Nomura Fixed Income Research

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Thirty Years Later
Securitization Is Still Good for America

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I. Introduction

Securitization is a good thing. On balance, it has produced far more benefit than harm. Unfortunately, in the wake of the Enron debacle, well-intentioned reforms could impair or discourage the use of securitization as a financing tool. To avoid unintended damage to a beneficial financing tool, policymakers must have complete and balanced information about securitization's role in the American financial system.

The present debate is framed in terms of "special purpose entities" (SPEs), "disclosure" and "auditing." Various writers have asserted or complained that Enron's accounting practices and its use of SPEs were improper. The complaint is essentially that Enron's financial statements failed to provide a fair reflection of its economic condition. At its roots, the controversy focuses on the same issue with which securitization professionals previously grappled, but under the rubrics of "equity relief," "effective leverage," and "risk transference."[1]

Although the concept of securitization is simple, the actual process is often complex. A major portion of the complexity arises from the legal and accounting landscape upon which securitization transactions must be constructed. Securitization techniques evolved faster than their surrounding legal and accounting frameworks. Accordingly, securitizations sometimes produce seemingly strange accounting consequences or rely on arcane and sometimes tenuous legal theories.

The Enron debacle may have the positive side effect of intensifying normative consideration of both (1) accounting for securitizations and (2) the legal status of securitized assets. Policymakers will have the best chance to reach the most correct results if they have the complete picture.

II. What is Securitization

Securitization is a financing tool. It is a close cousin to traditional secured debt. In a securitization, a company raises money by issuing securities that are backed by specific assets. In most cases, the underlying assets are loans, such as mortgage loans or auto loans. The cash flow from the underlying assets is the source of funds for the borrower/issuer to make payments on the securities.

Compared to traditional secured debt, securitizations are intended to provide a lender/investor with greater protection against the credit risk of the borrower/issuer. In principle, a securitization lender/investor is a kind of "super-secured creditor," with rights that surpass those of a traditional secured lender. Securitization employs the notion that the subject assets have been "sold" by the borrower/issuer and, therefore, will not become entangled in bankruptcy proceedings if the borrower/issuer files for protection under the bankruptcy code.[2]

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[1] *Securitization and Its Effects on the Credit Strength of Financial Services Companies: Moody's Perspective 1987-1999*, Moody's Investors Service (July 1999) (Moody's doc. no. SF7840.pdf)

[2] A core element of many securitization transactions is arranging for a "true sale" of the assets by the borrower/issuer. A true sale is one that a bankruptcy court would not characterize as a mere pledge of collateral

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Accomplishing a "sale" of the securitized assets often requires the use of an SPE. A typical securitization is structured as a two-step transaction. In the first step, the borrower/issuer transfers the subject assets to an SPE in a transfer designed to constitute a "true sale." In the second step, the SPE issues securities backed by the assets. The SPE uses the proceeds from selling the securities to pay the borrower/issuer for the assets. In addition, part of the "consideration" that the borrower/issuer receives for transferring the assets to the SPE is its ownership of the SPE.

III. The Good Side…

As a financing technique, securitization offers certain important advantages, which translate into benefits to America and the American economy. The most vivid example of such benefits is the residential mortgage sector. The securitization activities of the GSEs[3] have produced a highly liquid secondary mortgage market. Nearly $2½ trillion of residential mortgage loans are packaged into GSE securities. Another $500+ billion is packaged into mortgage-backed securities (MBS) issued by private companies. In all, about half of all the nation's residential mortgage loans are packaged into MBS. As a result, funds for residential mortgage loans are available all across the nation, and regional differences in interest rates for residential home loans are virtually non-existent. Today's secondary market for residential mortgage loans arguably has done more to promote the American Dream than any other instrument of national housing policy. For this alone securitization rightly can be viewed as the greatest financial innovation of the 20th Century.

Beyond the mortgage area, securitization has expanded the availability of consumer credit in general. Securitization of auto loans and credit card receivables has made auto loans and credit cards available to more Americans than would otherwise be the case. Superior access to credit by responsible households is undeniably beneficial, even though easier availability causes some consumers to borrow more than they should.

The benefits of securitization extend to the commercial sector as well. Equipment leasing companies use securitization to finance their leases on many different types of equipment. This makes the equipment available more cheaply to business of all types. Lessees of aircraft, computers, medical equipment, trains, and office equipment have all benefited from cheaper lease rates because of securitization.

Securitization produces its benefits by improving the efficiency of the financial system. It allows lenders to finance their lending activities more efficiently than they could with traditional corporate bonds or with bank loans. The sources of improved efficiency are easy to identify:

A. Asset-Liability Matching

Securitization transactions are generally based on matching the payments on the securities issued to the actual cash flows on the underlying assets (*e.g.*, securitized loans). That approach inherently

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to secure a loan. The distinction is very important. Collateral pledged to secure a loan becomes part of the bankruptcy estate when a borrower files for protection under the bankruptcy code. The collateral may become embroiled in the bankruptcy proceeding, and secured lenders that have an interest in the collateral may suffer delays or other difficulties in being able to liquidate the collateral to satisfy their claims. In contrast, assets sold by a borrower before it files for bankruptcy do not become part of the bankruptcy estate. Purchasers of the assets do not have to become involved in the borrower's bankruptcy proceeding in order to fully assert their rights in the purchased assets.

Deciding whether a given transfer of assets is a "true sale" or a mere pledge is a critical exercise for securitization lawyers. The main criteria on which the lawyers focus in making that determination is whether the borrower/issuer has transferred the economic risks and benefits of ownership with respect to the securitized assets. In theory, the greater the degree to which the borrower/issuer transfers the risks and benefits of ownership, the more likely it is that the transfer will be treated as a sale (and not characterized as a pledge). However, even when a securitization involves only a minimal transfer of the risks and benefits of ownership, securitization lawyers have developed legal theories to support the position that a "true sale" has occurred.

[3] Ginnie Mae (Government National Mortgage Association), Fannie Mae (Federal National Mortgage Association), and Freddie Mac (Federal Home Loan Mortgage Corporation).

achieves asset-liability matching with respect to the securitized assets. Asset-liability matching allows a lender to fund itself more efficiently and to pass some of the cost savings on to its customers.

B. Lower Funding Costs

Securitizations are structured to achieve high ratings. In general, their securities can be sold at tighter spreads (*i.e.*, lower interest rates) than the borrower/issuer could get with corporate debt or bank loans. Here, too, the borrower/issuer can pass along some of the savings to consumers.

C. Improved Liquidity

A company can never have too many sources from which to raise funds. By using securitization, a company can diversify its funding sources and reduce its dependence on bank loans, corporate bonds, and commercial paper. During the 1990s, the U.S. auto makers achieved significantly improved liquidity by using securitization.[4]

Countries around the globe have embraced the model of securitization developed in America. Those countries seek to realize for themselves, the improved financial efficiency that securitization brings. Companies in those countries want to harness the asset-liability matching, lower funding costs, and improved liquidity that securitization can offer. The view of those countries serves to reaffirm the conclusion that securitization is an important and beneficial innovation.

IV. …and the Not-so-Good Side

On the other hand, as with many important inventions and innovations, securitization has been used in ways that arguably have caused harm as well as good. For some companies, the primary motivation for using securitization has not been asset-liability matching, lower funding costs or improved liquidity. Instead, those companies have used securitization primarily because of the accounting results that securitization would allow them to achieve.

A. Shrinking the Balance Sheet

Many companies – including certain banks – use securitization to make themselves appear smaller than they really are. When a bank securitizes credit card receivables due from its customers, the bank removes the receivables from its balance sheet. Similarly, when a bank extends loans to its commercial customers through an "asset-backed commercial paper" (ABCP) program, the loans are never counted on the bank's financial statements.

A company can shrink its balance sheet by securitizing assets even if it retains all (or virtually all) of the risk associated with the assets. Sometimes a company retains the risk by holding a "subordinated interest" in the assets or by providing an explicit guarantee, such as a letter of credit. Other times, the risk retention is more subtle, taking the form of the right to receive "excess spread" over the asset's life.[5]

The effect of using securitization to remove assets from a company's balance sheet is to make the company's leverage ratio appear better. For example, if a company has $5 billion of capital and

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[4] *The Impact of Asset Securitization on the Auto Finance Industry*, Moody's Special Comment, July 1996.

[5] Excess spread is the difference between the yield on an asset and the all-in cost of financing an asset. For example, suppose a credit card portfolio produces a gross yield of 15%. Suppose further that (1) the portfolio is financed by issuing securities that pay a yield of 7%, (2) the cost of servicing the portfolio is 1%, and (3) credit losses consume 5%. The excess spread would be 15%-(7%+1%+5%), or 2%. If credit losses on the portfolio increase, the excess spread will be reduced dollar-for-dollar.

$50 billion of assets, its leverage ratio would be 10-to-1. However, if the company has $100 billion of assets, its leverage ratio would be worse: 20-to-1.

Even the savviest financial analysts sometimes have difficulty in discerning the true amount of leverage in companies that use securitization actively. Securitization has the effect of thwarting the usefulness of financial statement disclosures. In some cases, careful scrutiny of the footnotes to a company's financial statements would allow an analyst to see the true picture. On the other hand, even the footnotes are often insufficient to permit a seasoned professional to really understand a company's leverage. Fortunately, in the wake of Enron, the situation may be improving as companies push to improve their disclosures.[6]

B. Bank Capital Regulations

Some banks use securitization to reduce their regulatory capital requirements.

American taxpayers ultimately bear the cost of bank failures. Accordingly, the banking industry is strictly regulated, and part of the regulatory framework is capital requirements. Beneath all their detail and complexity, the regulatory capital requirements essentially impose limits on how much leverage banks can have. This motivates some banks to use securitization as a way to make their leverage appear smaller.

Consider the following example: Bank A and Bank B each have $5 billion of capital and $50 billion of identical assets (loans to customers). Bank A finances all of its activities through traditional sources such as deposits and inter-bank borrowings. Bank A's leverage ratio is clearly 10-to-1. Bank B takes a different approach. It finances $20 billion of its assets through securitizations that move the assets off its balance sheet. Bank B's balance sheet shows $30 billion of assets and $5 billion of capital, resulting in an apparent leverage ratio of only 6-to-1. Bank B appears stronger (*i.e.*, less leveraged) than Bank A even though the two are identical in economic terms. Even more important, under the existing framework, the regulatory *minimum* capital requirement for Bank B will be less than for Bank A.

C. Gains-on-Sale

Some companies have used securitizations to make their earnings seem stronger than they really are.

Securitization can effect a company's income statement as well as its balance sheet. As noted above, one of the ways in which a company may retain risk in securitized assets is through excess spread. Sometimes, excess spread from securitized assets is reported as income in the period received. It is income from assets that are not counted on the company's balance sheet. As long as the assets perform as originally expected, the flow of excess spread will follow expectations. However, if the assets experience high levels of either prepayments or credit losses, the flow of excess will be less than expected. Fluctuations in the flow of excess spread can cause a company's reported earnings to be volatile.

On the other hand, sometimes a company's right to receive excess spread is reflected as an asset on its balance sheet. If a company's securitization qualifies as a "sale" under accounting standards, the company may be required to recognize income immediately at the time of the securitization. This can happen if the estimated value of the retained "residual interest" (*i.e.*, the right to receive future excess

[6] Rachel Silverman, *GE's Annual Report Bulges with Data in Bid to Address Post-Enron Concerns*, Wall Street Journal, 11 Mar 2002, p. A3. The article states:

> In one of the most striking changes, GE included a special section about its use of "special-purpose entities." GE said it held a total of $56.41 billion of assets in special-purpose entities for 2001, up from $41.20 billion the prior year. GE's assets in these entities included $43.01 billion of receivables such as credit-card loans and equipment leases, which are packaged into diversified asset-backed securities that are sold to investors.

spread) combined with the proceeds of the securitization exceeds the cost of the assets. In such a case, the company recognizes non-cash income equal to the "gain on sale" of the assets. The amount of gain is largely dependent upon the assumptions used for valuing the retained residual interest.

During the latter half of the 1990s, many non-bank finance companies used gain-on-sale accounting to book income when they securitized their assets. Some of those companies used very optimistic assumptions. The large gains produced by gain-on-sale accounting initially produced very impressive levels of earnings, albeit on a non-cash basis. The high earnings translated into high earnings per share and, accordingly, high executive bonuses. Certain home equity lenders and manufactured housing lenders were among the most aggressive users of gain-on-sale accounting. Their strategy proved flawed: many of them later went bust, had to be acquired, or had to exit the sector. Their names are familiar to many: Cityscape, ContiMortgage, First Plus, Green Tree, IMC, Mego Mortgage, Southern Pacific, The Money Store, United Companies, Wilshire Financial, and others. Ultimately, their shareholders and general creditors had to bear the cost of the flawed securitization/gain-on-sale strategy.

D. Complexity

Enron has been criticized for making its financial structure so complicated that it defied reasonable attempts at analysis. Some users of securitization make themselves vulnerable to the same criticism. It can be extremely difficult to ascribe reasonable values to the residual interests that a company may retain following a securitization. Moreover, the transactions can create a multitude of SPEs, which may in turn hold residuals or other pieces of securitizations.

Even when following all applicable accounting standards, a company with a highly complex financial structure may thwart the underlying purpose of financial accounting: to fairly reflect the economic condition and prospects of the subject company.

E. Bankruptcy

The Enron debacle may focus scrutiny on another aspect of securitization: the status of securitized assets when a company goes into bankruptcy. By using securitization, a company place its securitized assets beyond the reach of the bankruptcy system, which, arguably, might be unfair to its other creditors.

The securitization industry embraces the view that securitized assets are *excluded* from the bankruptcy estate of a company that has filed for bankruptcy protection. Indeed, private sector (*i.e.*, non-GSE) securitization relies most heavily on this position. However, the bankruptcy code itself does not directly address the status of securitized assets, and Congress has yet to give its stamp of approval to the process.

As noted in part II, above, securitization hinges on the idea that securitized assets have been legally "sold." The corollary is that securitization investors can be viewed as a special, super-protected class of creditors – creditors who have such an exalted status that they can satisfy their claims without even going to the bankruptcy court.

Although Congress has never granted or acknowledged special status for securitization investors, it has done so for certain other creditors. For example, section 559 of the bankruptcy code provides special relief for creditors who lend via repurchase agreements covering U.S. Treasury securities. Other sections of the bankruptcy code provide similar relief when a financing arrangement is in the form of a swap agreement (§ 560), commodity contract (§ 556), or securities contract (§ 555). All these special provisions allow certain claimants against a bankrupt company to avoid the bankruptcy process.

The absence of a bankruptcy code provision expressly clarifying the status of securitized assets casts a shadow over securitization. Just within the past year, one bankrupt company (LTV Steel) tried to attack its own securitizations:

> [T]hrough a bewildering and complex array of documents, and through the establishment of the SPVs (which have no real function), the Lenders have conjured the illusion that the Debtors do not own their inventory, do not own their accounts, and are not in the business of manufacturing and selling steel products… The Lenders' complex documents and legal constructs are designed to create the appearance of a daily "arms-length sale" of all the Debtors' current business assets (inventory and proceeds in the form of accounts) to the Inventory SPV and the further "arms-length sale" of the Debtors' accounts from the Inventory SPV to the accounts SPV. The purpose of this fiction is obvious: to remove all of the Debtors' current assets from the jurisdiction of the Bankruptcy Court, to deprive the Debtors' unsecured creditors of the ability to realize any meaningful recovery from the Lenders' enormous equity cushion, and to enable the Lenders to exercise remedies without any accountability to this Court or any other parties in interest. In other words, the Lenders have attempted to "opt-out" of the United States Bankruptcy Code to capture the most valuable assets of the Debtors to dispose of as they see fit, at a painful cost to the Debtors' employees, unsecured creditors, and shareholders.[7]

Although the attack failed, its shadow remains. A basic policy question that needs to be answered (once and for all) is whether private parties can "opt-out" of the bankruptcy system by using securitization as the means of financing assets.

V. Conclusion

Securitization is just a tool – admittedly a powerful tool – but still just a tool. Like most other tools, it can be used properly or misused. The fact that a tool is capable of being misused does not mean that it should be rejected, abandoned or destroyed.

The benefits of improved availability of credit and heightened economic efficiency are entirely separate from the perceived abuses associated with certain securitization activities. The right approach would be for policymakers to address perceived abuses directly, while remaining mindful not to undermine securitization as a whole. They must avoid throwing the baby out with the bathwater.

On the accounting front, policymakers should push for an accounting standard that is *neutral* with respect to the mere *form* of a transaction. That is, they should push for a standard that relies on real economic *substance*. In other words, determining whether a securitization results in removing securitized assets from a company's balance sheet should depend on economic substance rather than the mere form of the transaction. More particularly, a securitization should not result in removal of securitized assets from a company's balance sheet if the company retains risks or benefits associated with the future performance of the assets. If the company retains no risks or benefits associated with the asset's future performance – either directly or indirectly through an SPE or otherwise – then the transaction should be treated as a sale and the assets should not appear on the company's balance sheet. Such an approach would eliminate the motivation to exploit loopholes or gimmicks for manipulating financial reports. Securitizations motivated primarily by accounting considerations might no longer occur, but those with real economic motivation (*i.e.*, lower funding costs, asset-liability matching, improved liquidity) would certainly continue.

Whatever works on the accounting side ought to work as well in the realm of bank regulation. An approach that is *neutral* with respect to form ought to rout out transactions driven solely by "regulatory capital considerations," while not disturbing those motivated by real economic substance.

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[7] Cadwalader Wickersham & Taft, *Pending Challenge to Securitization Structure*, Memorandum to Clients and Friends (29 Jan 2001; quoting LTV's brief; available online at: http://www.cwt.com/assets/Pending%20Challenge%20to%20Securitization%20Structure.pdf)

Bankruptcy… Congress should clarify the status of securitized assets by amending the bankruptcy code. Last year's proposed bankruptcy reform bills contained suitable provisions,[8] but none of those bills was passed. Congress needs to act swiftly and firmly to remove the cloud of uncertainty that hangs over securitization. Doing so will reduce the costs (legal fees) associated with private sector securitizations and further improve the efficiency boost to the American economy.

Securitization was made in America and much of the world has now embraced it. The magnitude of its benefits is overwhelming. Because securitization developed faster than the surrounding legal and accounting framework, certain questionable uses for securitization developed as well. With good policy, we can fix the malfunctioning parts of the securitization machine without having to scrap the whole.

[8] H.R. 333, 107th Cong., 2d Sess. § 912 (2001); H.R. 3211, 107th Cong., 2d Sess. § 13 (2001)

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