Nomura Fixed Income Research

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Off-Balance Sheet Update (November 2003)

I. Introduction

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It now seems unlikely that this year's accounting changes will *force* banks to consolidate their asset-backed commercial paper (ABCP) programs. Nonetheless, some banks have chosen to do so. It also appears highly unlikely that banks will be forced to consolidate their credit card securitization trusts. The situation for CDOs is somewhat tougher: although the matter is far from settled, there appears to be continuing risk that some CDO managers will be forced to consolidate their deals.

Additionally, interim and proposed changes to U.S. risk-based capital guidelines should preserve advantageous treatment for ABCP programs even if accounting policies take an unexpected turn toward forcing consolidation.

We now expect the level of ABCP issuance activity to remain strong over the coming months. The term securitization market will not likely be forced to absorb a flood of receivables from a contracting ABCP sector. We expect CDO issuance volumes to remain somewhat depressed, partly as a result of continued accounting treatment uncertainty.

The current situation is somewhat surprising. FASB and the SEC appear to be headed in opposite directions. The SEC is firmly retaining a principles-based disclosure framework and is pushing companies to provide amplified disclosure of their off-balance sheet activities.[1] In addition, the SEC recently concluded that the U.S. accounting system must shift to a posture that is more principles-based.[2] Meanwhile, FASB seemingly rejects a principle-based approach in favor of one that is rule-based and which includes loopholes for companies who do not like the rules.

The pricing impact of these developments on most structured finance investors should be neutral in the near-term. We do not expect that the near-term evolution of accounting policies, including FIN 46, will create any supply or demand shocks that materially move spreads for any securitized products. We expect that 2004 will bring continuing confusion and consternation about accounting policies, but no real change.

[1] U.S. Securities and Exchange Commission [hereinafter "SEC"], Commission Statement About Management's Discussion and Analysis of Financial Condition and Results of Operations, Release Nos. 33-8056, 34-45321, FR-61 (22 Jan 2002), 67 Fed. Reg. 3746 (25 Jan 2002) (available at http://www.sec.gov/rules/other/33-8056.htm); SEC, Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, Release Nos. 33-8182, 34-47264 (28 Jan 2003), 68 Fed. Reg. 5981 (5 Feb 2003) (available at http://www.sec.gov/rules/final/33-8182.htm).

[2] SEC, *Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System* (25 Jul 2003) (available at http://www.sec.gov/news/studies/principlesbasedstand.htm)

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II. Discussion

Off-balance sheet accounting has been a top-line issue for securitization professionals in 2003. FASB released FIN 46[3] in January and then proposed changes to FAS 140 in June.[4] In the wake of Enron's demise in late 2001 and passage of the Sarbanes-Oxley Act[5] in mid-2002, it initially *appeared* that FASB would restrict the availability of off-balance sheet accounting.

A. ABCP and FIN 46: The ¶ 9(c) Loophole

At first blush, the tone and the general language of FIN 46 seemed quite strict. For example, *in general terms*, FIN 46 appears to require consolidation of thinly capitalized special purpose entities (SPEs). FASB described the applicable situation as follows:

> 5. An entity shall be subject to consolidation according to the provisions of this Interpretation if, by design, either of the following conditions exists:
>
> a. The total equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support from other parties. That is, the equity investment at risk is not greater than the expected losses of the entity. (Refer to Appendix A for discussion of expected losses.)…

Later in FIN 46, FASB seemed to suggest that a 10% level of equity capital was roughly the right amount in most cases:

> 9. An equity investment of less than 10 percent of the entity's total assets shall not be considered sufficient to permit the entity to finance its activities without subordinated financial support in addition to the equity investment unless the equity investment can be demonstrated to be sufficient in at least one of the following three ways:
>
> a. The entity has demonstrated that it can finance its activities without additional subordinated financial support.
>
> b. The entity has at least as much equity invested as other entities that hold only similar assets of similar quality in similar amounts and operate with no additional subordinated financial support.
>
> c. The amount of equity invested in the entity exceeds the estimate of the entity's expected losses based on reasonable quantitative evidence.
>
> 10. Some entities may require an equity investment greater than 10 percent of their assets to finance their activities, especially if they engage in high-risk activities, hold high-risk assets, or have exposure to risks that are not reflected in the reported amounts of the entities' assets or liabilities. The presumption in paragraph 9 does not relieve an enterprise of its responsibility to determine whether a particular entity with which the enterprise is involved needs an equity investment greater than 10 percent of its assets in order to finance its activities without subordinated financial support in addition to the equity investment.

Many market participants initially believed that the tough-sounding language of paragraphs 9 and 10 would require ABCP sponsors to consolidate their programs.

However, as usual, the devil was in the details. Certain ABCP sponsors seized on the language of ¶ 9(c) as a loophole. Instead of 10 percent, some of those ABCP sponsors have argued that an outside equity investment of less than 0.1% would be enough to avoid consolidation. To use the ¶ 9(c) loophole, an ABCP sponsor must "estimate" that its program's "expected losses"[6] are very small – in the area of 0.1%. Sponsors have made such estimates based on the historical loss

[3] Financial Accounting Standards Board [hereinafter FASB], *FASB Interpretation No. 46, Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51* (17 Jan 2003) (available at http://www.fasb.org/draft/fin46.pdf); *see also* FASB, *Exposure Draft, Proposed Interpretation Consolidation of Variable Interest Entities a Modification of FASB Interpretation No. 46* (31 Oct 2003) (available at http://www.fasb.org/draft/ed_prop_interp_vie.pdf).

[4] FASB, *Statement of Financial Accounting Standards No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (Sep 2000); FASB, *Exposure Draft, Proposed Statement of Financial Accounting Standards Qualifying Special-Purpose Entities and Isolation of Transferred Assets, an Amendment of FASB Statement No. 140* (10 Jun 2003) (available at http://www.fasb.org/draft/ed_qspe.pdf).

[5] Pub. L. No. 107-204, 116 Stat. 745 (2002).

[6] As defined in FIN 46, ¶ 8.

experience of their programs. However, in doing so, they disregarded the fact that a key ingredient of the historical losses was their practice of removing distressed assets from the programs and returning those assets to the banks' balance sheets.

In the jargon of ABCP, exploiting the ¶ 9(c) loophole is called "selling an expected loss tranche." A number of bank sponsors of ABCP programs already have pursued the ¶ 9(c) loophole. As of mid-July, three banks reportedly had done so: Mellon Bank, Citibank, and HSBC. Interestingly all three use the same auditor, KPMG.[7] Since then, it is probable that other banks have followed-suit.

By "estimating" expected losses in the 0.1% range, a bank can operate its ABCP program with leverage of 1,000-to-1. That is an extremely high degree of leverage. It is much higher than the leverage found in regular companies. The largest banks maintain leverage in the range of 11-to-1. Major commercial finance companies operate at roughly that level as well. Most non-financial businesses operate with single-digit leverage ratios (*i.e.*, leverage of less than 10-to-1).

Another interesting aspect of expected loss estimates in the 0.1% area is that they seem to conflict with the customary levels of "allowances for loan and lease losses" (ALLL) maintained by banks. Banks generally maintain ALLL of roughly 1.0%. As of June 30, the average level of loan loss allowance for all FDIC-insured institutions was 0.96%. The average level for all commercial banks was 1.03%. The average level for commercial banks with assets greater than $10 billion was 1.05%. The average level for commercial banks with assets between $1 billion and $10 billion was 1.02%.[8]

Significantly, an ABCP sponsor can use the ¶ 9(c) loophole without having to worry about ¶ 9(a). The two are *alternatives*. Thus, the fact that most ABCP programs have "additional subordinated financial support" does not matter for ¶ 9(c). In a typical case, an ABCP program's "additional subordinated financial support" takes the form of a credit enhancement facility designed to protect the program's senior securities from credit risk. For most ABCP programs, the size of the credit enhancement facility equals 5% to 10% of a program's assets.

Is the ¶ 9(c) loophole an accident, or did FASB intentionally include it? FASB's subsequent actions have not been aimed at closing the loophole. Therefore, FASB probably intended to create the loophole in the first place.

Now that the ¶ 9(c) loophole has been publicized,[9] FASB is making gestures (nothing more) toward closing it. On October 31, FASB released a proposed modification to FIN 46. The modification would add a new paragraph 9A as follows:

> 9A. Qualitative assessments shall be carefully considered before attempting to estimate the entity's expected losses and equity investment at risk in paragraph 9(c). If, after diligent effort, a reasonable conclusion cannot be reached based solely on qualitative considerations, the amounts required by paragraph 9(c) shall be estimated.[10]

In essence, proposed ¶ 9A tells a reporting company that it cannot use the ¶ 9(c) loophole unless it *really* wants to. It seems unlikely that proposed ¶ 9A would actually stop any ABCP sponsor that is determined to use the ¶ 9(c) loophole.

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[7] Gregory, M., *Is There ABCP Post-FIN 46*, Asset Securitization Report (14 Jul 2003).

[8] *See* "Statistics on Depository Institutions" at the FDIC web site.

[9] *See, e.g.*, Rosenberg, H., *Longer Paper Routes – Banks Have Gone to Greater Lengths to Keep Assets Off Their Balance Sheets; That Means Higher Prices for Commercial Paper*, CFO Magazine (16 Oct 2003); Kaur, M., Bukspan, N., and Fritz, T., *FIN 46, Regulatory Capital Relief, and U.S. ABCP Conduits*, Standard & Poor's special report (5 Jun 2003); Pilcer, S. and Trier, N., *ABCP Market Overview: First Quarter 2003 – All Talk and No Action*, Moody's special report (18 Jun 2003); Gregory, M., *Is There ABCP Post-FIN 46*, Asset Securitization Report (14 Jul 2003).

[10] *See* note 3, *supra*.

B. Other ABCP Strategies to Avoid Consolidation

Securitization professionals have identified a few other strategies for avoiding consolidation, but none is as versatile as the ¶ 9(c) loophole. One of the alternatives is to structure an ABCP conduit as a "QSPE" under FAS 140. This alternative is often impractical because it places awkward operational constraints on a conduit. A second alternative, called the "silo method," involves a loophole in ¶ 13 of FIN 46. That loophole depends on how a bank's customer accounts for its borrowings from the bank's ABCP conduit. So far, only Bank of America has pursued the silo method. A third strategy for avoiding consolidation is for banks to band together and to jointly administer an ABCP program. That way, no single bank would have a majority stake that would trigger consolidation. Only a few banks have pursued the so-called "joint venture" approach. Most have steered clear because each one is loath to share control of its ABCP conduits with other banks.

C. U.S. Risk-Based Capital and ABCP

Regardless of whether or not loopholes in FIN 46 survive, it seems unlikely that U.S. bank sponsors of ABCP programs will be required to consolidate their ABCP programs for risk-based capital purposes. The U.S. bank regulators recently published interim rules that prevent such consolidation through the first quarter of 2004.[11] In addition, the regulators also issued a proposal to make such treatment permanent.[12] However, neither the interim rule nor the proposed permanent rule would exclude a consolidated ABCP program from the calculation of a bank's tier 1 leverage capital ratio. This means that most banks would still prefer to keep their ABCP programs entirely off their financial statements.

The U.S. regulators are to be applauded for finally coming to grips with the risk-based capital treatment of bank-sponsored ABCP programs. However, the regulators arguably should be criticized for reaching the wrong conclusion. In both the interim and proposed rules, the U.S. bank regulators preserve an artificial distinction in the treatment of ordinary commercial banking activities. The distinction depends merely on whether an institution conducts those activities through an ABCP program.

The regulators have chosen to make a material distinction between two kinds of activities with essentially identical risk.[13] In the ordinary case, a bank that indirectly lends through its sponsored ABCP program is in the same economic position as one that lends directly to the same borrower on comparable economic terms. Using the ABCP program usually does not change a bank's exposure to risk compared to what it would be from regular secured corporate lending.

More pointedly, if a U.S. bank makes a loan to a corporate customer, secured by the customer's trade receivables, the regulatory capital charge generally would be 8% of the loan amount. However, if the bank executes essentially the same transaction through its ABCP program, the capital charge will be *much* less. To achieve the favorable treatment, the bank arranges for its ABCP program to "purchase" the customer's receivables. The purchase price corresponds to the amount of the loan. Naturally, the balance of the purchased receivables must fully cover the purchase price and must also include a cushion to protect against receivables that become uncollectible. In other words, the

[11] Office of the Comptroller of the Currency [hereinafter "OCC"], Federal Reserve System, Federal Deposit Insurance Corporation [hereinafter "FDIC"], and Office of Thrift Supervision [hereinafter "OTS"], Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Interim Capital Treatment of Consolidated Asset-Backed Commercial Paper Program Assets, 68 Fed. Reg. 56530 (1 Oct 2003).

[12] OCC, Federal Reserve System, FDIC, and OTS, Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Asset-Backed Commercial Paper Programs and Early Amortization Provisions, 68 Fed. Reg. 56568 (1 Oct 2003).

[13] A bank's risk of loss may not be *exactly* the same when it extends a loan in the traditional way versus when it makes the loan indirectly through its ABCP program. The ABCP programs transfers the extremely small risk of catastrophic loss to the outside ABCP investors. The extremely small amount of risk transferred to ABCP investors is reflected in the A-1/Prime-1/F-1 ratings that ABCP routinely attains. All other risks associated with the loan (or "receivables purchase") are retained by the bank through support facilities that it provides to the ABCP program.

amount of receivables must exceed the "purchase price" (*i.e.*, the amount of the loan), just as it would in the context of an ordinary secured loan.[14]

In the jargon of ABCP, the presence of excess receivables is called "first loss protection." This is somewhat misleading because it implies that the bank is in a "second loss" position. A cushion of extra receivables is equally present in both a traditional secured loan structure and in a "receivables purchase" through an ABCP program. Either situation reasonably can be compared to a regular residential mortgage loan. There, the lender makes a loan equal to roughly 80% (more or less) of the value of the mortgaged property. The portion of the home's value above the amount of the loan provides a layer of "first loss protection" to insulate the lender from the risk that home prices fall or that the condition of the home deteriorates.

When a bank uses its ABCP program to indirectly extend loans to its customers, it retains the economic risk of those loans through "support facilities" that it provides to the program. In a typical case, a bank supplies two separate support facilities. One is called a "liquidity facility" and the other is called a "credit enhancement facility." The bank uses such an arrangement to attain the most favorable treatment that it can from the bank regulators.

The rating agencies generally have held the view that doing business through an ABCP program does not materially change a bank's exposure to risk. For example, even before the release of FIN 46, Moody's had been very clear about the need to reflect the real economic substance of securitizations in its corporate rating analysis. The rating agency routinely "adds back" securitized assets for purpose of calculating a company's "effective leverage:"

> Clearly, if the seller retains the vast majority of the risk associated with its securitizations, then off-balance-sheet treatment of securitized assets and the recognition of gain-on-sale will cause the seller's balance sheet leverage to grossly overstate his capital sufficiency relative to the leverage ratio of a portfolio lender. In order to make comparisons between securitizers and balance sheet lenders more meaningful, Moody's developed an alternative measure known as the "effective leverage ratio."
>
> The effective leverage ratio is a restatement of the traditional ratio of debt to tangible common equity to what it would be if securitizations were accounted for as financing transactions and not as sales. For companies that have no securitizations, the effective leverage ratio is the same as the ratio of debt to tangible common equity. For companies that do not record gain on sale for their securitizations, the effective leverage ratio is closely related to the ratio of equity to managed assets. For companies that do record gain on sale for their securitizations, the effective leverage ratio is a restated debt to tangible equity ratio, wherein "debt" includes securitization debt and "tangible equity" is net of the effects of gain-on-sale accounting.
>
> This line of analysis revealed that many finance companies were operating with very thin capital bases. Our paper on alternative financial ratios demonstrated this for many independent finance companies which specialized in sub-prime lending and securitization.[15]

More recently, shortly after the initial release of FIN 46, Moody's reaffirmed its practice of looking through off-balance sheet securitization structures and into the real economic substance of the underlying transactions:

> In our analysis of fundamental credit risk, Moody's has always looked through the accounting treatment of any transaction and instead focused on where the risks or benefits of the underlying assets or cash flows reside. In doing this analysis, we have generally concluded that in many cases special purpose vehicles transfer relatively little risk despite their off-balance sheet treatment. As a result, we have always factored in the risks that these instruments pose to banks in our credit analysis. These risks can include not just credit risk but liquidity risk and operational risk.[16]

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[14] The cushion generally equals to 10% to 25% of the amount of the financed receivables. *See* Bate, S., Bushweller, S., and Rutan, E., *The Fundamentals of Asset-Backed Commercial Paper*, Moody's special report, at 65 (3 Feb 2003).

[15] Foley, T. et al., *The Evolution of Moody's Views on Securitization*, Moody's Special Report (May 1999) (reprinted in Clarkson, B. et al., *Securitization and Its Effect on the Credit Strength of Companies: Moody's Perspective 1987–2002*, Moody's Special Comment at 5, 7 (Mar 2002); footnote omitted).

[16] Fanger, F. and Bauer, G., *Impact of FASB Interpretation No. 46 (Consolidation of Variable Interest Entities) on Moody's Ratings for U.S. Banks*, Moody's special report (Feb 2003).

S&P is somewhat less clear in its exact methodology, but the rating agency has firmly noted that it factors the risks of ABCP programs into its rating analysis for banks. Responding to the initial release of FIN 46, S&P stated:

> Given the strength of the Tier 1 to risk-weighted assets ratios, even if the entire amounts of the assets in the CP conduits were consolidated, Standard & Poor's does not expect any bank to fall out of compliance or even out of the "well-capitalized" area of 6% Tier 1 to risk-weighted assets, nor do we expect to make any rating changes as a result. Standard & Poor's had been aware of the banks' liabilities with regard to their CP conduits and had factored them into our thinking about economic capital requirements. Consequently, barring any new information from the expanded disclosure requirements of the new FASB interpretation, no ratings actions are anticipated.[17]

In addition, a highly respected academic commentator has observed that banks generally do not shed risk by doing business through their ABCP programs. In arguing that ABCP programs should be consolidated on bank financial statements, he has stated that:

> Clearly, this issue is difficult to sift through, particularly given the voluminous nature of the contracts which govern the actions of a given SPV. However, once these contracts are distilled into the simple economics behind these complex transactions – namely: which party holds the risk and reward of ownership of the transferred assets – the decision regarding consolidation becomes clear.
>
> * * *
>
> Therefore, if the risks and rewards of owning the senior notes, <u>no matter how cleverly disguised in a variety of contracts</u>, resides generally with the conduit's banks sponsor, the consolidation decision is clear: consolidation should occur on the bank's balance sheet.[18]

Why, then, have the regulators preserved an artificial distinction? There are three possibilities. The first is that they misunderstand what's really going on. This is unlikely. The regulators are not stupid. The second possibility is that the regulators have been suckered into preserving the distinction by the banks that they regulate. This too is unlikely. The regulators are not patsies. The third possibility is the most likely one: The regulators believe that the basic (*i.e.*, 8%) capital requirement is simply too high in relation to the risk of certain lending activities. It is impractical for the U.S. regulators to abandon international capital accords from which the basic capital requirement stems. However, by allowing special treatment for ABCP programs, the regulators have created a loophole through which any determined institution can achieve a reduced capital requirement for its secured corporate lending activities.

D. FIN 46 and CDOs

The CDO sector faces greater uncertainty from FIN 46 than does the ABCP sector. If a CDO manager's fees give it more than half of the economic up-side of the deal, the manager could be required to consolidate the CDO on its financial statements. The details relate to the calculation of "expected residual returns" under FIN 46 ¶ 8. That paragraph specifies: "[a] variable interest entity's expected losses and expected residual returns shall include… fees to the decision maker…"

If a manager's fees are included in the calculation, the manager could have more than half of the expected residual returns and would have to consolidate the CDO. CDO professionals had argued that certain kinds of fees should be excluded from the calculation. Those arguments seem to have received a cool reception from FASB's staff. The staff has proposed positions that would include all fees.[19]

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[17] Azarchs, T., *U.S. Banks to Consolidate Assets of Special-Purpose Entities Following FASB Interpretation No. 46*, Standard & Poor's special report (17 Jan 2003).

[18] Sanders, A., *Banks: The Next Enron?*, unpublished monograph (11 Apr 2002) (available at http://fisher.osu.edu/~sanders_12/Banks.pdf) (emphasis in original).

[19] *Impact of Kick-Out Rights Associated with the Decision Maker on the Computation of Expected Residual Returns under Paragraph 8(c) of FASB Interpretation No. 46, Consolidation of Variable Interest Entities*, Proposed FASB Staff Position No. FIN 46-c (3 Sep 2003) (available at http://www.fasb.org/fasb_staff_positions/prop_fsp_fin46-c.pdf); *Treatment of Fees Paid to Decision Makers and Guarantors as Described in Paragraph 8 in Determining Expected Losses and Expected Residual Returns of a*

At a recent meeting, FASB itself reportedly took a slightly softer approach on the issue, suggesting that manager fees could be excluded in certain cases.[20] In particular, reports of the discussion indicate that manager fees could be excluded from the calculation of expected residual returns if three criteria are met: (i) the fees are fixed, (ii) the manager can be replaced by a simple majority vote of investors, and (iii) the fees are commensurate with the manager's efforts. In essence, FASB seems headed toward the conclusion that the CDO manager fees can be excluded from the calculation if the manager is a bare-bones service provider.

E. FAS 140

On the FAS 140[21] front, not much has changed since the summer. FASB is still considering amendments to FAS 140 that would potentially make it harder for securitization issuers to achieve off-balance sheet treatment for their deals. More specifically, the proposed amendments would restrict the permitted activities of qualifying special purpose entities (QSPEs).[22] The proposal generated a storm of comment letters. Many objected to the proposed amendments because they want to protect off-balance sheet treatment for their securitizations or securitizations of their clients.[23] Some expressed objections with the whole framework of FAS 140 and FIN 46.[24] Others expressed agreement with the proposed changes, but argued that the amendments should be phased-in more slowly.[25]

Subsequently, information trickled out of FASB informally. FASB quietly indicated that plain vanilla master trust structures should be able to retain their QSPE status under FAS 140.[26]

For the near term, we believe it is highly unlikely that FASB will amend FAS 140 in a manner that actually curtails the availability of off-balance sheet treatment for securitizations. On the other hand, if experience is a guide, the amendment, when it comes, will create administrative and restructuring burdens for issuers.

F. SEC Developments

Shortly after FASB released FIN 46, the SEC released its new rules on the disclosure of off-balance sheet activities.[27] Congress directed the SEC to create off-balance sheet disclosure rules in § 401(a)

Variable Interest Entity under FASB Interpretation No. 46, Consolidation of Variable Interest Entities, Proposed FASB Staff Position No. FIN 46-d (10 Sep 2003) (available at http://www.fasb.org/fasb_staff_positions/prop_fsp_fin46-d.pdf).

[20] Gregory, M., *FASB: No Relief in Sight for CDO Managers*, Asset Securitization Report (17 Nov 2003).

[21] FASB, *Statement of Financial Accounting Standards No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (Sep 2000) (available at http://www.fasb.org/st/)

[22] FASB, *Exposure Draft, Proposed Statement of Financial Accounting Standards Qualifying Special-Purpose Entities and Isolation of Transferred Assets, an amendment of FASB Statement No. 140* (10 June 2003) (available at http://www.fasb.org/draft/ed_qspe.pdf)

[23] The Americans Securitization Forum and The Bond Market Association, joint comment letter dated 28 Jul 2003 (available at http://www.fasb.org/ocl/1200-001/16217.pdf); Bear Stearns, Lehman Brothers, Morgan Stanley, JP Morgan Chase, and Merrill Lynch, joint comment letter dated 31 Jul 2003 (available at http://www.fasb.org/ocl/1200-001/16408.pdf); for a listing of, and access to, all comment letters on the proposed FAS 140 amendment see http://www.fasb.org/ocl/fasb-getletters.php?project=1200-001.

[24] New York State Banking Department, comment letter dated 25 Jul 2003 (available at http://www.fasb.org/ocl/1200-001/16270.pdf); New York State Society of Certified Public Accountants, comment letter dated 30 Jul 2003 (available at http://www.fasb.org/ocl/1200-001/16282.pdf); *see also* Grant Thornton LLP, comment letter dated 11 Aug 2003 (available at http://www.fasb.org/ocl/1200-001/16652.pdf) ("We would prefer to see the Board reconsider whether the control-based model in Statement 140 is the most appropriate model to determine when sale treatment is appropriate, rather than create new rules designed to reduce the number of QSPEs…")

[25] USAA Investment Management Co., comment letter dated 30 Jul 2003 (available at http://www.fasb.org/ocl/1200-001/16274.pdf).

[26] Gregory, M., *Three More FIN 46 FSPs from FASB*, Asset Securitization Report (8 Sep 2003).

of the Sarbanes-Oxley Act.[28] The Congressional directive is now embodied in § 13(j) of the Securities Exchange Act of 1934.[29] The new rules will require companies to amplify their disclosures of off-balance sheet securitization activities. The new disclosures are supposed to be included in the "Management's Discussion and Analysis" (MD&A) section of filed reports. The new rules *do not* require companies to include off-balance sheet items directly on their financial statements.

In late July, the SEC released its congressionally mandated study "on the adoption by the United States financial reporting system of a principles-based accounting system."[30] The SEC's study urges a shift toward an accounting framework that is primarily principles-based, but which also includes rules to provide an appropriate amount of implementation guidance. Explaining its vision, the SEC stated:

> To distinguish this study's vision of the optimal approach from less formally defined approaches proposed by others, we refer to our approach as "objectives-oriented" standard setting. We do occasionally refer to principles-based standard setting in the study, by which we mean standard setting approaches that approximate the objectives-oriented approach we have defined. This study concludes that objectives-oriented standard setting is desirable and that, to the extent U.S. standard setters have not already done so, the benefit of adopting this approach in the U.S. should justify the costs.
>
> In contrast to objectives-oriented standards (as we have defined the term), rules-based standards can provide a roadmap to avoidance of the accounting objectives inherent in the standards. Internal inconsistencies, exceptions and bright-line tests reward those willing to engineer their way around the intent of standards. This can result in financial reporting that is not representationally faithful to the underlying economic substance of transactions and events. In a rules-based system, financial reporting may well come to be seen as an act of compliance rather than an act of communication. Additionally, because the multiple exceptions lead to internal inconsistencies, significant judgment is needed in determining where within the myriad of possible exceptions an accounting transaction falls.[31]

In fact, the SEC study specifically identified derecognition of financial assets and liabilities – the subject matter of FAS 140 – as one of the key areas especially in need of repair:

> An examination of the U.S. literature reveals that there are certain standards (and related interpretive guidance) that are rules-based. In particular, there are four topics for which the bodies of literature are often thought of as being overly rules-based. These are: accounting for leases, accounting for derivatives and hedging activities, stock-based compensation arrangements, and ***derecognition of financial assets and liabilities***. As we have noted previously, the primary characteristics of rules-based standards are the existence of exceptions and bright-lines which lead to very detailed implementation guidance, which often leads to even more bright-lines.[32]

The SEC noted that its proposal for moving toward an objectives-oriented accounting framework would improve the comparability of financial statements of different issuers. The SEC's discussion of the point echoes the views expressed by Moody's.[33] The SEC stated:

> We believe that, overall, the movement to an objectives-oriented approach to standard setting should result in increased comparability in terms of economic substance. Indeed, the comparability arguably associated with a rules-based regime is often illusory. This is for four reasons.
>
> First, complex financial engineering stimulated by and designed to circumvent a rules-based regime reduces transparency and, correspondingly, may reduce genuine comparability of underlying economic circumstances.[34]

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[27] SEC, Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, Release Nos. 33-8182, 34-47264 (28 Jan 2003), 68 Fed. Reg. 5981 (5 Feb 2003), (available at http://www.sec.gov/rules/final/33-8182.htm).

[28] Pub. L. No. 107-204, 116 Stat. 745 (2002)

[29] 15 U.S.C. § 77m(j).

[30] SEC, *Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System* (25 Jul 2003) (available at http://www.sec.gov/news/studies/principlesbasedstand.htm).

[31] *Id* (footnote omitted).

[32] *Id* (emphasis added, footnotes omitted).

[33] *See* text accompanying note 15, *supra*.

We do not expect the SEC's study to produce any noticeable changes in the short-run. However, between three and five years from now, we expect that study's impact will begin to appear in tangible form.

Interestingly, FASB had previously issued its own proposal to adopt a principles-based approach to setting accounting standards.[35] The proposal generated a large number of comment letters.[36] We do not expect the FASB proposal to have impact that is independent of the SEC's study.

G. Conclusion

Off-balance sheet accounting treatment for most securitizations appears safe for the time being. CDOs are the key potential exception. Over the longer-term, powerful forces pushing for financial statement transparency and comparability of financial statements across companies may jeopardize off-balance sheet treatment. In the meantime, we'll continue to analyze developments as they occur.

— E N D —

[34] SEC, *Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System* (25 Jul 2003, footnotes omitted) (available at http://www.sec.gov/news/studies/principlesbasedstand.htm).

[35] FASB, Proposal: Principles-Based Approach to U.S. Standard Setting (21 Oct 2002) (available at http://www.fasb.org/proposals/principles-based_approach.pdf).

[36] *See* http://www.fasb.org/ocl/fasb-getletters.php?project=1125-001.

III. Recent Nomura Fixed Income Research

Fixed Income General Topics

- U.S. Fixed Income 2003 Mid-Year Outlook/Review (27 June 2003)
- Off-Balance Sheet Update (11 March 2003)
- Report from Arizona: Coverage of Selected Sessions of the February 2003 Securitization Conferences (18 February 2003)
- Senate Report Attacks Structured Finance (6 January 2003)
- Fixed Income 2003 Outlook & 2002 Year-in-Review (19 December 2002)
- Securitization Glossary (26 November 2002)

MBS

- Monthly Update on FHA/VA Reperforming Mortgages: Historical Prepayment Speeds, Default Losses, and Total Returns (5 November 2003)
- Australian MBS Primer (9 September 2003)
- Agency Capped Callable LIBOR Floaters Offer Structuring Flexibility to Create Investment Profiles That May Be Difficult to Create in New Issue CMO Floaters (2 July 2003)
- A Journey to the Alt-A Zone (3 June 2003)
- Oops… They Did It Again – Jumbo MBS Credit Enhancement Levels Keep Falling (2 April 2003)
- Monthly Update on FHA/VA Reperforming Mortgages: Historical Prepayment Speeds, Default Losses, and Total Returns (4 March 2003)
- Terrorism Insurance Update (published in Nomura CMBS Weekly Report, 7 June 2002)

CMBS

- GNPL REMIC Factor Comparison (28 October 2003)
- GNMA Project Loan Prepayment Report (14 October 2003)
- CMBS Watchlistings, Downgrades, and Surveillance (2 October 2003)
- Temporal Aspects of CMBS Downgrades and Surveillance (1 July 2003)
- Some Investment Characteristics of GNMA Project Loan Securities (1 May 2003)
- CMBS Credit Migrations (4 December 2002)

ABS

- What a Coincidence? – One Reason Why CDOs and ABS Backed by Aircraft, Franchise Loans, and 12b 1 Fees Performed Poorly in 2002 (19 May 2003)
- Healthcare ABS Primer (18 October 2002)
- Report from Paradise Island: Coverage of Selected Sessions of ABS East 2002 (7 October 2002)
- ABS Credit Migrations (9 Jan 2002, updated 5 March 2002)

Corporates

- US Corporate Monthly - April (9 May 2003)
- US Corporate Monthly - March (8 April 2003)
- McDonalds Corp. (31 March 2003)
- Hewlett-Packard (25 March 2003)
- The Boeing Company (14 March 2003)
- US Corporate Monthly - February (7 March 2003)
- US Corporate Monthly - January (14 February 2003)
- Alcoa, Inc. (3 February 2003)

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