

19 May 2005

Urgent By Fax

Our Ref.: C/FRSC

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,

Companies (Amendment) Bill 2004 Proposed legislative amendments to the definition of "subsidiary"

The Financial Services and The Treasury Bureau (FSTB) advised us that there are certain matters to be followed up by them and reported back to the Bills Committee, as set out in the "List of follow-up actions to be taken by the Administration" following on from the seventh meeting of the Bills Committee on 7 April 2005. They have requested that we provide a response to some of the matters set out in the list and we are pleased to provide our comments below.

1(b) Impact of the Bill on the development of the asset-securitisation market in Hong Kong

Hong Kong Mortgage Corporation Limited (HKMC)'s submission dated 11 March 2005 (LC Paper No. CB(1)1113/04-05(01)(paragraph 14) and Professor Kalok Chan's submission dated 16 March 2005 (LC Paper No. CB(1)1130/04-05(01)(second last paragraph)

In a common mortgage-backed securitisation structure, there are usually two transfers of the mortgage assets: the first transfer is by the originator (usually a bank) to an intermediary, which is then followed by the second transfer of the mortgage assets by the intermediary to a special purpose entity (SPE) set up by the intermediary. Following that, the SPE would securitise the mortgage assets and sell the related securities to outside investors.

Given that the first transfer is usually effected by way of a true clean sale between two unrelated parties, the originator (which is usually also the service provider) would be able to remove the mortgage assets from its balance sheet even when the "control-based" definition of subsidiary is used. This is because the entity to which the mortgage assets have been transferred will not have been set up by the originator, and will not be

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controlled in any other way by the originator. Accordingly, the passing of the Bill would neither have an impact on the financial statements of those originators undertaking a transfer of mortgage assets to the intermediary nor have an effect on their incentives for making such a transfer. The Bill will therefore not affect the demand from originators to enter into such transactions.

As far as the second transfer is concerned, the characteristics of the transfer and the establishment of the SPE as set out in Annex 4 to the HKMC's submission clearly demonstrates that control exists between the intermediary and its SPE. Accordingly, it is true that, after passing the Bill, the mortgage assets transferred from the intermediary to the SPE will likely have to be consolidated back into the financial statements of the intermediary and, as a consequence, the financial ratios of the intermediary will be affected. However, we do not consider the new accounting treatment per se will result in the investors demanding a higher yield of return.

We believe that, if the investors were to require a higher return, the main reason would be to compensate for any higher risks involved in the intermediary conducting more business than the market would perceive to be prudent given its capital base. However, investors are already aware of the additional risks being undertaken by the entity because these are spelled out in a note to the financial statements, and so the investor will be able to take that risk into account when determining the return required for making an investment. The principal impact of the proposed amendments to the definition of subsidiary would be to present the information now contained in the note more prominently (and more accurately) in the financial statements. The new presentation is designed to provide a more appropriate reflection of the results and the state of affairs of the group. However, viewed in the whole, there would be no change to the amount of information provided in the financial statements.

The Hong Kong Capital Markets Association's submission dated 31 December 2004 (LC Paper No. CB(1)647/04-05(01)(paragraph 4)

We consider that the statement "continued growth and expansion in the number of issuers will only be supported by the ability to achieve off balance sheet treatment for securitized assets" is unfounded. Among those jurisdictions that have already adopted and will soon adopt the control-based definition of subsidiary for the purpose of preparing consolidated financial statements, many of them have securitisation markets that are significantly larger than Hong Kong. These include Australia and the European Union.

1(c) To clarify whether the current off-balance sheet treatment for securitization SPEs has failed to give a "true and fair view" of the company's group accounts

We are of the view that off-balance sheet treatment for securitisation SPEs by the entity that has control over them would result in the financial

statements of that entity not giving a true and fair view. This is because the financial statements so presented fail to take into account all of the assets and liabilities controlled by the group of that entity. Currently, however, financial statements of Hong Kong Companies are not qualified by their auditors for non-consolidation of SPEs because HKAS 27 Consolidated and Separate Financial Statements includes certain specific provisions for companies incorporated under the Companies Ordinance that require those companies to use the definition of a subsidiary as set out in section 2(4) of the Companies Ordinance in preparing consolidated financial statements. The specific provisions are included based on the legal advice that the definition of "subsidiary" and "holding company" in sections 2(4) and 2(7) of the Companies Ordinance are exhaustive for the purposes of preparing group accounts as defined by section 124(1) of the Companies Ordinance and, accordingly, a Hong Kong company may not consolidate a company that does not meet the definition of a subsidiary in the Companies Ordinance. However, it should be noted that the inclusion of these specific provisions in HKAS 27 was always intended by the Institute to be a short-term interim measure in anticipation of the proposed amendments to the Companies Ordinance and designed to avoid the need to automatically qualify the financial statements of Hong Kong companies that had SPEs. It should also be noted that for non-Hong Kong incorporated companies the obligation to consolidate SPEs currently exists, and failure to do so would result in financial statements not showing a true and fair view and therefore receiving an audit qualification.

Because of what we have described above, there exists in Hong Kong an inconsistency in the application of the "true and fair view" principle. As indicated, it was always the intention of the Institute for this inconsistency to be short-lived. If the law is amended to provide a carve-out for a specific business activity or business sector from the need to consolidate controlled entities, we are concerned that this may encourage many entities to take advantage of these provisions. This would then perpetuate the existing inconsistency, and this is something that we would strongly advocate against.

1(e) To provide a detailed response in respect of the overseas experience in particular...:

HKMC's submission dated 11 March 2005 (The True Sale Initiative in Germany)

In the HKMC's submission dated 11 March 2005, certain information about the True Sale Initiative (TSI) in Germany was attached. Based on the information provided, we note that the 13 banks involved in the TSI had lobbied for changes in tax and insolvency legislation to make it easier for them to securitise their debts. We also note that, prior to the introduction of the TSI in Germany, every mortgage had to be registered if it was securitised. Accordingly, we consider that the TSI is a fiscal rather than an accounting measure to facilitate securitisation in Germany. From an accounting perspective, any German company that is listed will be required to comply

with International Financial Reporting Standards from January 1, 2005, and will therefore be required to consolidate SPEs.

In Hong Kong, no changes to the current legislation similar to that in Germany would be needed to accommodate securitisation transactions. Accordingly, we do not believe the TSI in Germany provides valid grounds for arguing against the proposed amendments to the definition of subsidiary in the Companies Ordinance.

We trust that the above assists the Bills Committee with their deliberations on the matters raised. Should the Bills Committee have any questions on the above we would welcome the opportunity to explain our comments further.

Yours sincerely,

Stephen Chan

Executive Director

SSLC/EH/al

c.c. Miss Emma Lau, Deputy Secretary (Financial Services), FSTB
 The Hon. Mandy Tam, Legislative Councillor (Accountancy)
 Ms. Connie Szeto, Clerk to the Bills Committee on Companies (Amendment)
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