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Securitisation in Hong Kong

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Securitisation professionals are continuing to have to look elsewhere in the region for deals given the extremely low level of activity in Hong Kong - both before and after the onset of the current credit and liquidity turmoil. Unlike some other Asian jurisdictions which have still managed to bring new issues to the market in recent months, Hong Kong has remained dormant with no reported new issues in 2007.

Even The Hong Kong Mortgage Corporation Limited (HKMC), Hong Kong's leading originator of mortgage-backed securities, stayed away from the asset-backed securities (ABS) market last year without doing its annual residential mortgage-backed transaction pursuant to its Bauhinia MBS Limited programme. The HKMC has accounted for approximately one-quarter of all Hong Kong securitisations over the last decade and it is looking to expand its securitisation platform to non-mortgage assets and selected overseas markets.

One positive aspect of the Hong Kong market generally is that investors are not turning their back on alternative asset classes. Hong Kong continues to be one of the most developed markets for structured products, many of which are sold to retail investors. This strong investor appetite, coupled with the government's support of the financial services industry, has led to volume growth and product sophistication in the non-asset backed space. This is reassuring for ABS originators and arrangers and will hopefully provide some incentive for them to return to the market in the near future.

Despite the lack of new issuance, warehousing activity has continued across various asset classes, albeit at a relatively slower pace.

Market participants are looking forward to the inaugural Asia-Pacific Securitisation Forum in Macau on September 17 and 18 this year. The forum includes ABS and collateralised debt obligation streams and focus sessions on Korea, India, Taiwan and Japan.

Structures

Many of the structures and securitisation techniques that have been used in other common law jurisdictions (eg, Australia and England) have been used in Hong Kong.

In March 1997 The HKMC was established with objectives including promoting wider home ownership and developing the secondary mortgage market in Hong Kong. The HKMC is a public listed company owned by the Hong Kong government which has an authorised share capital of HK\$3 billion, of which HK\$2 billion has been subscribed and paid up.

The HKMC provides a strategic intermediary role by purchasing mortgages from banks and mortgage lenders operating in the Hong Kong market. To date, The HKMC has established two mortgage-backed securities programmes:

- a guaranteed mortgage-backed pass-through programme established in late 1999; and
- the Bauhinia programme, Hong Kong's first \$3 billion multi-currency series segregated mortgage-backed securities programme, which was launched in December 2001.

The Bauhinia programme documents were updated as part of the Series 2004-2 issue to provide for retail offerings and expand the categories of underlying mortgage loans which can be securitised through the programme. The Series 2004-2 issue was the first retail offering of mortgage-backed securities in Asia (coupled with notes for institutional investors) and included a plain-language retail prospectus which was registered with the Hong Kong Securities and Futures Commission.

Legal and regulatory regime

General

The Hong Kong Special Administrative Region operates a common law system, historically based on English law. The Joint Declaration of December 19 1984 between the United Kingdom and the People's Republic of China (PRC) provided for the PRC to legislate for the

preservation of Hong Kong's capitalist system after the handover on July 1 1997. The Basic Law was enacted by the PRC in April 1990 and provided that the laws in force in Hong Kong as at June 30 1997 would remain in force after the handover, apart from any laws that contravene the Basic Law.

The Basic Law sets out general principles concerning issues such as the political structure in Hong Kong, the judiciary and the right to private property. The Basic Law also provides that the capitalist system will be preserved in Hong Kong for at least 50 years from the date of the handover.

Thus, the legal system in Hong Kong remains a system which is largely based upon English law. Unlike many of the civil law jurisdictions in Asia (eg, Korea, Japan and Taiwan), Hong Kong did not have to introduce specific legislation to facilitate securitisation. The regulatory regime in Hong Kong makes it one of the most securitisation-friendly jurisdictions in the Asia-Pacific region.

Therefore, as a general rule the securitisation techniques and structures that have been used in similar common law jurisdictions, such as Australia and England (both of which have had extremely active securitisation markets for more than 20 years), will broadly be able to be duplicated in Hong Kong. Examples include synthetic, trust and whole business/secured loan-type structures.

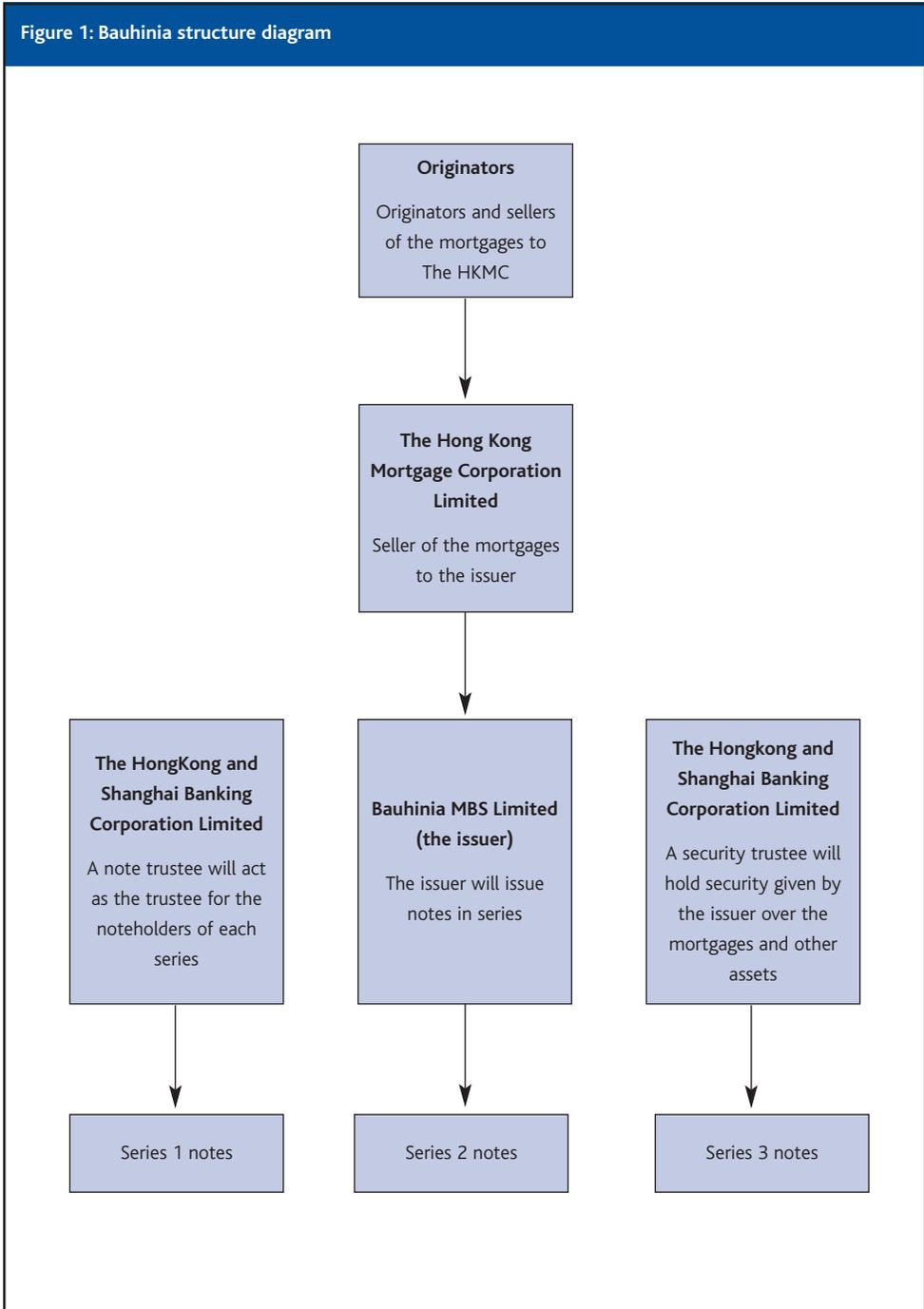
Insolvency

The Companies Ordinance and the Conveyancing and Property Ordinance contain anti-avoidance provisions in relation to corporate insolvency similar to those in other developed markets. As expected, rating agencies require legal true-sale opinions in cash securitisations to deal with these provisions specifically, rather than simply relying on the general qualification as to insolvency laws and other laws of general application affecting the rights of creditors.

Preferences

Under Section 266B of the Companies Ordinance, any conveyance or transfer of property by a company to a

Figure 1: Bauhinia structure diagram



person in the six months (or, in the case of an unfair preference to an associate, two years) before the commencement of its winding-up will be deemed an unfair preference of its creditors upon the winding-up of the company and will be invalid if:

- at the time, or as a consequence of the preference, the company is unable to pay its debts as they fall due or the value of its assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities;
- that person is one of the company's creditors or a surety or guarantor for any of its debts or other liabilities; and
- the company does anything or suffers anything to be done which has the effect of putting that person into a position which, in the event of the company's insolvency, will be better than the position the person would have been in had nothing been done.

However, a court will not restore the position to what it would have been if the company had not given the unfair preference, unless the company was influenced in deciding to give the unfair preference by a desire to produce the effect set out in the third bullet point above. A company that gives unfair preference to a person which, at the time the unfair preference was given, was an associate of the company is presumed to have been so influenced unless the contrary is proved.

Floating charge

Under Section 267 of the Companies Ordinance, a floating charge created within 12 months of the commencement of the winding-up of a company will be invalid unless the company was solvent immediately after the creation of the charge. However, the charge will be valid in relation to the amount of any cash paid to the company at the time of or subsequent to the creation of, and in consideration for, the charge, together with interest.

Disclaimers of onerous property

Under Section 268 of the Companies Ordinance, a liquidator may, with the leave of the court, disclaim any onerous property within 12 months of the commencement of the winding-up of the company or such extended period as may be allowed by the court. The disclaimer determines the rights, interest and liabilities of the company in the relevant property, but does not affect the rights or liabilities of any other person, except insofar as is necessary for the purpose of releasing the company from liability. A person sustaining loss or damage as a result of the disclaimer is deemed to be a creditor of the company to the extent of the loss or damage, and may prove for the loss or damage in the winding-up.

Onerous property for these purposes includes any unprofitable contract and any other property of the company which is unsaleable or not readily saleable, or is such that it may give rise to a liability to pay money or perform any onerous act.

Fraudulent disposition

Under Section 60(1) of the Conveyancing and Property Ordinance, a disposition of property made with intent to defraud creditors will be voidable at the instance of any person prejudiced by such disposition. This does not extend to any estate or interest in property disposed of for valuable consideration and in good faith to any person not having, at the time of the disposition, notice of the intent to defraud creditors.

Recharacterisation

The analysis under Hong Kong law as to the risk of a court recharacterising a sale as a form of security interest is broadly consistent with that under English law. Accordingly, rating agencies are generally comfortable with the level of comfort provided by Hong Kong counsel on this issue.

Regulatory regime

The main regulatory body is the Hong Kong Monetary Authority. Authorised institutions intending to conduct

any securitisation transaction in Hong Kong should inform the authority of their intention well in advance (Hong Kong Monetary Authority Guideline 4.6, August 1997) and will need to comply with the relevant guidelines.

Legislation introducing Basel II as it applies to Hong Kong banks came into effect on January 1 2007. Basel II's impact on the Hong Kong securitisation market is likely to follow its impact in other developed financial markets.

In the 2008 to 2009 Budget the financial secretary reaffirmed the government's commitment to enhance the competitiveness of Hong Kong's finance industry. This includes a review of the existing regulatory regime for the securities market "to improve market quality and reduce compliance costs for the industry". A review of the Companies Ordinance is part of this process.

Assignment of assets

Assets such as receivables may be assigned in equity without the need to give notice to debtors of the transfer under Section 9 of the Law Amendment and Reform (Consolidation) Ordinance. There is no need for equitable assignments to be in writing unless they relate to land (Section 5(1) of the Conveyancing and Property Ordinance).

For an equitable assignment to be effective, valuable consideration must be given and the parties must have a clear intention to assign. An equitable assignment is carried out by the seller making a written offer, which is accepted by the special purpose vehicle (SPV) buyer by payment of the purchase price for the assets. The transfer of ownership of assets in this manner means that notice to debtors is not required and the transfer does not give rise to transfer tax.

However, there are disadvantages in having an equitable rather than a legal assignment. For example, the purchaser of the debt has no right to take any action to enforce the debt against the debtor. The only person entitled to do so is the seller of the assets; therefore, the SPV will need to join the originator as a party to any legal action against the obligor. In addition, the originator and the obligor may amend the terms and

conditions of the receivables without the involvement of the SPV and the obligor can obtain a good discharge from the obligations from the originator. Most securitisations that use an equitable assignment of assets require representations and warranties from the originator to the effect that it will not undertake these activities in relation to the receivables without consent.

In addition, in most securitisation transactions involving equitable assignment provision is made for the perfection of title to the assets which have been assigned to the SPV. This is generally achieved by means of a legal assignment of those assets where notice is given to the debtors. Under Section 9 of the Law Amendment and Reform (Consolidation) Ordinance, in order to perfect a legal transfer of the assets express notice must be given to the obligor and the assignment must be absolute and in writing, signed by the assignor and must not purport to be by way of charge only. Many securitisation structures require perfection only when certain defined title perfection events have occurred.

A transfer of mortgages should be registered with the relevant land registry so that the transferee will have the priority of the original registration. However, in most securitisations in jurisdictions such as Australia, registration of mortgage transfers is not required by rating agencies until the occurrence of certain trigger events.

Under Section 45 of the Conveyancing and Property Ordinance, it is possible to tack a further advance under an existing mortgage to take priority to a subsequent mortgagee if three conditions are met:

- The subsequent mortgagee consents to this effect;
- The further advance does not exceed the stated maximum secured by the first mortgagee; and
- The first mortgage is an all-moneys mortgage in favour of an authorised banking institution.

Security

Many securitisation structures include a charge given by the SPV in favour of a security trustee, which will hold

that charge for the benefit of secured creditors (including the noteholders).

Section 80 of the Companies Ordinance requires the prescribed particulars of a charge created by an SPV incorporated in Hong Kong to be delivered to the registrar of companies in Hong Kong. If this is not done within the prescribed period, the charge will be void as against a liquidator and any creditor of the SPV. The Slavenburg approach to registration of charges by non-Hong Kong companies with a potential place of business in Hong Kong has been abolished pursuant to amendments to Section 91 of the Companies Ordinance which came into effect last December. These amendments provide that the registration of charges provisions of the Companies Ordinance apply only to charges on Hong Kong property of a non-Hong Kong company registered as an 'oversea company' or charges on Hong Kong property acquired by such a company. So, charges by foreign companies with a place of business in Hong Kong but which are not registered as an oversea company are not required to be registered.

Issue of securities

Any issue of debt securities must comply with the relevant provisions of the Companies Ordinance and the Securities and Futures Ordinance, including prospectus requirements and advertising restrictions.

In general, under the Companies Ordinance a prospectus is required when a company offers debt securities to the public. Some guidance is provided on when an offer is considered to be to the public, although the Companies (Amendment) Ordinance 2004 further clarifies which types of debenture offer may be made without triggering the prospectus requirements, including:

- offers to professional investors (including market professionals and certain high net-worth individuals);
- offers to no more than 50 persons; and
- offers where the minimum denomination or consideration payable is not less than HK\$500,000.

The Securities and Futures Ordinance contains a prohibition against issuing or possessing material that advertises or invites the acquisition, subscription or disposal of securities. The prohibition does not apply where the invitation is not to the public. In addition, the Securities and Futures Ordinance contains a number of exceptions to the prohibition, including where the material is issued to professional investors.

Transfer tax and taxation

In Hong Kong, stamp duty is payable on transfers of interests in land, including the transfer of mortgages (although the collector of stamps has been willing to adjudicate that a mortgage transfer is not subject to stamp duty). The rates are sliding rates up to 3.75 per cent for prices paid for the property in excess of HK\$6.72 million. Otherwise, stamp duty is chargeable only on certain transfers of stock.

There is no withholding tax on interest payments in Hong Kong and Hong Kong does not tax capital gains. Furthermore, there is no value added tax or goods and services tax in Hong Kong. However, there is a profits tax payable by every person "carrying on a trade, profession or business in Hong Kong" in respect of profits "arising or derived from Hong Kong...from such trade, profession or business" (Section 14(1) of the Inland Revenue Ordinance). To ensure the tax neutrality of a Hong Kong-incorporated SPV, it is important to ensure that its profit matches its allowable deductions.

Emerging asset classes

The regulatory regime in Hong Kong is such that a wide variety of assets may be securitised. However, residential mortgage-backed deals are likely to remain the cornerstone of the Hong Kong market. Negative equity mortgages and infrastructure assets have also been securitised and the latter may return to the market given the government's declaration to undertake various infrastructure projects.