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# Off-Balance Sheet Update (March 2003)

11 March 2003

## I. Introduction

The effects of FIN 46[1] are starting to appear in certain companies' financial statements. Diverse views are emerging on the ultimate impact that FIN 46 will have. Some reporting companies expect to be required to consolidate more of their SPEs, though they continue to investigate potential strategies to avoid consolidation. Others express greater optimism that they will find practical solutions to avoid consolidation.

Bank sponsors of asset-backed commercial paper (ABCP) programs seem to have the greatest stake in the issue. Following closely behind them are banks and other large institutions that manage collateralized debt obligations (CDOs). Undoubtedly, both groups will continue to explore strategies for avoiding consolidation. They need to act quickly: FIN 46 will become fully effective for reporting periods starting with the third quarter of this year. The market will see the major impact, if any, in reports that appear early in the fourth quarter.

Ironically, securitization intermediaries may stand to gain from FIN 46. If FIN 46 compresses the level of securitization activity through ABCP programs, it might boost the level of activity through term deals. Wall Street firms and bond insurers may snare business that they otherwise never would have seen. Today's $700 billion ABCP market could shrink by as much as half. Even if a significant share of that financing activity ultimately could not migrate to the term ABS arena, the portion that could successfully migrate might amount to more than $100 billion. Such a level of increased issuance could be expected to widen spreads noticeably until investors absorb it in their portfolios.

## II. FIN 46 in Concept

As many readers are already aware, FIN 46 is an accounting interpretation that requires companies to consolidate certain SPEs that formerly did not have to be consolidated. FIN 46 expands the criteria for consolidation to include non-traditional means of controlling an SPE or of holding its economic risks and benefits.

Before FASB[2] released FIN 46, ownership of the majority of an SPE's equity – and control through the associated voting rights – was the primary basis for consolidation. The old regime had narrow, rigid standards and a well-defined framework in which financial professionals could structure corporate finance activities. FIN 46 establishes a somewhat broader set of standards and a less well-defined framework. While FIN 46 is not merely a conceptual statement, it clearly embraces the conceptual stance that the earlier standards had failed to capture all the cases where, in policymakers' view, consolidation should have been the appropriate result.

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[1] Financial Accounting Standards Board, *FASB Interpretation No. 46, Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51* (17 Jan 2003) (*available at* http://www.fasb.org/int46.shtml).

[2] The Financial Accounting Standards Board (FASB) is the body responsible for defining generally accepted accounting principles (GAAP).

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### A. Roots

While the Enron scandal arguably is the proximate cause of FIN 46, its real roots lie deeper. Long before Enron, financial professionals devised structures that banks, finance companies, and other businesses could use to conduct activities on an "off-balance sheet" basis. The motivation for doing so was heightened in the late 1980s by the introduction of risk-based capital guidelines for banks and thrifts. Off-balance sheet activities were advantageous because they produced lower regulatory capital requirements than the same activities would have on an on-balance sheet basis. In essence, off-balance sheet activities allowed institutions to operate at higher levels of economic leverage without incurring any regulatory detriment.

For a long while, everything worked well. The reduced regulatory capital requirement from off-balance sheet activities allowed institutions to make loans at marginally lower interest rates. This arguably gave a boost to the American economy, as businesses were able to borrow more cheaply. There seemed to be no losers. Only in a remote and theoretical sense were there any: Shareholders of institutions that used off-balance sheet strategies faced a tougher challenge in using financial statements to understand the institutions' businesses and to measure their risks. Secondarily, American taxpayers bore the burden of increased risk of bank and thrift insolvencies because of the higher economic leverage at the institutions.

Eventually, off-balance sheet activities and their associated risks drew the attention of policy makers. FASB wrestled with them initially in the context of sales of financial assets with recourse.[3] Subsequently, U.S. bank regulators initiated their "recourse project" to consider the right level of regulatory capital that institutions ought to hold against various off-balance sheet risks. Both efforts progressed slowly for several years. Urgency seemed unnecessary. A notable sign of trouble emerged with a wave of finance company failures attributed to "gain-on-sale" accounting. That accounting method was an unfortunate by-product of FASB's work on recourse sales. Only later did the issue of un-consolidated SPEs take center stage with…Enron.

Enron's demise in the fall of 2001 presented a virtual nightmare scenario: outright financial fraud combined with hyper-complicated financing arrangements in which SPEs and off-balance sheet accounting were used both to dodge taxes and to conceal the real economic condition of the enterprise. For proponents of off-balance sheet activities, the only saving grace was that fraud figured so heavily in the Enron story. Off-balance sheet activities at most other companies could be distinguished as not being tainted by crooked or unwholesome motives.

### B. After Enron

The fallout from Enron was so intense and so widespread that it deserves to be counted alongside the S&L crisis and the Drexel Burnham junk bond fiasco as one the greatest financial scandals of the past 25 years. Congress responded quickly. The original bill that evolved into the Sarbanes-Oxley Act was introduced on 14 February 2002. After several months of deliberations, Congress passed the Sarbanes-Oxley Act in its final form.[4] Section 401 of the law was aimed squarely at off-balance sheet transactions and SPEs. Subsection (a) directs the SEC to issue rules requiring companies to disclose all material off-balance sheet transactions.[5] The SEC recently issued regulations

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[3] FASB, *Statement of Financial Accounting Standards No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (Sep 2000); FASB, *Statement of Financial Accounting Standards No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (Jun 1996); FASB, *Statement of Financial Accounting Standards No. 77, Reporting By Transferors for Transfers of Receivables with Recourse* (Dec 1983).

[4] Pub. L. No. 107-204, 116 Stat. 745 (2002) (signed into law on 30 July 2002).

[5] The relevant portions of § 401(a) reads as follows:

> SEC. 401. DISCLOSURES IN PERIODIC REPORTS.
>
> > (a) DISCLOSURES REQUIRED- Section 13 of the Securities Exchange Act of 1934 (15 U.S.C. 78m) is amended by adding at the end the following:
> >
> > * * *

implementing that requirement.[6] Subsection (c) of § 401 directs the SEC to conduct a study of off-balance sheet transactions and to report its findings.[7] That report will be due around the middle of next year.

Meanwhile, the Big Five accounting firms (Arthur Anderson was still around) proposed to the SEC that it issue rules on the disclosure of off-balance sheet activities and SPEs. The SEC published the proposals as a "Commission Statement" in late January 2002.[8]

Which brings us to FIN 46. Even before the original version of the Sarbanes-Oxley Act was winding its way through the halls of Congress, FASB reactivated its long-standing "consolidation project," which had been on hold for more than a year. That project ultimately produced FIN 46. Over the course of 2002, FASB worked hard on the consolidation project. And, it did not have to work in a vacuum. Many interested parties shared their views and offered their insights. In late March, the Bond Market Association (BMA) hosted a press briefing at which industry experts explained why securitization activities should be distinguished from those of Enron. FASB held numerous public meetings and received comment letters from the BMA and others. However, at every step along the way, FASB had to remain mindful that its result would have to fit into a larger framework shaped by the Sarbanes-Oxley Act and impending SEC regulations. A final source of pressure came in the form of a Senate report released just weeks before FIN 46.[9] FASB never really had that much room in which to maneuver.

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> '(j) OFF-BALANCE SHEET TRANSACTIONS- Not later than 180 days after the date of enactment of the Public Company Accounting Reform and Investor Protection Act of 2002, the Commission shall issue final rules providing that each annual and quarterly financial report required to be filed with the Commission shall disclose all material off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of the issuer with unconsolidated entities or other persons, that may have a material current or future effect on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues or expenses.'.

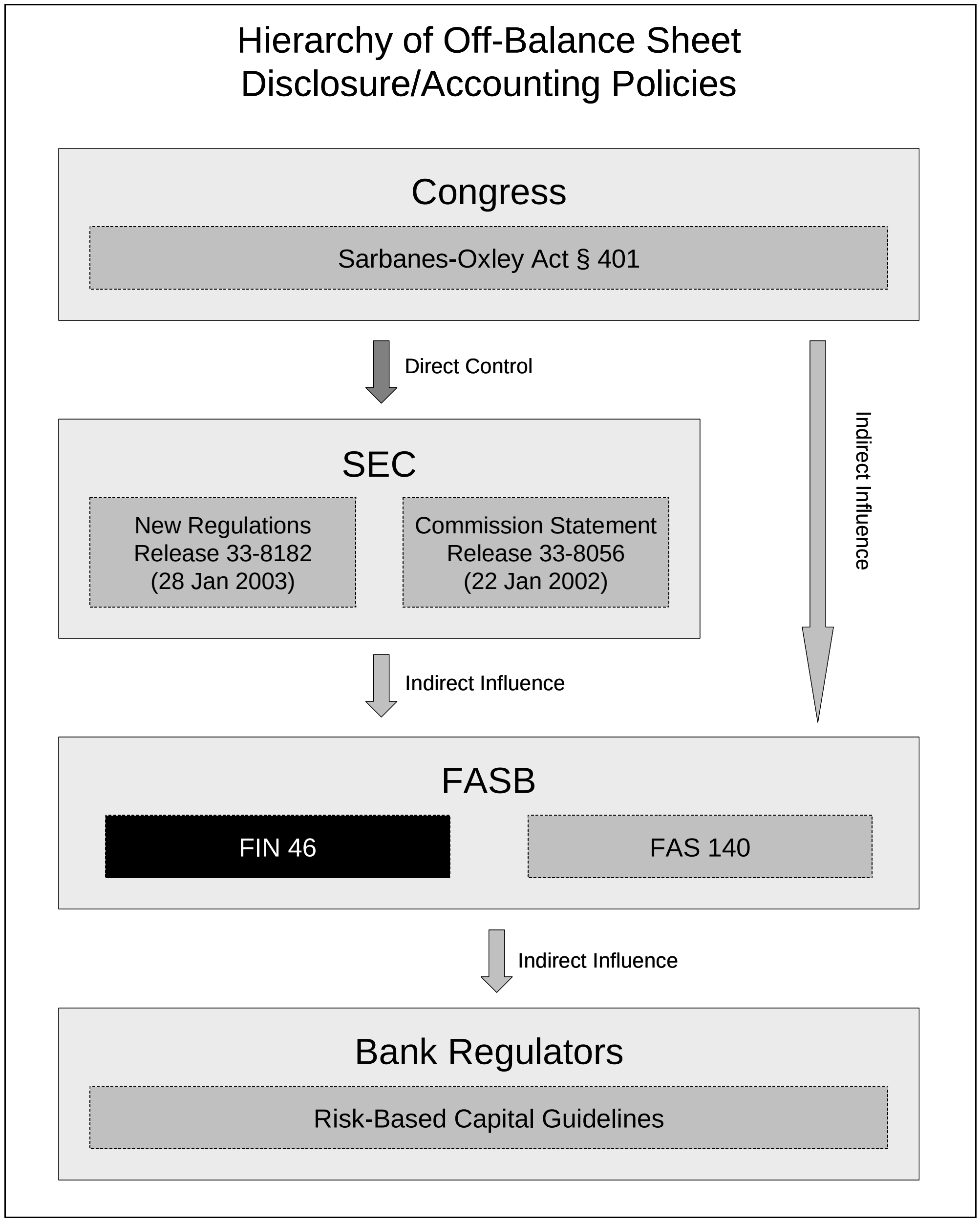
[6] Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, Securities Act Release No. 8182 (28 Jan 2003), 68 Fed. Reg. 5981 (5 Feb 2003), *available at* http://www.sec.gov/rules/final/33-8182.htm. Interestingly, this release was issued about ten days after FIN 46. It refers explicitly to FIN 46 and employs FIN 46 concepts such as "variable interests." See part III, infra, for a description of variable interests.

[7] Section 401(c) reads as follows:

> (c) STUDY AND REPORT ON SPECIAL PURPOSE ENTITIES–
>
> (1) STUDY REQUIRED- The Commission shall, not later than 1 year after the effective date of adoption of off-balance sheet disclosure rules required by section 13(j) of the Securities Exchange Act of 1934, as added by this section, complete a study of filings by issuers and their disclosures to determine–
>
> (A) the extent of off-balance sheet transactions, including assets, liabilities, leases, losses, and the use of special purpose entities; and
>
> (B) whether generally accepted accounting rules result in financial statements of issuers reflecting the economics of such off-balance sheet transactions to investors in a transparent fashion.
>
> (2) REPORT AND RECOMMENDATIONS- Not later than 6 months after the date of completion of the study required by paragraph (1), the Commission shall submit a report to the President, the Committee on Banking, Housing, and Urban Affairs of the Senate, and the Committee on Financial Services of the House of Representatives, setting forth–
>
> (A) the amount or an estimate of the amount of off-balance sheet transactions, including assets, liabilities, leases, and losses of, and the use of special purpose entities by, issuers filing periodic reports pursuant to section 13 or 15 of the Securities Exchange Act of 1934;
>
> (B) the extent to which special purpose entities are used to facilitate off-balance sheet transactions;
>
> (C) whether generally accepted accounting principles or the rules of the Commission result in financial statements of issuers reflecting the economics of such transactions to investors in a transparent fashion;
>
> (D) whether generally accepted accounting principles specifically result in the consolidation of special purpose entities sponsored by an issuer in cases in which the issuer has the majority of the risks and rewards of the special purpose entity; and
>
> (E) any recommendations of the Commission for improving the transparency and quality of reporting off-balance sheet transactions in the financial statements and disclosures required to be filed by an issuer with the Commission.

[8] Commission Statement about Management's Discussion and Analysis of Financial Condition and Results of Operations, Securities Act Release 8056 (22 Jan. 2002), 67 Fed. Reg. 3746 (25 Jan 2002).

[9] U.S. Senate Permanent Subcommittee on Investigations, FISHTAIL, BACCHUS, SUNDANCE, AND SLAPSHOT: FOUR ENRON TRANSACTIONS FUNDED AND FACILITATED BY U.S. FINANCIAL INSTITUTIONS (2 Jan 2003), available at http://govt-aff.senate.gov/010203psireport.pdf.




### C. And Now

FIN 46 is intended to reduce the likelihood of another Enron. Its standards are specific and appear difficult (or impossible) to circumvent. Under FIN 46, a company cannot avoid consolidating an SPE merely by not owning its *traditional* equity interests. If a company owns the *economic* equity of an SPE, it most likely will have to consolidate the SPE on its financial statements. This will bring the accounting treatment for certain SPEs into harmony with the traditional *objectives* of financial accounting.

## III. How It Works

First of all, FIN 46 does ***not*** apply in certain circumstances. Most importantly, it does not apply to a "qualifying special purpose entity" or "QSPE" under FAS 140 (¶4c).[10] The upshot of this exclusion is that FIN 46 will not require consolidation of the SPEs created in the vast majority of term securitizations backed by mortgage loans, auto loans, and credit card receivables. However, ABCP programs and CDOs usually do not qualify for this exclusion.

FIN 46 designates certain SPEs as "variable interest entities" or "VIEs." An SPE can be classified as a VIE in one of two ways (¶5). First, if an SPE's equity interests are too small to absorb its expected losses, the SPE will be a VIE. Second, an SPE will be a VIE if the holders of its equity lack (i) the ability to control the SPE through voting rights, (ii) the obligation to absorb losses if they occur, ***or*** (iii) an uncapped right to share in the SPE's profits. In plain terms, the first criterion applies to an SPE that is thinly capitalized, while the second applies to one whose equity holders do not have traditional equity rights and risks.

FIN 46 introduces the concept of "variable interests" (¶2c). In essence, variable interests correspond to the rights and risks traditionally associated with equity. The term "variable interest" is defined expansively to include gains and losses as well as (i) fees paid to the company that controls a VIE (¶8c) and (ii) fees paid to a company that provides guarantees for the VIE (¶8d).

FIN 46 specifies that a company must consolidate a VIE if it holds either (i) variable interests that will absorb a majority of losses or (ii) variable interests that will receive a majority of the VIE's residual returns[11] (including fees) (¶14).[12] Here, the requirement to consolidate seems grounded on a notion of holding a majority of a VIE's economic equity.

The tough aspect of applying FIN 46 lies in calculating the amounts of a VIE's variable interests. That calculation is necessary in order to determine whether a company owns a majority. Although the appendices to FIN 46 includes simple examples of such calculations, market participants are forced to grapple with how to perform the calculations in complicated real-world situations. Much uncertainty remains.

## IV. Looking Ahead

A few simple cases are already clear. If a company holds all the variable interests that absorb a VIE's losses, the company will have to consolidate the VIE. In real world terms, if a bank holds all the risk of loss on an ABCP program (*e.g.*, by providing all the credit enhancement), it will have to consolidate the program. Alternatively, even if a bank *does not* hold a majority of the risk of loss (*e.g.*, there are multiple providers of credit enhancement), it may still be required to consolidate the VIE if it holds variable interests that entitle it to a majority of the residual returns. This could occur if the bank receives large fees for administrative and other services that it provides to the program.

The same principles apply in the context of CDOs. The manager might hold variable interests that either expose it to a majority of the losses or which entitle it to a majority of the residual returns. In either case, the manager would be required to consolidate the CDO.

CDO managers and bank sponsors of ABCP programs are exploring strategies to avoid consolidation under FIN 46. One potential approach is to restructure their CDOs and ABCP programs to fall within the FAS 140 exclusion. This could be tough because it would greatly constrain their ability to actively manage the asset portfolios backing their deals and programs.

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[10] Paragraph references are to the numbered paragraphs of FIN 46.

[11] "Residual returns" essentially correspond to economic profits (¶¶2b, 8b, 8c, 8d)

[12] If one company holds a majority of variable interests that absorb losses while another holds a majority of the variable interests that receive residual returns, the one exposed to losses must consolidate the VIE.

A second potential approach would be for a CDO manager or ABCP sponsor to disperse a VIE's economic risks and benefits among many parties, so that none holds a majority of variable interests requiring consolidation. This approach could prove impractical if third-party holders of variable interests insist on having a measure of control proportionate to their economic stake.

A third potential approach would appear outwardly similar to the second but would work differently. Under this variation, a company manages to find an aggressive (but not manifestly unreasonable) basis for measuring variable interests in a way that does not closely correspond to their economic risks and benefits. The company might then avoid consolidation by dispersing variable interests without necessarily dispersing economic risks and benefits. For the next few months, this approach will likely represent a "Holy Grail" for which CDO managers and ABCP program sponsors will search. It remains to be seen whether financial professionals can find it.

The next few months will reveal whether any of the foregoing strategies, or possibly others, will be successful. Either way, the securitization landscape is going to change. Even if FIN 46 forces some unwanted changes on the securitization industry, the improvement that it brings to financial reporting may be worth it in the end.

In addition, even if FIN 46 magically disappeared tomorrow, the new SEC rules[13] should greatly expand corporate disclosure of off-balance sheet arrangements. Users of corporate reports will be better able to understand the impact of off-balance sheet activities on the companies that they analyze.

From a regulatory perspective, FIN 46 may be a good thing. If FIN 46 ultimately requires financial institutions to consolidate many SPEs that formerly were not consolidated, the regulators will have to squarely face the issue of determining the right level of capital that institutions should hold for the activities conducted through those SPEs. That determination always should have been a matter of regulatory policy rather than accounting policy. However, under the pre-FIN 46 accounting regime, regulators approached the issue with little vigor and financial institutions did not push for a concrete resolution because they were content with the *status quo*. Now, financial institutions are strongly motivated to urge their regulators to confront the issue head-on.

Our view on these issues is a matter of record.[14] Accounting standards and capital regulations should draw distinctions based on real economic substance and not based merely on the form of financing arrangements. If two companies engage in activities that have identical economic consequences, the accounting and capital treatment should be the same for both, regardless of the form in which those activities are conducted. More pointedly, the use of securitization should not change a company's accounting and capital treatment for its activities unless that use produces a commensurate change in the real economic risks and benefits of those activities.

— E N D —

[13] *See* note 6, *supra*.

[14] Nomura Fixed Income Research, *Accounting vs. Reality: Can We Handle the Truth?* (16 Apr 2002). Nomura Fixed Income Research, *Thirty Years Later Securitization Is Still Good for America* (15 Mar 2002).

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