

Submission dated 18 February 2005 from Ms Ann Rutledge, a partner of R & R Consulting

Background

My comments to Legco in respect of the proposed Company Law amendment are both professional, as a securitization consultant and former Moody's rating analyst with 15 years' experience in Asian bond market development, as well as personal, as a friend of Hong Kong.

R&R Consulting is a quantitative credit metrics firm, specializing in credit scoring and security structuring. Our twofold mission is to bring rigor and standardization to risk measurement, and to develop innovative risk management ideas that match capital and risk. We are respected for our independence and transparency; our book on securitization is widely considered as definitive.¹ Our largest client base is tertiary education institutions, followed by U.S. bank regulatory institutions, and large non-U.S. banks.

An express goal of R&R Consulting is to jettison Hong Kong to the forefront of Asia as a regional debt repackaging center. We believe Hong Kong is ideally positioned to fill this role. Even though, to-date, Hong Kong's securitization activity has been limited, its legal, accounting, tax and financial system institutions make it the world's most conducive to securitization—a point on which many securitization authorities concur.² The suitability of the Hong Kong environment for securitization owes much to its Anglo-Saxon legal foundation, its strong pro-creditor orientation, the conduciveness of its tax and accounting framework to business, and its eminently capable labor pool.

Personally and professionally, I worry that the proposed Amendment has a potential negative impact on Hong Kong's future market development. As a Wellesley-Yenching Fellow at Chung Chi College, CUHK, I became an admirer of the resiliency and optimism of my colleagues and students. I returned in late 1990 to do reform-revitalization work at the Hong Kong Futures Exchange. Later, I was the Moody's Investor Service senior Asian securitization analyst and author of Moody's Hong Kong residential mortgage-backed bond rating method, which I specifically tailored for use by Hong Kong institutions.³ Today I remain involved in Hong Kong as an adjunct associate professor of finance at the Hong Kong University of Science and Technology ("HKUST"), President and Treasurer of the Chinese International School ("CIS") Foundation of New York, and director of the Hong Kong New York Association.

Does the Proposed Amendment Serve Its Stated Goals in Hong Kong?

We conclude that it does not.

The rationales for Hong Kong to reflect the mechanics of securitization SPE consolidation in Hong Kong Company law, as we understand them, are three-fold:

- (1) To put Hong Kong in compliance with the directives of IAS;
- (2) To motivate greater uniformity in the corporate reporting format, in line with IAS goals; and
- (3) To prevent an Enron-like situation from occurring in Hong Kong

¹ Sylvain Raynes and Ann Rutledge, *The Analysis of Structured Securities*, New York: Oxford University Press, 2003.

² For example, see Vinod Kothari's website, which has a global following.

³ Ann Rutledge, *Moody's Approach To The Hong Kong Residential MBS Market*, 1997. The original approach was designed to be used by financial guaranty ("monoline") institutions only, but I localized and adapted it for general use.

On the first point, I am not alone in observing that IAS has been unpopular and as a result has undergone dramatic changes in the past two years. Needless to say, if IAS 27 and SIC today are substantially revised after they are written into Hong Kong Company Law, that would put Hong Kong *out of compliance* with its accounting framework.

On point number two, *neither* the European nor the American framework is entirely satisfactory in reflecting the economic impact of securitization on a company's financial position. However, the IAS/IFRS control-based approach is worse than FASB 140 and Fin 46/46R in reflecting economic reality.

This is not just my conclusion; many clients whose mission is to develop local capital markets have told us they consider IAS/IFRS **a serious barrier to the development of securitization**. Here, the fate of the German True Sale Initiative is instructive. Several large German banks collaboratively struggled to establish standards for genuine securitization to help collegial institutions in Germany, much as securitization helped the insolvent U.S. financial market two decades ago. But adoption of the European accounting framework most recently has effectively halted the initiative.

Speaking to point three, Enron is irrelevant to securitization. Enron SPEs and securitization SPEs do not share the same characteristics. Enron SPEs involved a high degree of recourse and would not have qualified for true sale treatment under either accounting framework, GAAP or IAS; whereas the starting point of securitization SPEs is a true sale concept. True sale means **absolutely the company relinquishes control** of certain assets, which come off the balance sheet. The salient difference between IAS and GAAP in respect of securitization SPEs is the separate accounting treatment of assets financed off-balance sheet in a true sale context under FASB where IAS 27 requires consolidation across-the-board. The IAS demand for uniformity does not provide a better defense to Enron-like situations. It does, however, lower the representational faithfulness of reporting under IAS for true securitizations.⁴

Even if Enron is an irrelevant example, securitization SPEs do, certainly, carry risks. The most salient is fraud, when non-existent receivables are sold into the SPE, undetected by the auditors. A very famous recent U.S. case was National Century Financial Enterprises, which resulted in US\$3.3 billion of losses and a major U.S. bank's exiting the trustee business.

Neither the IAS/IFRS nor GAAP are designed to prevent this risk. But the U.S. Securities & Exchange Commission has just published new guidelines for registering securitization transactions that will positively facilitate fraud detection, as well as helping investors analyze the risk of securitization SPEs generally: Regulation AB. Regulation AB incorporated extensive commentary by market participants; as a result, its data disclosure requirements are specifically designed to facilitate transparency in off-balance sheet financings. Reg AB is well-crafted and serves the interests of the market. It is a model that Hong Kong's Securities & Futures Commission and accountancy profession could profitably consider.

Is It Better for Hong Kong to Act Now or Wait and See?

⁴ At the risk of becoming too detailed and academic, I would like to point out that there are two paradigms of securitization, but only one is that of "true" securitization. Cash securitization, which I call "true" securitization, such as the HKMC carries out, involves the legal sale and derecognition of assets. Synthetic securitization, as is widely practiced in Europe, keeps the assets on the balance sheet but transfers the risk under credit-default or total-return swaps. These transactions may or may not involve and SPE. They are governed mainly under ISDA. The main motivation is regulatory arbitrage, and a second motivation is balance sheet cosmetics. Because the risk transfer mechanism is more like insurance than a sale, it is more difficult to assess the risk of these transactions, and they carry more downside. Given that Europe has never succeeded in developing cash securitization markets and prefers this type of private arrangement, the IAS framework is perhaps genuinely appropriate in its native environment. However, for countries actively seeking to work out their market impediments by creating greater asset efficiency, like Korea, Australia, Taiwan, indeed China on a small scale, and the U.S. originally, cash securitization is a more powerful tool. And cash securitization needs accounting standards that are designed with its particular features in mind.

IAS is in flux. For much of the 20th Century, it was unpopular framework and no national market supported it. IAS has gained political endorsement only since the mid-1990s, when the U.S. Securities & Exchange Commission under the mantle of IOSCO and the European Union endorsed it in the name of global standards harmonization and convergence. So, I wish to emphasize that countries are adopting IAS mainly for political reasons; technically it is broadly considered as inferior.

IAS is a “work in progress” accounting framework, and so it will continue to be in flux. It is converging towards GAAP faster than the other way around (i) because of strong regulatory and technical pressures from the U.S.; (ii) because in technical terms, GAAP reflects capital market practice better, being better designed to evidence value and risk; and (iii) because the IASB framework, a principles-based doctrine, is more ambiguous than the bright-line audit guidance approach of GAAP. In fact, the IASB encourages IAS accounting professionals to turn to GAAP guidelines for interpretive support.⁵

At the same time, SEC support for the IAS is significant, given that the SEC now has its own approach to disclosure. Regulation AB, as we have noted above, departs radically from traditional corporate finance analysis. **Watch for dramatic changes to the current securitization accounting rules** because Regulation AB is technically far superior to anything published by the IASB or FASB. It emphasizes static pool performance disclosures and other securitization-specific data which are not part of the corporate finance analytic framework, and which are used by securitization professionals to determine risk and value.

Going forward, Regulation AB is likely to cause rethinking of consolidation and measurement, because (i) is far superior in terms of representational faithfulness and (ii) there is no turning back from securitization as an important tool of corporate finance in growing economies. For these reasons, I conclude it is better for Hong Kong to follow the example of other Asian markets that have been more active than Hong Kong in institutionalizing securitization, such as Korea, Japan and Taiwan, and adopt a wait-and-see position rather than to act now.

How Would the Proposed Amendment Affect Hong Kong’s Financial Sector?

We believe it will hamper the economic growth and financial development of Hong Kong, and that Hong Kong institutions will be specifically disadvantaged in ways that will not affect foreign institutions.

Many foreign institutions that were based in Hong Kong and geared up to do securitization advisory business as of March 2003 have actually left the region (CSFB, ING) or have relocated to Singapore (BNP, UBS). Those that remain are mainly conducting business in Korea, Taiwan and Japan. Banks specializing in principal trading of defaulted assets are mainly based close to the source, in Japan and China. These institutions are untouched by the proposed Company Law amendment.

The proposed Amendment would not affect Hong Kong’s ability to securitize domestic assets because Hong Kong’s law permits those assets to be sold and repackaged offshore in the United States or wherever it will receive the most favorable tax and accounting treatment.

But what the Amendment does, effectively, is **deprive Hong Kong institutions** of the chance to acquire the fundamental techniques of securitization and structured finance: statistical loss determination, cash flow stripping, prepayment analysis, tranching, triggers, credit evaluation through path-dependent Monte Carlo simulations. Hong Kong institutions will not have the chance to see deals done in Hong Kong, and the foreign banks will not teach them. They are too busy making money to share their knowledge with the rest of the world.

⁵ Barry J. Epstein and Abbas Ali Mirza, **WILEY IAS 2004: Interpretation and Application of International Accounting and Financial Reporting Standards**, 2004.

The only way for Hong Kong institutions to learn is by doing. And if my experience at HKUST is any indication, Hong Kong finance professionals will learn very quickly if they have the direct opportunity. My students come from a mix of local and foreign institutions. They are all hungry to learn, and they know securitization skills command a premium in the global marketplace. The hardworking ones leave with an appreciation for the beauty and flexibility of securitization, and a desire to put their newfound skills to work in Hong Kong.

Conclusion

The prima facie evidence that **securitization promotes economic growth and capital market health** is very compelling. Securitization now outstrips corporate bond finance in the U.S. because it offers a better cost of funds for corporations. There is mounting evidence that investors more secure, with better governance and data transparency when they invest in securitization SPEs than when they invest in traditional corporate bonds. For these reasons, I encourage Legco to adopt a forward-looking approach and consider that securitization may bring the same benefits to corporations and investors in Hong Kong and Asia at large.

For U.S. banks languishing under deregulation, securitization showed a way-forward by allowing traditional banking services to redevelop cash management, trustee, custodian, financial advisory, underwriting and swap-underwriting businesses. It allowed not only clients but the banks themselves to better manage their own risk exposures without sacrifice to origination fee income. Given a chance, securitization could do the same in Hong Kong. Once Hong Kong banks gain the requisite know-how, there is no reason why Hong Kong could not achieve its potential as a debt reprocessing center for all of Asia, and develop thereby a lasting franchise advantage in a sector of fixed income markets that has grown the fastest for a quarter of a century. With the adoption of the proposed Company Law amendment, however, we believe there is a real risk of chilling the market before it has a chance to grow.