

16 March 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

Thank you for your letter of 3 March 2005, inviting me to give further views on the impact of the Companies (Amendment) Bill on the asset securitization market in Hong Kong. Below are my responses to the following two points:

- (a) the type(s) of “control: that a transferor (or originator) needed to exercise over its securitization SPEs, including a situation where the SPE was set up under the “auto-pilot” mechanism; and
- (b) other possible alternatives to address the issue, e.g. whether a mechanism could be devised in such a way that securitization SPEs would not fall within the proposed definition of “subsidiary” and hence would not be subject con consolidation in companies’ group accounts.

As the two questions are interrelated, I will provide my comments altogether.

First, the securitization SPE is established for the specific purpose of facilitating the financing with very limited scope of operations. SPEs commonly are created to contractually isolate the risks and rewards relating to a specific asset or project. The typical SPE charter explicitly specifies the operating activities of the entity. When the SPE is on autopilot, the managers essentially have nothing to control but simply to collect cash flows from the assets and distribute them to investors according to the terms of contract.

Even though the originator does not have control in form, some argue that it might have control in substance. The SIC 12 issued by the IASB enumerated a 4-point test to identify the originator exercising control of the SPEs: (a) the SPE, in substance, is structured in a way that its activities are being conducted on behalf of the originator; (b) the originator, in substance, has the decision-making powers to obtain control of the SPE

or its assets; (c) the originator, in substance, has rights to obtain the majority of the benefits of the SPE; or (d) the originator, in substance, bears significant residual risks related to the SPE.

Since most of the SPEs involve the use of credit enhancement provided by the originator which bears significant residual risks related to the SPE, they will fail test (d) and have to be consolidated.

There are at least two means of credit enhancement provided by the originator. First, it could provide a guarantee to the SPE's investors that losses will be no more than a pre-set percentage of assets. Second, the SPE could issue different tranches of securities of different seniority. For example, it could issue senior notes ("A notes"), junior note ("B notes") and the most subordinated note ("C note"). The originator could enhance the credit rating of senior and junior notes by purchasing the subordinated note, and effectively bear the residual risks of the SPEs.

Therefore, in order for securitization SPEs not to fall within the proposed definition of "subsidiary", the originator could choose not to provide any form of credit enhancement. However, this should make the securities issued by the SPEs less attractive and increase the required yield. I do not have data on how much this will increase the cost of issuing securitization notes. But obviously, this will reduce the incentives for securitization.

Thank you again for your kind invitation. I hope my views are of help to the Bills Committee

Yours truly



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