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**Bills Committee on Companies (Amendment) Bill 2004**
**Proposed Legislative Amendments to the Definition of "Subsidiary"**

**Statement of Heller Ehrman White & McAuliffe LLP**
**The United States Securitization Market**

We are pleased to submit this information to assist the Bills Committee in its review and deliberations regarding the Companies (Amendment) Bill 2004. Heller Ehrman White & McAuliffe LLP is an international law firm with 13 offices worldwide, including offices in Hong Kong, Beijing and Singapore. We represent many of the world's leading financial institutions and industrial corporations. We have one of the leading structured finance practices in the United States and present this information on the securitization market in the United States for inclusion into the record of the Bills Committee.

## Introduction

One of the greatest innovations in the US capital markets in the last 30 years has been the creation of the securitization market. Securitization, the process by which individual, illiquid assets are converted into marketable capital market instruments, has produced substantial benefits for banks and other financial institutions, corporations, consumers and business borrowers, and public and private investors. Securitization in the United States has grown to one of the largest capital markets in the world, to approximately US$7 trillion in asset-backed (ABS) and mortgage-backed (MBS) securities outstanding at this time.

Securitization is the process of pooling and repackaging loans or other income producing financial instruments into securities, such as debt securities or bonds, that are then sold to investors. Financial institutions and businesses of all kinds use securitization to *immediately* realize the cash value of an asset. These are typically financial assets, such as loans or mortgages, but can also be trade receivables, leases and other income producing assets. By pooling the assets together, the payment streams can be used to support interest and principal payments on debt securities, such as ABS and MBS.

When the right legal, regulatory and accounting framework is present, securitization can give borrowers access to funds, offer investors a wider choice of high-quality investments and improve the efficiency and liquidity of the capital markets. Securitization has a key role in the continued evolution of the capital markets and has applicability to many other sectors of the financial markets and economy.

**The Securitization Process in the United States**

*The SPE*

The centerpiece of almost all securitizations is the special purpose entity or "SPE". The SPE is established and intended to be legally separate from the original owner of the assets. SPEs have taken many forms, such as corporations, partnerships, limited liability companies and trusts. In each case, the SPE is operated as a separate entity, independent from the operations of the parent or original owner of the assets with its own officers, financial statements and legal rights and liabilities. Moreover, the SPE is structured to be legally remote from the bankruptcy or insolvency of the original owner or parent. Thus, in the event of the parent's liquidation under applicable bankruptcy or insolvency proceedings, its creditors should have no claim on the securitized assets of the SPE. For example, a corporate SPE would include the following restrictions in its charter documents and elsewhere:

> *Restrictions on Powers and Activities.* The SPE will not engage in any business or activities, except those necessary to its role in the securitization transaction.
>
> *Debt Limitations.* With certain exceptions, the SPE may not incur any debt whatsoever, except debt issued pursuant to the securitization.
>
> *Independent Directors.* The SPE must have at least one independent director or its functional equivalent. Rating agencies require that this be a person who is not and has not been a director, officer, employee, direct or indirect beneficial owner of equity, creditor, supplier or affiliate of the transferor of the assets.
>
> *No Merger or Consolidation.* The SPE may not merge, dissolve, liquidate, consolidate or sell assets (other than as a part of the securitization) as long as the securities issued by the SPE are outstanding.
>
> *Separateness Covenants.* The SPE should hold itself out as an independent entity distinct from the originator of the assets. Various charter covenants require the SPE to (1) maintain books and records separate and apart from any other entity, (2) maintain its accounts separate

and apart from any other entity, (3) not commingle assets with those of another entity, (4) conduct business in its own name, (5) maintain separate financial statements, (6) pay its own liabilities out of its own funds, (7) observe all corporate formalities, (8) maintain an arm's length relationship with any affiliates, (9) pay its own expenses, including salaries of employees, (10) not guarantee or otherwise become obligated for the debts of any other entity, (11) use separate stationary, checks and invoices, (12) maintain adequate capital, (13) not pledge its assets for the benefit of any other entity (except pursuant to the securitization transaction), and (14) correct any misunderstandings regarding its separate identity.

*Limitation on Voluntary Bankruptcy or Insolvency.* The consent of the independent director is required for the SPE to (1) file bankruptcy or insolvency proceedings, (2) dissolve, liquidate, consolidate, merge or sell substantially all of its assets, (3) engage in any other business activity, or (4) amend its charter documents.

*The Securitization Transaction*

In most securitizations, the originator of the assets sells them to the SPE which takes legal title to them. The payment streams generated by the assets can then be reconfigured to back the issue by the SPE of "pass-through" interests or "pay through" interests such as notes or other debt securities. In either case the securities are underwritten by an investment bank acting as a placement agent or underwriter who then sells the securities to investors. Various forms of "credit enhancement" can be added to the transaction to tailor and customize the offered securities to investor preferences. Techniques such as overcollateralization, senior and subordinate tranching of the securities, reserve funds and third-party support such as letters of credit, surety bonds or monoline insurance, are frequently used in these transactions. Based on these structures and techniques, ABS and MBS are very popular investments for many types of investors, particularly institutional investors who are active in the fixed-income and institutional debt markets.

*The Importance of Off-Balance Sheet Treatment*

In tandem with the goal of transferring assets to a legally separate and distinct entity, banks and other issuers of ABS and MBS often seek to remove the transferred assets from their books for regulatory, accounting and financial purposes. The benefits of this "off-balance sheet" treatment are discussed below. It is critical to note, however, that most securitizations would *not* occur without off-balance sheet treatment for the originator. Thus, as a part of each transaction, careful structuring and documentation are provided from both a legal and accounting standpoint to achieve the necessary results. Legal opinions are usually provided to confirm that a "true sale" of the assets of the originator to the SPE has taken place, as well as whether the SPE and its assets would remain with the SPE and not be "consolidated" with the assets of the originator or parent of the SPE upon a bankruptcy or insolvency of the latter. Similarly, accounting of the transactions involves separating the assets of the originator from the SPE to remove them from the originator's balance sheet. The objective is a transaction in which the SPE stands alone from its parent or the originator of the transferred assets with financial statements that are separate and *not* consolidated with those of another entity.

**A Short History of Securitization in the United States**

*The Mortgage-Backed Securities (MBS) Market for Residential Mortgages*

Although the practice of selling loans among banks has been around for many years, selling interests in loans is rather new, beginning in 1970 in the United States when the Government National Mortgage Association (Ginnie Mae) offered investors a new type of bond, the mortgage-backed security, or MBS. Ginnie Mae was followed by the Federal National Mortgage Association (Fannie Mae) and the Federal Housing Loan Mortgage Corporation (Freddie Mac) to promote home ownership in the United States by fostering a secondary market in home mortgages through MBS securitization. For investors, the MBS securitization process converted non-rated, illiquid home mortgage loans into highly liquid securities that carry investment grade ratings, possess low credit risk and offer competitive rates of return. For lenders, the MBS process enabled them to move illiquid mortgage assets and the related interest rate risk off of their balance sheets and replace them with cash to fund their operations, including expanding lending activities. For home buyers, the MBS process expanded the credit available to enable them to realize the dream of home ownership.

Growth in the market has led to more innovation and success. MBS structures have become more advanced over time, incorporating many of the techniques mentioned above and more. According to the Bond Market Association, a leading US industry group, by 2003 daily trading volume in residential mortgage-backed securities exceeded US$200 billion with US$5.3 trillion outstanding. This market is one of the largest and most liquid capital markets in the world.

*Development of the Asset-Backed Securities (ABS) Market*

While mortgages have been a principal driver of the explosive growth in securitization over the years, many other types of assets have benefited from securitization. Since the mid-1980s, many other types of asset classes have emerged. In the consumer area, securitizations of credit card debt, home equity loans, automobile loans, manufactured housing loans, student loans and other forms of consumer credit have become a major part of the market. For example, credit card receivables and home equity loans make up more than half of all ABS.

In the corporate credit area, asset-backed securities have greatly improved the availability of credit and the ability of corporate borrowers and issuers to raise capital, as well as financial institutions to improve their balance sheets and offer more products to their customers. Asset classes for securitization that have developed over the years include corporate bonds, corporate loans, real estate loans and credit leases. Banks have repackaged corporate bonds and loans into SPE-structured issues called collateralized debt obligations (CDOs) and collateralized loan obligations (CLOs). The CDO and CLO markets have become worldwide in their scope, including a significant presence in Asia. Another important asset class is asset-backed commercial paper (ABCP), in which corporations with high quality trade receivables can transfer them to bank-sponsored SPE conduits which, in turn, issue short-term notes (commercial paper) to institutional investors at attractive rates.

ABCP provides companies with an effective mechanism to raise debt more cheaply than through bank loans and offers yet another capital raising alternative to corporations through securitization.

*The Success of the Commercial Mortgage-Backed Securities (CMBS) Market*

The development of the market for securities backed by securitized mortgages on commercial real estate is illustrative of the dramatic transformation that securitization can have on the capital markets and a major sector of the economy. In the late 1980s and early 1990s the US real estate market was in a severe downturn, exacerbated in part by the crisis in the savings and loan industry. Banks and other real estate lenders also had suffered substantial losses and had many non-performing real estate loans on their books. Moreover, banks were reluctant to make new loans. Banks usually originated commercial real estate loans, but for regulatory and business reasons would commonly sell the loans to insurance companies, who purchased these loans to hold for long-term investment. But the insurance companies had suffered losses as well and were not buying any real estate loans from the banks. As a result, credit was not available in the commercial real estate industry, which came to a near-standstill.

The Resolution Trust Corporation (RTC) was formed by the US government in 1989 and, with substantial participation by Wall Street and the institutional investment community in the early 1990s, successfully began to use SPEs and securitization techniques to pool commercial real estate loans from troubled banks and savings and loans to create CMBS securities for sale into the secondary market. Based on the success of the RTC, Wall Street and the banking industry began to use CMBS to revitalize the real estate finance industry in the United States. Commercial banks and other real estate lenders began to originate loans specifically to sell them to new SPE conduits who would in turn issue new securities into the vast and deep secondary market. The CMBS market exploded with growth through the 1990s and has became one of the principal sources of capital for the real estate industry in the United States, as well as a permanent component of the nation's capital market infrastructure.

*How Big is the United States Securitization Market?*

The securitization market is large and represents a major portion of the total US debt market. Market information compiled by Nomura Fixed Income Research shows this:

| **Securitization Outstandings of 2003 Q3 (US$ billions)** | |
|---|---|
| Mortgage-Backed Securities (MBS) Issued by Government Agencies (Ginnie Mae, Fannie Mae, Freddie Mac) | 3,371 |
| Agency-Backed Collateralized Mortgage Obligations (CMOs) | 989 |
| Non-Agency Mortgage-Backed Securities (MBS) | 528 |
| Commercial Mortgage-Backed Securities (CMBS) | 389 |
| Asset-Backed Securities (ABS) | 1,365 |
| Asset-Backed Commercial Paper (ABCP) | 723 |
| Collateralized Debt Obligations (CDOs) and Collateralized Loan Obligations (CLOs) | 246 |
| **Total** | **7,611** |

The impact of securitization on the United States economy can be seen in the attached charts prepared by the Bond Market Association, which compare the ABS and MBS markets to the overall bond market.

**Benefits of Securitization**

Securitization has demonstrated benefits in a number of ways.

*Benefits to Banks and Other Originators*

Banks and other financial institutions use securitization as an important source of revenue and include it as a major component of their risk management programs. The benefits are many and include:

> *Removing Assets from the Balance Sheet.* Securitization enables an originator to reduce its assets and debt, and increase its ability to borrow, achieving greater leverage.
>
> *Asset/Liability Management.* Securitization can boost liquidity and allow a bank or other originator to manage its debt position to match cash flows with assets. Additionally, instead of holding loan assets to maturity and receive revenue over time, a bank can immediately realize on illiquid assets.
>
> *Reducing Credit Risk.* Assets legally transferred to a SPE transfer credit risk as well, thus eliminating the originating bank's credit risk on a transferred loan.

*Reducing Interest Rate Risk.* Similarly, the interest rate risk of each loan transferred to the SPE is transferred as well.

*Fees and Servicing Income.* Banks can usually retain loan origination fees, servicing fees and other fee income on assets sold to the SPE.

*Customer Relationship.* While loans transferred to the SPE become the property of the SPE, the selling bank retains its direct and personal relationship with its customer.

*Capital Relief.* Securitizations that qualify as sales of assets for regulatory purposes reduce required capital, enabling more efficient allocation for expansion or reinvestment and reduce the need for equity financing.

*Return on Equity.* Similarly, securitization improves return on equity by converting on-balance sheet lending business into off-balance sheet fee income that is less capital intensive. Return-on-assets (ROA) is also improved, reflecting more efficient use of capital.

*Lending Concentration.* Securitization is commonly used as a technique to reduce lending concentrations.

*Asset Disposals.* Securitization can offer a method to dispose of poor quality assets in an orderly and managed process, particularly when other alternatives are not practical.

It should be noted that the US banking regulators recognize the benefits and importance of securitization to banks and other regulated financial institutions. Discussion of these benefits and other issues can be found in the Comptroller's Handbook: Asset Securitization, issued by the United States Comptroller of the Currency, Administrator of National Banks, 1997.

*Benefits to the Investors*

Investors benefit from the legal and accounting separation of securitized assets as described above. ABS and MBS are popular investments as they offer a combination of attractive yields (superior to straight corporate bonds or sovereign debt), safety (usually rated investment grade by one of the international ratings agencies), liquidity, diversification and customized structures to fit particular investment criteria.

Of equal importance is that the independence of the SPE and the rated nature of the ABS or MBS frees investors from the need to analyze the particular assets in the pool which support the securities. For example, the purchasers of rated MBS are relieved of the burden of conducting extensive due diligence on (1) the many mortgage loans in the pool which provide the cash flow for the MBS, and (2) the bank that originated the loans. Similarly, unlike a bond issued directly by the bank, the purchasers of the MBS are largely immune from event risk of the bank. These characteristics have been important factors in the growth of the securitization market in the United States and have been critical to the development of securitization markets elsewhere in the world.

*Benefits to the Public*

Securitization contributes to lower borrowing costs, both for corporations and individuals. It has expanded the availability of credit in many sectors of the economy and improves the mobility of capital and labor. The existence of the secondary market for ABS and MBS increases the availability of capital for the economy. It aids in the deployment of capital to many areas that would otherwise be deprived of credit options. For example, banks have historically been limited in fund raising to the regions where they accepted deposits. By securitizing their loans, banks can generate new capital for new loans by accessing capital beyond their traditional regions. In addition, by subjecting the lending decisions of banks to valuation by the capital markets, securitization encourages an efficient allocation of capital in the market generally.

**Recent Accounting Developments in the United States**

Beginning in 2000 with Financial Statement of Accounting Standards No. 140 (FAS 140) and then with FASB Interpretation No. 46R (FIN 46R) in 2003, the Financial Accounting Standards Board (FASB) has begun to refine various accounting rules applicable to SPEs. Among other things, a transferor should treat as a sale (and *not* consolidate) financial assets for which control has been surrendered and liabilities have been eliminated. Many of the securitization principles described above are important to achieve this result. Surrender of control generally occurs if three conditions are met:

> (i) the transferred assets have been isolated from the transferor and put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy;
>
> (ii) the transferee has an essentially unconstrained right to further pledge or exchange the transferred assets *or* the transferee is a "qualifying special purpose entity" (QSPE) and its holders have an essentially unconstrained right to transfer their interests in the special purpose entity; and
>
> (iii) with certain exceptions, the transferor does not maintain effective control over the transferred assets through an arrangement that entitles and obligates the transferor to repurchase the transferred assets.

A QSPE is a trust, corporation or other legal vehicle that possesses the attributes of an SPE described above and is limited to performing the activities involved in the securitization. It is intended to be a passive "brain dead" entity with almost no discretion. It continues to serve as an important component of the securitization process.

In the wake of Enron and other miscues, accounting for asset transfers has received increased scrutiny. While FASB continues its work in this area and refinements to FAS 140 and other rules have been implemented and further changes proposed, the basic principles of asset transfers and

QSPEs remain intact and are used every day. Enron has not changed that. The QSPE rules were developed prior to Enron and remain at the center of most securitizations, irrespective of possible future discussions on accounting convergence. It should be remembered that Enron and others did *not* follow accepted securitization rules and principles in order to hide liabilities and problems from their financial statements; true sales did not occur, secret guarantees were given and improper accounting artifices were utilized to pursue fraudulent activities. Off-balance sheet treatment is a widely accepted and sound method to account for legitimate business transactions and corporate events.

**Summary**

Securitization has a key role in the continued evolution of the financial markets. It is not financial alchemy, but a tool for unlocking asset values and creating a market for allocating asset and credit risk.

Securitization reflects innovation in the financial markets at its best. The process allows banks and other originators to realize the value of illiquid assets and provides corporations and individuals with lower costs of capital and borrowing costs. At the same time, ABS and MBS offer investors an array of high quality fixed-income products with attractive yields. The importance of this market is evidenced by its dramatic growth since its inception over 30 years ago to approximately US$7 trillion ABS/MBS outstanding today.

The success of the US securitization market is being repeated in other parts of the world, including Asia. The keys to success have been many, but a flexible, forward-thinking legal and regulatory environment is critical.

Heller Ehrman White & McAuliffe LLP

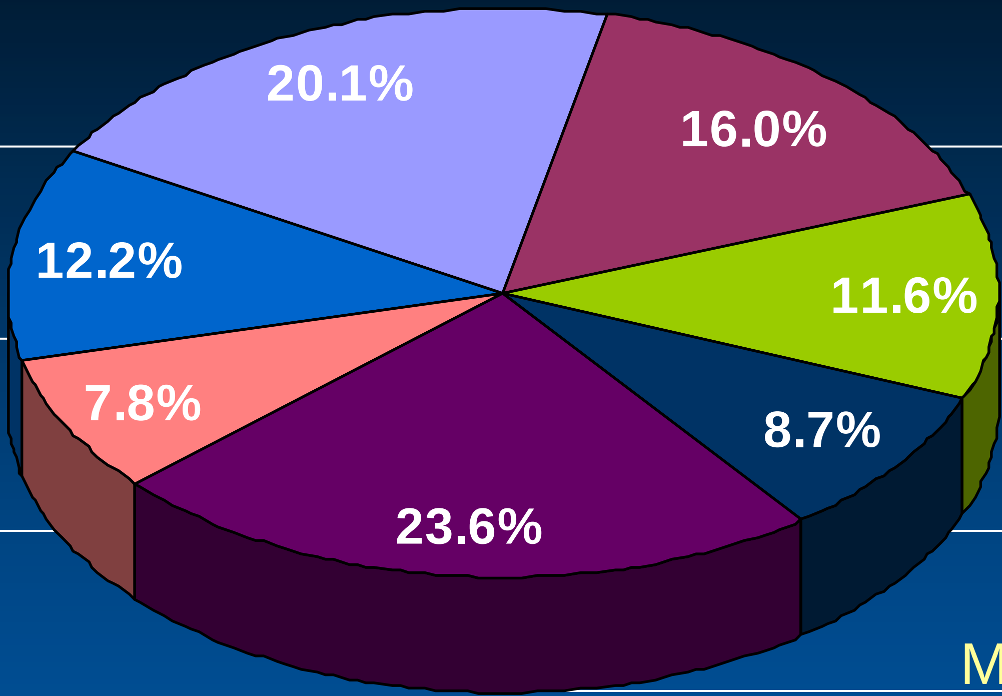
# Securitization’s Impact on the Economy

## Outstanding Bond Market Debt as of Sept. 30, 2003*

Corporate
$4.3 T

Federal Agency
$2.6 T

Asset-Backed
$1.7 T




Treasury(1)
$3.5 T

Money Market
$2.5 T

Municipal
$1.9 T

Mortgage-Related
$5.1 T

## Total Bond Market Debt Outstanding: $21.7 Trillion(2)

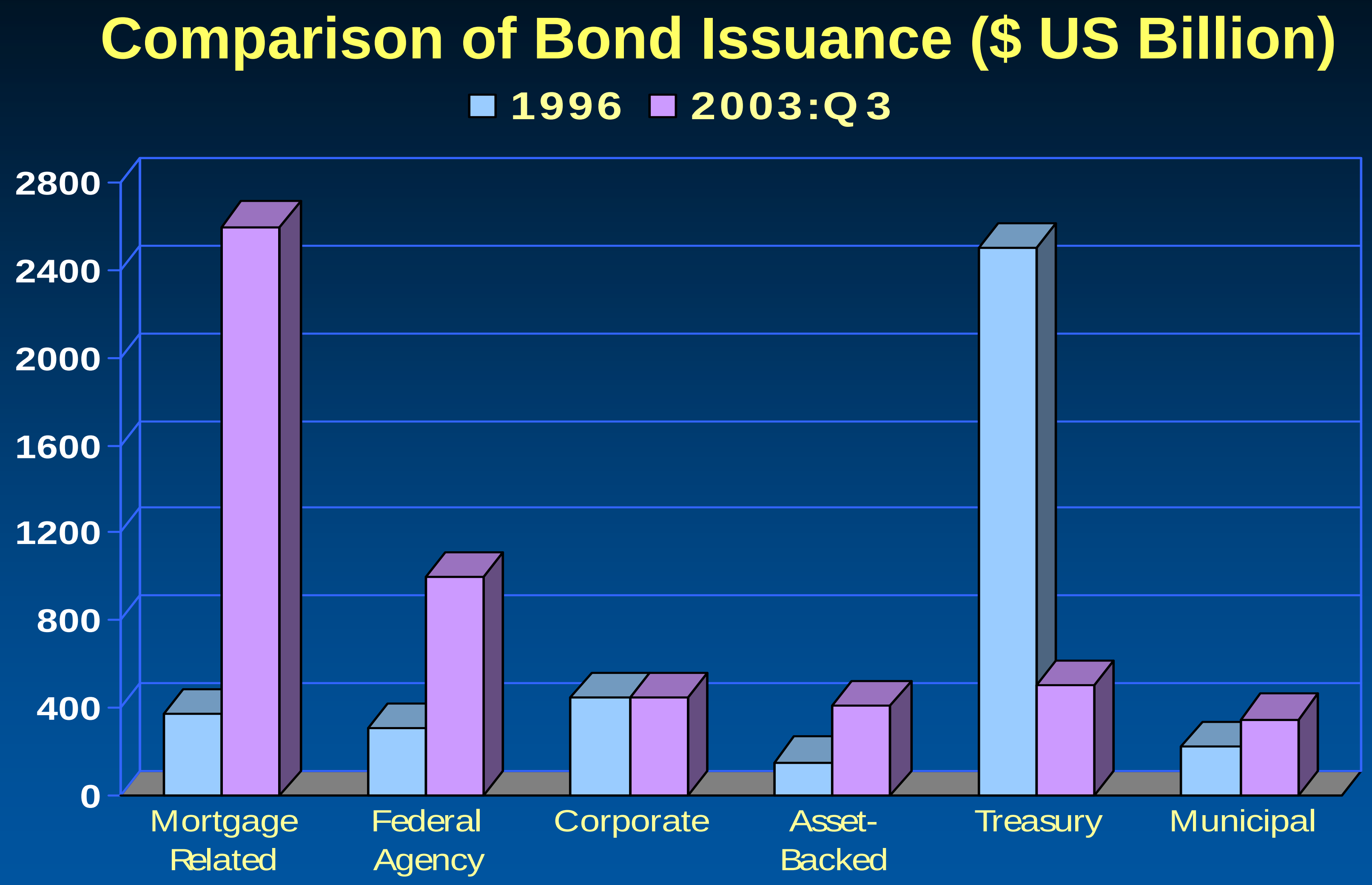
Source: The Bond Market Association Research Quarterly, November 2003

(1) Includes marketable public debt

(2) Figures may not add due to rounding

* The Bond Market Association estimates

Securitization’s Impact on the Economy

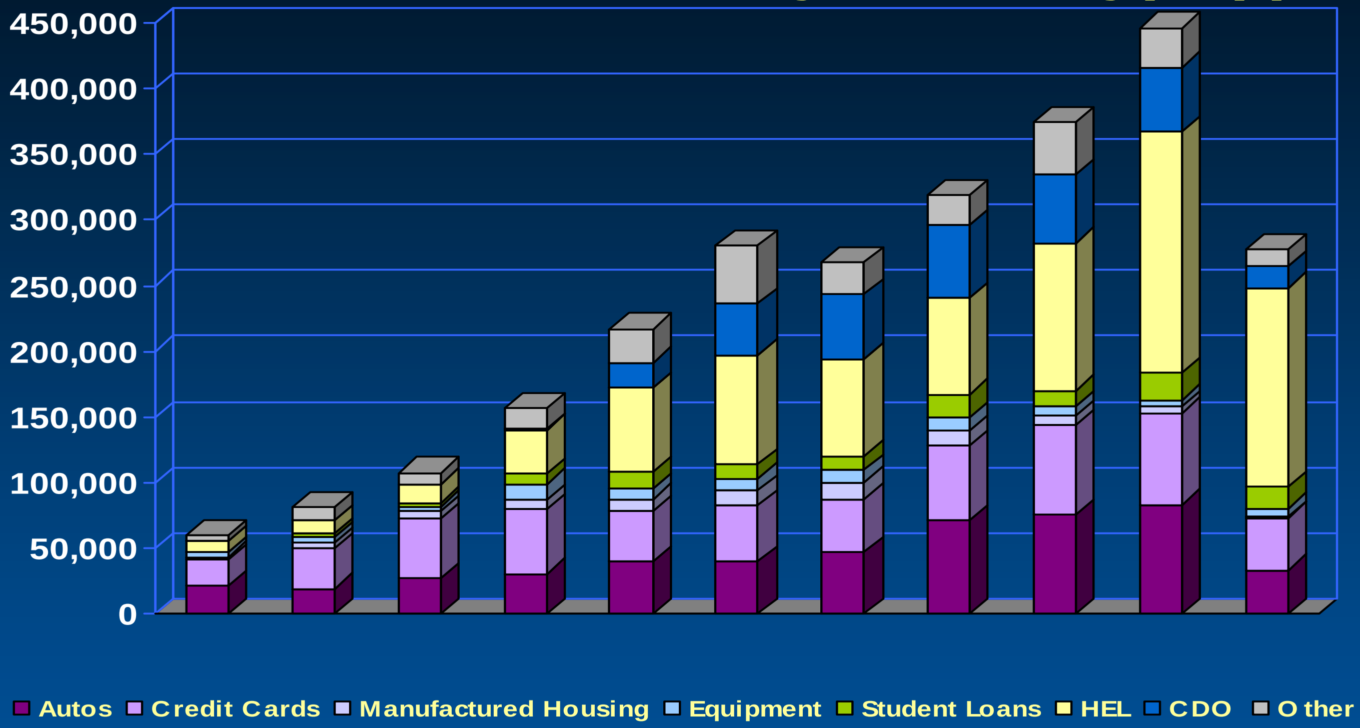



Source: The Bond Market Association Research Quarterly, November 2003

(1) Includes long-term issuance only

# Securitization's Impact on the Economy

## ABS Issuance by Asset Type(*)



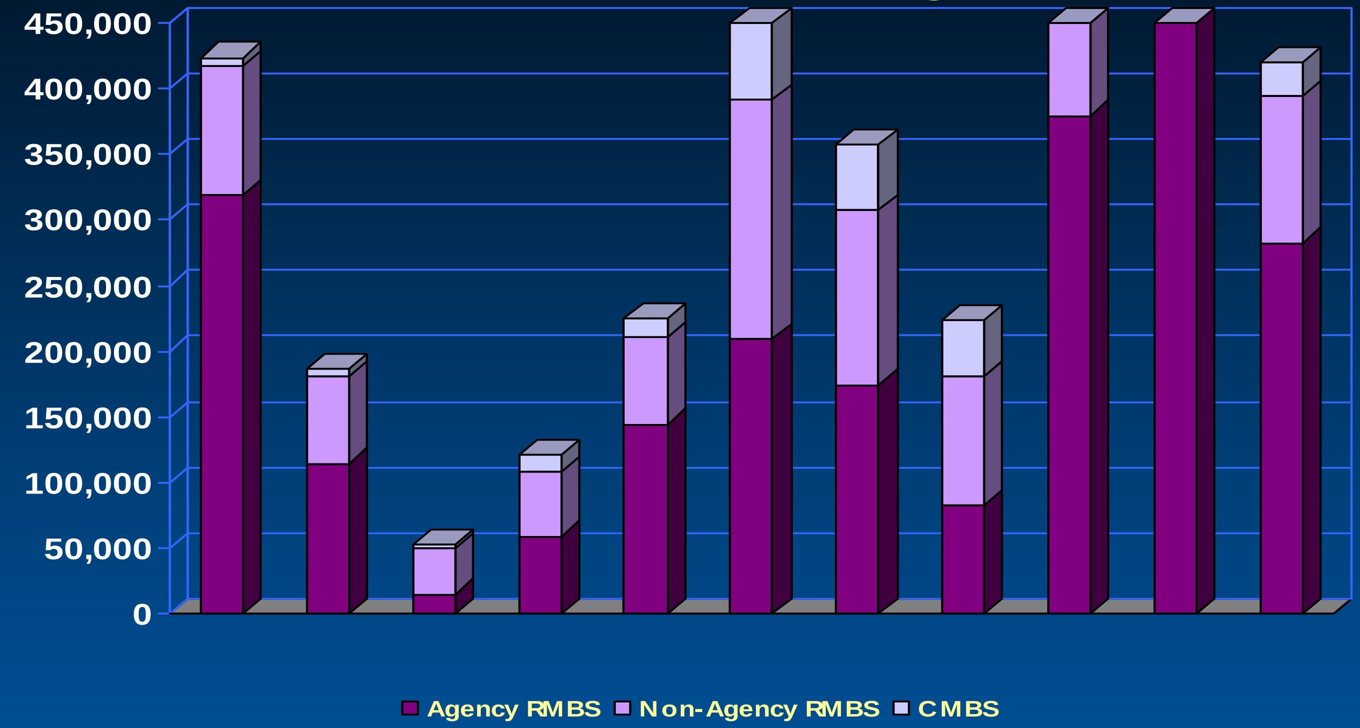

| | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 1H 2003 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Autos | $21,847 | $19,126 | $27,379 | $30,598 | $39,921 | $39,439 | $47,016 | $71,028 | $75,514 | $83,118 | $33,438 |
| Credit Cards | $19,009 | $30,625 | $45,155 | $49,175 | $38,183 | $43,069 | $40,675 | $57,142 | $68,118 | $70,187 | $39,903 |
| Manufactured Housing | $2,487 | $4,662 | $5,767 | $7,547 | $9,353 | $11,817 | $12,854 | $11,277 | $7,150 | $4,619 | $714 |
| Equipment | $3,592 | $4,008 | $3,442 | $11,534 | $8,322 | $8,989 | $9,545 | $9,702 | $7,104 | $5,328 | $6,192 |
| Student Loans | $340 | $2,462 | $2,862 | $8,047 | $12,474 | $10,229 | $10,314 | $18,351 | $12,521 | $20,937 | $16,421 |
| HEL | $8,257 | $10,433 | $14,466 | $33,516 | $63,660 | $83,774 | $74,070 | $73,236 | $112,472 | $182,806 | $152,022 |
| CDO | $385 | $48 | $2 | $333 | $19,437 | $38,655 | $49,413 | $55,577 | $51,672 | $49,694 | $15,822 |
| Other | $3,708 | $9,441 | $8,258 | $15,663 | $25,741 | $44,313 | $23,476 | $22,464 | $39,617 | $29,872 | $13,012 |

Source: Thomson Financial Securities Data

(*) Includes Public & 144a transactions

# Securitization’s Impact on the Economy

## MBS Issuance by Sector

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