IAS 27 and SIC 12 however, ownership is neither sufficient nor necessary to determine the consolidation of SPEs. It's "control" of the entity that counts. IAS 27 defines control as "*the power to govern the financial and operating policies of an enterprise so as to obtain benefits from its activities,*" whereas SIC 12 defines control as "*contributing to or benefiting from the risks and the rewards of the SPV.*"

The Hong Kong Mortgage Corporation Limited and the Hong Kong Capital Markets Association argue that the proposed Companies (Amendment) Bill 2004 that entrenches the definition of subsidiary by these "control" rules will challenge the off-balance sheet objective of a typical securitization, and as a result, it will hamper the growth of the young ABS market. This will put Hong Kong in a disadvantaged position against other markets such as Australia and Japan, as one of the centers for ABS issues in the region.

It is informative also to revisit the often-stated motives for securitizing assets. The key motivations for securitization anywhere in the world are essentially considered to be the same, and they include selling risks, access to cheaper funding, diversifying funding sources, optimizing balance sheets, and engaging in regulatory and or tax arbitrage. From the point of view of the ABS issuer, securitization may be viewed as a sale or a financing. Since securitization has features of both, it can reflect the many motivations of the issuer such as financial, tax, accounting, and even strategic reasons. If the ABS originator's motive for securitization is to release capital tied up in assets for re-application, it is necessary to make sure that the assets that are to be sold to the SPE represents a "true sale" and that the ABS originator has sold the risks with the assets. In this case, consolidation of the SPE is not relevant, because ownership and control of the assets passed to the SPE. If the ABS originator however regards the transaction as a mechanism to release capital tied up in assets in order to turn over the capital without relinquishing control over the assets, it may be that no "true sale" has taken place. If a jurisdiction allows these assets to be taken off-balance sheet while some of the risks still rest with the company, it is clear that such a balance sheet is not representative. For many years this "true sale" nature of ABS has been a subject of debate, and it has cast light upon the reasons for pursuing off-balance sheet transactions. The reasons are typically seen to include (1) window-dressing a firm's balance sheet and financial ratios, (2) enhancing the firm's capital ratio so as to increase its borrowing capacity, and (3) hiding risky assets from investors who otherwise would attach a much larger discount to the firm's market value. If one accepts the modest view of the efficient markets hypothesis, all these reasons do not survive scrutiny – indeed, the common advice that no smart investor should believe a balance sheet is damning, and one that regulators should indeed lament.

We also believe it is necessary to summarise the specific questions that are being addressed, given all the opinions contained in the various submissions, and Government's responses. Fundamentally, four questions are posed:

1. What is the expected impact of the meaning of "subsidiary" in the Companies (Amendment) Bill 2004 on the asset-securitization market in Hong Kong?
2. Should Hong Kong adopt instead the "linked presentation method" for group accounts?
3. Should the Companies (Amendment) Bill 2004 be deferred until the International Accounting Standards Board (IASB) has completed its review of IAS 27 regarding whether or not the revisions to the "control" model for subsidiaries should also be applied to SPEs?
4. What is the case for providing a "carve-out" from the definition of "subsidiary" for asset securitization SPEs similar to the concept of the Qualification SPE available under the US accounting rules?

The questions are interrelated, and we therefore believe it is sensible to (re)state points of principle that seem to underlie the all the questions prior to giving opinions about the questions specifically.

To commence, two aspects of the proposed amendments to company legislation seem to be in conflict, namely what "subsidiary" means in general , on the one hand; and what the notion of a "subsidiary" may encompass in the financial sector when SPEs and securitization may be considered on the other. The overriding context for all the

questions are in the final analysis a matter of what attitudes prevail in Government towards the corporate regulatory environment (including legislation that relates to corporate governance, financial reporting, etc); and then also financial sector regulation.

Firstly, with respect to the corporate regulatory environment, few (if indeed any) arguments can be sustained which attempt to present the case that ultimately "control" is inappropriate as a test to define what a subsidiary is and what not. In our view, any other way of treating subsidiaries would be regressive and against world opinion, because any other treatment of subsidiaries would be an attempt to misrepresent the status of the controlling business. Our position is thus entirely in accord with that of the Government, which is attempting to align the Hong Kong meaning of "subsidiary" in the Companies Ordinance more closely with that in the International Accounting Standards. It would seem unnecessary to present all the corporate governance reasons in support of this view again in this letter – in all, it is about disclosure, information, and a regulatory environment that attempts to facilitate information, and not obfuscation.

Secondly, a point of conflict arises in the Hong Kong financial sector about the meaning that the IAS treatment of "subsidiary". In principle, it appears if the Hong Kong Mortgage Corporation, supported by the Hong Kong Capital Markets Association, argues that the proposed requirement to consolidate subsidiaries (in this context SPEs used to create Asset Backed Securities) may create the situation where Singapore and Australia (amongst others) may provide financial sector businesses with the opportunity to engage in regulatory arbitrage, because these jurisdictions may allow companies to move assets off-balance-sheet in the creation of ABS in those jurisdictions. In this case it is suggested that Hong Kong will lose securitization business, and so the development of our financial markets will suffer. There can be no doubt that the continued development of the Hong Kong capital markets is highly desirable, particularly with the momentum that Hong Kong has already achieved, the effort that has gone into this over the last decade or more, and the huge potential that exists for raising capital for the development of the PRC.

There is a view of financial innovation which defines it as the creation of financial products that both suppliers and users of funds may demand, products with varying functional attributes to satisfy investment, financing, and risk management preferences. Note that this contrasts with a school of thought held in many circles (academe included) that "financial innovation" is merely the exploitation of loopholes in legislation in a jurisdiction, or engaging in regulatory arbitrage between jurisdictions, or "engineering" other mechanisms to take advantage of legal differences between jurisdictions. While it is important and attractive for our financial sector development to foster ABS issues to widen and deepen our financial markets, ABS itself has for some years no longer been innovative, and could indeed be seen as a mature product as the technology is applied to more and more diverse financial assets. It is our opinion that entering into competition with other jurisdictions by providing opportunities to engage in regulatory arbitrage (or match it) in ABS, is against the real meaning of financial innovation. There are many jurisdictions in the world that can easily out-compete Hong Kong when it comes to regulatory arbitrage. It seems to us that a more serious threat to Hong Kong is to do the easy thing (match regulatory arbitrage), instead of the right thing (don't engage in it).

It is here where we see convergence between the proposed amendments to corporate legislation and the effect it may have on SPEs in the financial sector: if Hong Kong is

concerned about corporate governance matters, including financial reporting that purports to be clear and transparent, then this is contradicted by facilitating opportunities to create off-balance sheet finance opportunities anywhere, because by definition off-balance sheet financing is intended to distort an enterprise's financial position. We thus return to the four questions.

What is the expected impact of the meaning of "subsidiary" in the Companies (Amendment) Bill 2004 on the asset-securitization market in Hong Kong?

Our view is that this will force financial companies to conduct securitizations where the SPVs are not subject to corporate control – in effect, this is possibly what the intention of a "true" ABS should be. It is likely that this could be accompanied by all the advantages that originators of financial assets may enjoy from releasing capital to do more business. With good management, we also see that this may actually strengthen balance sheets.

Should Hong Kong adopt instead the "linked presentation method" for group accounts?

By all accounts this would be a singular step, as the only other jurisdiction that follows this logic is the UK. We believe the consolidation by control model, as proposed by the government, makes most sense.

Should the Companies (Amendment) Bill 2004 be deferred until the International Accounting Standards Board (IASB) has completed its review of IAS 27 regarding whether or not the revisions to the "control" model for subsidiaries should also be applied to SPEs?

If anything, it seems waiting to see if the "control" model is favoured makes sense. However, it is likely that the control model will be adopted for SPEs for all the reasons suggested above. There may in fact be some advantage for Hong Kong to pre-empt the IASB by proceeding with the *Companies (Amendment) Bill 2004,* in order to offer international leadership in best practice.

What is the case for providing a "carve-out" from the definition of "subsidiary" for asset securitization SPEs similar to the concept of the Qualification SPE available under the US accounting rules?

With reference to our contextual argument above, we believe there is no case for providing carve-out provisions in general. Regulatory competition is not a game that has a final winner, and by engaging in this game at all Hong Kong regulators may in fact be acting against the city's long-term interests.

On another front, however, we are somewhat sympathetic with the position of the Hong Kong Mortgage Corporation, especially after the Hong Kong Monetary Authority has invested so much resources in setting it up, that by all counts it seems to be doing fine, and is achieving its objectives.

When banks have easy access to the capital markets for funds, such as the bank equity markets, the need to remove the assets off the balance sheets, really, is very little. On the other hand, securitization can be taken as a financing tool for a bank that restricts asset growth on one hand while at the same time allowing the bank to access the broader

capital markets for funds. This is achieved by allowing banks to remove their assets (to be securitized) from its balance sheets without adding assets to it at the margin, so that the bank's capital ratio can be improved or prevented from declining. In Hong Kong, the securitization of mortgages under the auspices of the Hong Kong Mortgage Corporation has to some extent achieved this, and has thus provided better liquidity to banks. Also, the process is "cheap" enough so that the transaction cost of doing securitization has not been prohibitive. Otherwise it would have been passed on to the mortgagors (the borrowers). So, we believe the impact of the proposed Bill on "mortgage securitization" is also definitely of public interests because it may affect the cost of financing home ownership if financial circumstances change. We do not have the data and enough information to evaluate by how many basis points, if any at all, the mortgage interest rate could go up as a result of the proposed Bill taking effect. However, we believe that further investigation along this line should be done before we leap into any legislative decision. The general public in Hong Kong definitely would not want to pay the higher cost of home ownership, and if further research has confirmed the increase in the cost of homeownership because of the induced changes in the current process of mortgage securitization, a carve-out should be considered for the Hong Kong Mortgage Corporation, and the Hong Kong Mortgage Corporation alone. An easy way to achieve this could be to add a provision to the ordinance under which the Hong Kong Mortgage Corporation functions that overrides the proposed definition of subsidiary in the Companies (Amendment) Bill 2004.

If a carve-out for the Hong Kong Mortgage Corporation is indeed considered a viable alternative for the mortgage-securitization industry, it is imperative to have administrative and/or regulatory measures to prevent the carve-out becoming a beast out of control. After all, off-balance-sheet transactions is a big grey area still in much debate in the United States, as Fannie Mae (a government-sponsored entity that specializes in “buying and reselling” mortgages, and is the largest source of financing for home mortgages in the United States) has recently been caught committing accounting malpractices by not reporting their off-balance-sheet use of derivatives in “hedging” their asset pools (see “SEC Staff 'Thoroughly' Probing Fannie Mae 's Accounting” in The Wall Street Journal on Feb 9, 2005). The mortgage-backed securities and the banking industry in Hong Kong definitely cannot afford to be seen having to deal with problems like this.

We hope our views are of help to the Bills Committee. If the Committee finds it necessary we are willing to appear before the Committee to discuss further any of the aforementioned issues.

Yours truly

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