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Clerk to Bills Committee
The Legislative Council
Legislative Council Building
8 Jackson Road
Central
Hong Kong

(Attn: Ms. Connie Szeto)

Dear Sir/Madam,

Bills Committee on Companies (Amendment) Bill 2004
Invitation for submissions

Thank you for your letter of 10 November 2004. I enclose our submission to the Bills Committee on the Companies (Amendment) Bill 2004 for your further action.

Yours faithfully,

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Bills Committee on
Companies (Amendment) Bill 2004

Invitation for submissions

Introduction

1. Thank you very much for the invitation seeking the views of the Hong Kong Mortgage Corporation ("**HKMC**") on the Bill. The HKMC has previously made a number of submissions[1] on behalf of the securitisation industry respectively to the Hong Kong Society of Accountants (since renamed as the Hong Kong Institute of Certified Public Accountants ("**HKICPA**")) and the Financial Services and the Treasury Bureau ("**FSTB**"). These submissions were concerned with, initially, changes proposed by the HKICPA to Hong Kong Accounting Standards ("**HKAS**") which would have an adverse impact on the asset securitisation industry and, subsequently, with the consequential proposed legislative amendments to the definition of "subsidiary" in the Companies Ordinance ("**CO**").

2. We appreciate that the FSTB recognised in paragraph 3 of the Legislative Council brief dated 6 October 2004 that this Bill might have an impact on the asset securitisation industry and they would continue to watch international developments, in particular, in relation to the international accounting standards ("**IAS**") closely. For ease of reference, we briefly summarise our salient points below:

(a) the mortgage-backed securitisation ("**MBS**") market in Hong Kong has great potential for growth. However, the proposed amendments will make off-balance sheet treatment, which is a major driver for some transactions, very difficult to achieve and thus have a chilling effect on Hong Kong's fledgling securitisation market (around 0.48% of GDP in 2003, as compared to 13.3% in the US, 4.7% in the UK, and 6.3% in Australia);

(b) there is continuing controversy over the effects of IAS on the global securitisation industry and the American, Australian and European Securitisation Forums have made submissions to the International Accounting Standards Board ("**IASB**") and been in discussion and negotiation with the IASB on modifications to the IAS to facilitate off-balance sheet treatment for genuine MBS transactions where the risks have been transferred from the transferor to a special purpose entity ("**SPE**");

[1] Submissions dated 20 October 2000 to the Hong Kong Society of Accountants, and 15 May 2003, 8 August 2003, 30 June 2004 and 9 November 2004 to the FSTB, attached as ***Annexes 1 to 5***.

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(c) the amendments to the CO will entrench the current IAS definition of "subsidiary" into the CO when the relevant IAS themselves are in a state of flux and in fact quite controversial in some respects. The IASB has a number of projects[2] in progress which are reviewing the relevant IAS and the related exposure drafts are expected to be due out in 2005. When such changes are introduced and if they affect the definition of "subsidiary" or other provisions in the CO, this would require another round of legislative amendments to the CO;

(d) entrenchment of the definition of "subsidiary" in the CO will therefore put Hong Kong at a competitive disadvantage vis-à-vis other countries (like Australia and Singapore) that do not have entrenched definitions; and

(e) some banking regulators have already taken the view that IAS do not adequately address regulatory capital reporting requirements for banks. In relation to the consolidation of SPEs as required by the IASB/HKICPA, the Hong Kong Monetary Authority ("**HKMA**"), in discussions with the banking industry associations, has indicated its view that the consolidation of SPEs does not properly reflect the risks assumed by the banks (i.e. consolidation would overstate the retained risks and understate the capital adequacy ratio). The HKMA therefore is requesting the supervised banks to continue to submit separate accounts drawn up in accordance with existing supervisory standards (i.e. without consolidating SPEs). We understand that the Australian Prudential Regulatory Authority will also implement a separate parallel reporting requirement from banks.

3. In May 2004, the HKICPA adopted IAS 39 as HKAS 39, which will come into effect from 1 January 2005. There is however a caveat that its full effect would not apply until such time as the current definition of "subsidiary" is amended in the CO so that it would be in line with the HKAS 39. If the proposed legislative amendments to the CO are passed, this will mean that Hong Kong originators will not only be subject to the provisions of HKAS 39, which already greatly restrict the scope for off-balance sheet treatment, but in addition will have to deal with the effect of IAS 27 and SIC-12 (adopted as HKAS 27 and HK-Int 12[3]), the combined effect of which will make achieving off-balance sheet treatment even more difficult.

4. In addition, we would also submit that, irrespective of whether the definition of "subsidiary" is enacted in its current form, the "true and fair view" ("**TFV**") override proposed in the Bill as a solution to enable the CO to adapt to future changes in accounting standards may be unable to achieve its stated aim without amendment.

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[2] Active projects include: Consolidation (including special purpose entities) and Convergence.

[3] HKAS 27 deals with the preparation and presentation of consolidated financial statements for a group of entities under the control of a parent; HK-Int 12 deals with consolidation of special purpose entities; and HKAS 39 deals with the accounting treatment of financial assets and liabilities including the derecognition of assets on sale/transfer.

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Definition of "subsidiary"

5. The existing definition of "subsidiary" in Hong Kong is similar to the definitions in Australia and Singapore and is based on the three classic tests of (a) control of the board, (b) more than 50% of the voting power or (c) more than 50% of the share capital of an entity. The definition to be introduced in Hong Kong is very similar to the existing definition in the UK Companies Act 1985 which incorporates a "dominant influence" test, in addition to the three classic tests, to determine the existence of a parent-subsidiary relationship. However, notwithstanding the adoption of IAS in Australia and Singapore, these jurisdictions have no intention to amend the definition of "subsidiary" in their legislation.

6. Moreover, the companies legislation in Australia and Singapore does not prescribe any requirements for the contents of financial reports, instead it is stipulated that financial reports must comply with accounting standards as promulgated from time to time. Accordingly, despite their respective adoption of IAS, neither Australia nor Singapore sees the need to amend its existing definitions of "subsidiary" and therefore neither has a definition of "subsidiary" which captures securitisation SPEs: consolidation issues in relation to SPEs in these jurisdictions are dealt with by way of the accounting standards.

7. In Hong Kong, however, the proposed amendments, if passed, would effectively entrench a specific definition of "subsidiary" into the CO and if accounting standards subsequently changed in a way that became inconsistent with the entrenched definition, further legislative amendments would be needed. This puts Hong Kong at a disadvantage vis-à-vis Australia and Singapore in terms of its ability to introduce synchronised changes to the CO as and when accounting standards are changed.

TFV override as solution to entrenchment problem

8. To counter this disadvantage, it is argued in the Legislative Council brief that the TFV override provision will cater for the evolving nature of accounting reporting requirements. The TFV override requires directors to depart from "any requirement of the Tenth Schedule" or any "other requirements of the Ordinance as to the matters to be included in a company's balance sheet and profit and loss account" where compliance would be inconsistent with the requirement to present a TFV. Accordingly, it is argued, if accounting standards change, there will not be a need to amend the CO immediately in a synchronised manner since any inconsistency between the CO and accounting standards can be, and indeed must be, dealt with by the TFV override.

9. The TFV requirement is a legal concept and therefore a matter to be determined by the court. In determining whether a set of accounts complied with the requirement to give a TFV, the court would in turn look for guidance to the practices of professional accountants and would regard compliance with accounting standards

as prima facie evidence that the accounts in question gave a TFV[4]. Thus if accounting standards change so must what is regarded as a TFV change along with those accounting standards. The wording of the TFV override is derived from and almost identical to similar provisions of sections 226A and 227A of the UK Companies Act 1985[5]. However in the UK, there is authority[6] which suggests that the effect of the TFV override is limited only to matters of disclosure and does not enable a company to depart from other provisions of the Act (e.g. definitions) even though section 227A also has language that overrides other provisions of the Act. If a similar interpretation of the TFV override is adopted in Hong Kong, then if accounting standards change in a manner which conflict with parts of the CO other than the Tenth Schedule and other matters of disclosure, the TFV override will not enable a company to disregard the requirements of the CO and follow accounting standards. Accordingly, the Bills Committee may wish to consider whether the TFV override provision should be amended to expressly extend its overriding effect over other sections in the CO, such as the definitions section.

10. However, even if a revised TFV override is implemented, there is also the practical difficulty to be overcome by a company wishing to avail itself of the TFV override provisions. The obligation to present accounts in the format specified by the CO is onerous, and one which is backed by heavy criminal penalties on a company's directors for non-compliance (see sections 123(6) and 124(3) of the CO). Accordingly, to depart from the requirements of the CO is not something that can or will be lightly undertaken and, even if the directors of a company were of the view that it was necessary to make use of the TFV override, it is questionable whether the company's auditors could be persuaded to endorse such departure. To illustrate this point, even now, trying to obtain a consistent opinion from the Big 4 accountancy firms is difficult and we are aware of one example cited by a leading bank where one of its clients, a prospective MBS issuer, has approached two of the Big 4 accountancy firms for an opinion on the availability of off-balance sheet treatment for its proposed transaction. The client was given an affirmative advice by one accountancy firm but a negative advice from another. It was not possible to resolve this divergence of advice, despite the client having spent 18 months trying to do so. In the end due to the uncertainty, the client decided not to proceed with the transaction. Thus whilst theoretically there might appear to be scope for painless adaptation to changes in accounting standards through the availability of the TFV override, the asset

[4] Joint Opinion of Leonard Hoffman QC (now Lord Hoffman) and Mary Arden (now Arden LJ) in 1983.

[5] On 11 November 2004, the Companies Act was amended to require listed companies to prepare individual and group accounts in accordance with IAS. However, unlisted companies are given the option to prepare individual and group accounts either in accordance with the previous provisions of the Companies Acts (Companies Act accounts) or in accordance with IAS. Sections 226A and 227A deal with Companies Acts accounts and incorporate a TFV override.

[6] In the Argyll Foods case (unreported), the company in question chose to consolidate the accounts of a subsidiary, using the TFV override to justify its contravention of certain provisions of the Companies Act 1948. The magistrates who heard the case decided that the accounts did not show a TFV, and subsequently the Department of Trade and Industry (which had brought the prosecution) issued a statement interpreting the decision as confirmation that the "true and fair view override" was limited to the disclosure requirements of the Companies Acts and could not be used to enable a company to depart from other provisions (e.g. definitions) in the Acts (see Palmer's Company Law paragraph 9.203) (***Annex 6***).

securitisation practitioners that we have consulted are of the prevailing view that it is doubtful whether the TFV override provisions will prove to be easily utilised in practice.

Possible options for Bills Committee to consider

11. **Carve-out for securitisation SPEs**: Our preferred option is for the legislation to expressly provide a carve-out from the definition of "subsidiary" for asset-securitisation SPEs similar to the concept of the Qualifying SPE (**"QSPE"**) available under US accounting rules. The IASB and the Federal Accounting Standards Board have entered into an agreement[7] for the convergence of international and US accounting standards; however, notwithstanding concern about the abuse of SPEs following a number of financial scandals (e.g. Enron), it is significant to note that there are apparently as yet no plans to phase out the concept of QSPEs under FASB 140, which remains untouched due to the importance of the US$ 7.1 trillion[8] securitisation industry to the US economy.

12. **Adoption of "linked-presentation"**: Alternatively, the HKICPA should consider possible amendments to the HKAS which would enable asset-securitisation SPEs to use the UK's "linked-presentation" format for their accounts which could clearly disclose the effect of the securitisation transaction on the originator's balance sheet (ref. example in ***Annex 7***). Although "linked-presentation" will no longer be available for listed companies in the UK as from 1 January 2005, unlisted companies will still have the option for the time being to make use of the rules. In our discussions with the HKICPA, they were however not receptive to the proposition to introduce "linked-presentation" in Hong Kong. On the other hand, there is an ongoing dialogue between the IASB and the American, Australian and European Securitisation Forums on possible amendments to the IAS to accommodate securitisation activities based on the "linked-presentation" approach. However, we understand that a period of 1-2 years may be required before a suitable framework is agreed.

13. **"Wait and see" approach**: As a result of the discussions with the trade forums, the IASB itself is undertaking a review of IAS 27 and is intending to publish an exposure draft of proposed amendments to IAS 27 as soon as mid-2005[9], which will also consider whether or not the revisions to the "control" model for subsidiaries should also be applied to SPEs. In view of the short delay before publication of the exposure draft, we submit that it would not be objectionable for there to be a short deferral of the amendments so that the exposure draft provisions can be properly considered for their effect on Hong Kong.

14. In preparing this submission, we have consulted widely with the Asian Securitisation Network, which includes within its membership leading practitioners of Hong Kong's asset securitisation industry. Hong Kong would benefit substantially by

[7] The Norwalk Agreement dated 18 September 2002.
[8] Outstanding amount of mortgage-backed and asset-backed securities in the US as at 30 June 2004.
[9] Consolidation (including special purpose entities) Project Update 23 November 2004 and IASB Update November 2004, both attached as ***Annex 8***.

encouraging the growth of a large and sophisticated securitisation industry which would put us in a leading position to influence the development of the securitisation market in China, and the best way to achieve this would be to promote a flexible and business-friendly legislative environment which can respond quickly to changes in international practices to ensure that Hong Kong is not placed at a competitive disadvantage in relation to at least other financial centres in the region. The adoption of the legislative changes without any measures to facilitate genuine securitisation transactions will not be conducive to the development of Hong Kong's securitisation industry and we would urge the Bills Committee to give positive consideration to the options put forward above.

The Hong Kong Mortgage Corporation Limited
9 December 2004

The Hong Kong Mortgage Corporation Limited

Previous Submissions of the HKMC to the Hong Kong Society of Accountants ("HKSA") and the Financial Services and the Treasury Bureau ("FSTB")

(see Annexes 1-5)

Annex 1 – Submission dated 20 October 2000 to the HKSA

Annex 2 – Submission dated 15 May 2003 to FSTB

Annex 3 – Submission dated 8 August 2003 to FSTB

Annex 4 – Submission dated 30 June 2004 to FSTB

Annex 5 – Submission dated 9 November 2004 to FSTB

The Hong Kong Mortgage Corporation Limited

HKMC's Submission to
Bills Committee on
Companies (Amendment) Bill 2004

(Annexes 6 – 8)

Annex 6 – Palmer's Company Law paragraph 9.203

Annex 7 – Example of UK's "linked-presentation" format

Annex 8 – IASB's Consolidation (including special purpose entities) Project Update dated 23 November 2004 and IASB Update November 2004

9 December 2004

Remarks:

The voluminous Annexes 1 to 8 are not enclosed. Members of the Bills Committee who are interested to have sight of the Annexes may contact Ms May LEUNG at 2869 9132.