Commentary

Efforts To Bail Out The U.S. Economy Could Impede Legitimate Uses Of Securitization

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Overreaction to the current U.S. economic crisis could have long term ramifications reducing the use of longstanding and generally beneficial financial structures. The efforts to rescue the economy from the effects of what began as a sub-prime mortgage meltdown and has now become a generalized credit crunch affecting even the most creditworthy borrowers, have provided an occasion for various interest groups to question securitization as a financing strategy. Citing a small number of real abuses as well as the perceived inflexibility of these structures — especially concerning potential mortgage debtor relief that, hypothetically, banks would grant if only they had the authority to do so — some are urging that the utilization of these strategies be curtailed, either by legal prohibition or by eliminating the financial reporting advantages attendant to securitizations.

The critics may not fully appreciate the legal and accounting attributes that make securitization a legitimate and useful multifaceted tool. They should realize that unilateral debt relief mandated by either the government or by the original lending institution would not be an appropriate solution. Instead, what must be rectified are the failures by financial institutions to prudently utilize a legal and accounting tool that has served to create enormous liquidity in the financial markets.

As explained in the following paragraphs, when properly employed, securitization is a financial strategy that is well grounded in both property and contract principles, and has demonstrable benefits for the nation's economy. However, political over-reactions to real economic distress, directed in part at the use of securitizations, will likely exacerbate the turmoil by raising the spectre of abrogation of the rights of those holding securitized asset investments.

Altering Securitizations To Fix The Economy

The bond between economic freedom and democracy has long been understood. Contract and property rights are two essential components of an economically free and democratic society. We must continue to enjoy constitutionally granted empowerment to freely use, exclude, and transfer ownership of both tangible and intangible property, lest we seriously risk the deterioration of our competitive economy. That is why caution is necessary when suggesting radical moves such as unilateral debt relief, whether

imposed by the U.S. government or generously granted, under political pressure, by original lenders. Either of these actions would fundamentally alter the basically sound, but temporarily fragile, financial system that has given the U.S. the most successful economic structure in world history.

It appears that, for some critics, securitization has become the scapegoat for the financial and economic travails now being endured. That is in part due to how the securitization process, on the surface, could appear to be a form of legerdemain, as it enables financial institutions to transform relatively illiquid assets, such as receivables from loan and lease contracts, into marketable securities, which are then widely distributed to investors around the globe, none of whom have actual decision-making powers vis-à-vis the underlying debtors.

However, when correctly executed, securitization is based on a collection of legitimate contract and property transactions that can have a material beneficial impact to market participants as a whole. Most recognize that the enormous expansion of home ownership over the past several decades, for only one example, has been the direct result of the development and widespread use of securitizations. Imposing changes in these arrangements after the fact, either directly or by indirectly causing changes to be made to financial reporting rules that facilitate the use of these arrangements, would only serve to diminish the beneficial results of their employment.

Certainly there are real questions to be answered regarding lending practice failures, which have arisen from the quantity of so-called "toxic debt" that has and will continue to threaten the stability of the U.S. and the world financial institutions and broader economies. It has been suggested that financial institutions permitted, if not actually encouraged, lenient lending standards because of the ability to unload risky debt through securitization. The trusts, which are the transaction vehicles that make securitization possible, had a fiduciary duty to carefully examine and assess the quality of paper being purchased, and many seem to have failed in meeting that obligation. The ability to perform that task was, however, likely impaired by extreme overvaluation in the housing market, which in turn arguably was a consequence of a more broad-based asset pricing bubble stimulated or at least abetted by government interest rate policy. This would not be our first experience with massive dislocation caused by poorly conceived and shifting public policies, as those who remember the thrift and banking crises of the late 1980s/early 1990s can attest.

The U.S. has experienced the bursting of other asset bubbles; this time it just happened to be with inflation of home valuation. The abridgement or functional elimination of a financial structure that makes securitization possible will not adequately remedy the root causes of the mortgage meltdown. Modifying existing, already-executed loans and leases could actually exacerbate the current crisis by destroying the confidence businesses and investors have in securitized assets as being a predictable and protected investment option.

Securitization Basics

Entities that generate a large number of similar receivables, such as mortgage loans, credit card receivables, or automobile loans, commonly securitize those receivables. Securitization is the transformation of groups of homogeneous receivables into securities that can then be sold to investors. For example, commercial loans can be converted into collateralized debt obligations (CDOs), which entitle the investors to receive specific cash flows generated by the loans. A bewildering variety of "financially engineered" claims to these cash flows, resulting from "slicing and dicing" whole loans into pieces offering alternative patterns of promised cash flows suitable to different investors' needs, has probably contributed to the current distrust of the process, notwithstanding that these engineered instruments were driven by market demand.

Issuance of the securities, with an established liquid market, indirectly reduced the cost of borrowing by a host of borrowers, from major corporations to home owners. When properly structured, financial assets transferred to a qualified special purpose financing entity (QSPE) can be removed from the sponsor's statement of financial position, together with the debt raised to finance the acquisition of those assets from the sponsoring enterprise. Numerous financial institutions have utilized securitization as a tool to lower risk, add liquidity, and enhance economic efficiency. If some participants in this process —

investors, trustees, lenders, auditors and others — have been negligent in overseeing the substantial and financial reporting aspects of these actions, that should be dealt with directly, without endangering its ongoing use.

What Legal Principles Are Involved In Securitization?

The securitization process involves many aspects of modern contract and property law. For example, the overarching objective of securitization is the legitimate metamorphosis of loans/leases (contracts) into securities (personal property). A financial institution must take several defined steps to reach that objective, which similarly entail contract and property elements. An independent special purpose financing entity (SPE) and then a qualified special purpose financing entity (QSPE) must be formed. The originating financial institution sells and relinquishes control over a pool of homogenous loans/leases to the SPE. This must satisfy so-called "true sale" legal criteria. Rights to principal and interest payments made by borrowers on the underlying assets are marketed and sold to investors. Overall, securitization is simply a collection of sophisticated transactions that are governed by well-established contract and property law principles.

Understanding the details is essential as the Government continues its attempt to bail out the U.S. economy and to slow or stop the spiraling financial downturn. If securitization is a sound and legitimate business practice, neither the financial institutions nor the U.S. government should take any steps to modify terms of loans/leases that have effectively been sold to arm's-length investors. Ill-considered reactions at this time could have severe ramifications for decades to come as borrowing options become more limited and, ultimately, more expensive, with predictable negative macro-economic consequences.

History And Evolution Of SPEs And QSPEs

Briefly, since the mid-1980s, the Financial Accounting Standards Board (FASB), the U.S. accounting standard setting body, has been addressing the concept of SPEs. Since one of the basic objectives of entities engaging in securitizations is to isolate the assets and related obligations, removing them from the lender's balance sheets, derecognition criteria must be met. A financial institution is unable to market and sell interests in securitized asset pools without establishing an SPE. An SPE is a legal entity, such as a corporation, trust, or partnership, which is created for the limited purpose of acting as a depository for assets in a securitization transaction. A caveat for any SPE is that the SPE is restricted to engaging in only those activities that are granted in the legal documents creating the entity. The sponsoring entity (bank, etc.) must actually relinquish control over the assets transferred, and not be obligated to repay the borrowings incurred by the SPE.

These are essential steps because the assets the originating financial entity passes through a "true sale" to the SPE must be considered "legally isolated." In other words, when properly formulated, once assets pass to the SPE they are no longer available to the originating entity or its creditors. This is a key characteristic, so that these assets are protected if the originating entity should become bankrupt. This physical and legal separation of assets reduces the risks an investor would otherwise face, and most likely be unwilling to accept, to only those risk associated with their investment and not the financial stability of the originating entity.

The two central questions FASB has undertaken to resolve regarding this structure have been: 1) whether financial assets transferred to SPEs can be removed from the originating entity's (the transferor's) statement of financial position, and 2) whether a gain on the transfer of assets to the SPE can be recognized at the date of transfer. A corollary concern has been whether debt incurred by the SPE (needed to fund the purchase by the SPE of the financial assets from the originating entity) can also be excluded from the originating entity's statement of financial position.

The concept of accounting for special purpose entities evolved slowly since, as is typical, innovations in financial structures outpaced accounting theory. In 1990 an important standard was imposed that was specifically oriented toward off-balance sheet leases. By the mid-1990s, due to the rapidly growing popularity of off-balance sheet structures, particularly securitizations, it became clear that an expanded, more broadly applicable standard was required to preserve and enhance the representational faithfulness of financial reporting. In mid-1996, Financial

Accounting Standard (FAS) No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, was issued. FAS 125 established the concept of the qualified special purpose entity or QSPE and imposed a "control over financial assets" criterion for the de-recognition of financial assets, superseding the formerly utilized "risks and rewards" criterion which was the de facto standard under less formal guidance set forth by the FASB's Emerging Issues Task Force (EITF).

Recognizing A 'True Sale'

FAS 125 was superseded by FAS 140 in September 2000. FAS 140 is very similar to FAS 125, but among its distinguishing characteristics was a change in the criteria for application of "gain on sale" accounting. Securitizations are accounted for as a sale only if: 1) a QSPE is used to buy the assets, 2) each holder of its beneficial interests has the right to pledge or exchange the beneficial interest and there is no condition that both constrains the holder from taking advantage of that right and provides more than a trivial benefit to the transferor, and 3) the transferor does not maintain effective control over the assets.

FAS 140 also describes in detail the need for the QSPE to be demonstrably distinct from the transferor; the necessary limitation on permitted activities; the types of assets that may be held; and the restrictions on sales or other dispositions of QSPE-held assets. When all conditions are met, the QSPE is not consolidated in the financial statements of the originating entity. The act of not consolidating the QSPE signals to readers of the originating entity's financial statements that that originating entity cannot exercise authority or control over the QSPE. The non-consolidation of QSPEs is now at risk, however, as regulators and standard-setters grapple with the collateral issues raised by the most recent financial crises.

Guidelines For Determining If The QSPE Is Legally Isolated

In promulgating FAS 140, the FASB stated that "two step" securitizations, taken as a whole, generally would be judged under present U.S. law as having isolated the assets beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership. FAS 140 discussed such "two step" structures, under which the requisite test is as follows:

> First, the corporation transfers financial assets to a special-purpose corporation that, although wholly owned, is so designed that the possibility that the transferor or its creditors could reclaim the assets is remote. This first transfer is designed to be judged to be a true sale at law, in part because the transferor does not provide "excessive" credit or yield protection to the special-purpose corporation, and FASB understands that transferred assets are likely to be judged beyond the reach of the transferor or the transferor's creditors even in bankruptcy.
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> Second, the special-purpose corporation transfers the assets to a trust or other legal vehicle with a sufficient increase in the credit or yield protection on the second transfer (provided by a junior beneficial interest that continues to be held by the transferor or other means) to merit the high credit rating sought by third-party investors who buy senior beneficial interests in the trust. Because of that aspect of its design, that second transfer might not be judged to be a true sale at law and, thus, the transferred assets could at least in theory be reached by a bankruptcy trustee for the special-purpose corporation.

However, the special-purpose corporation is designed to make remote the possibility that it would enter bankruptcy, either by itself or by substantive consolidation into a bankruptcy of its parent should that occur. For example, its charter forbids it from undertaking any other business or incurring any liabilities, so that there can be no creditors to petition to place it in bankruptcy. Furthermore, its dedication to a single purpose is intended to make it extremely unlikely, even if a QSPE somehow entered bankruptcy, that a receiver under the U.S. Bankruptcy Code could reclaim the transferred assets because it has no other assets to substitute for the transferred assets.

What Benefit Is Exchanged In A 'True Sale'?

Under generally accepted accounting principles (GAAP), the economic interest held by the originating entity of a securitization trust, representing the right to receive interest spreads is equivalent to an interest-only strip security (I/O strips). These represent interest coupons only, with no claim to the

principal payments on the underlying, stripped securities (e.g. mortgage notes). As there is no principal payment involved, such I/O strips cannot be classified as "held to maturity" under GAAP (FAS 115, *Accounting for Certain Investments in Debt and Equity Securities*, issued in 1993). Under that standard, I/O strips must be "marked to market" at each balance sheet date — that is, reported at fair value, and not at amortized historical cost amounts. Due to inevitable changes in parameter values (e.g., expected prepayment speeds, default rates), fair value will vary from period to period. These factors must be addressed by the reporting entity's accounting system, to ensure that the presentation of financial statements will be GAAP-compliant.

What Interest Is Acquired In A 'True Sale'?

A QSPE acquires an intangible good (the right to collect on the receivables due in a pool of loans/leases), which it is subsequently free to retain, pledge, or sell. To pay for the receivables it essentially buys from the financial institution the QSPE will convert those assets into securities (frequently called "certificates"). The QSPE will typically group and then market these securities in classes or "tranches" to investors based on their credit quality. Depending on the structure chosen, various tranches may be claims to cash flows during different phases of the underlying debt's term (e.g., early years, later years), interest or principal payments only, or even more exotic derivatives (e.g., floating rate returns created from fixed rate debt).

When QSPE assets are isolated from the transferor's possible bankruptcy, the QSPE's credit quality is enhanced and the financing costs on the debt are most often reduced. To further lower financing costs, the QSPE can obtain either internal or third party credit enhancements. Internal credit enhancements would include direct recourse, over collateralization, and reserve or spread accounts. Third party credit enhancements, similarly, could include cash collateralized accounts and financial guarantees. As a result of utilizing some form of credit enhancement, the resulting securities are more liquid than the underlying receivables.

What Is At Stake In The Current Debate?

If the U.S. government or the originating entity unilaterally grants debt relief to the borrowers of loans/leases that are securitized and held by a QSPE, assuming that doing so would be upheld by inevitable court challenges, investors will unfairly bear the burden of poor business decisions made by the originating financial entity and by the securitization trustee, possibly abetted by inadequate due diligence and financial statement auditing. When the borrowers of securitized loans/leases make principal and interest payments on their debts, those payments do not go to the lender that made the loans/leases initially. Instead, after the originating institution sells those loans/leases in a "true sale," those payments go to the trust, even if the originating institution retains servicing obligations.

When the trust is the true owner of anticipated loan/lease payments it is able to perform statistical calculations and project expected future returns. As a result, the trust is able to obtain a rating from a rating agency such as Moody's, Standard & Poor's, or Fitch, in order to enhance the marketability of a class of securitized assets. Investors are more inclined to purchase securities when they have been assigned a favorable rating and when the trust can provide reliable projections of the return an investor would receive on their investment.

The originating entity does not have authority to modify loans/leases it no longer owns. Were this not the case, the perceived risk of modification would make the instruments unappealing as investments.It should be inconceivable that the government would abrogate property rights, but in the current almost panic-stricken circumstances the formerly inconceivable is now no longer impossible. Interest groups and consumers unfamiliar with certain fundamental principles of both economics and accounting, however, continue to encourage bold actions from their elected representatives. The threat of modification is unnerving to investors because modification almost always means reducing or delaying payments due. A reduced or delayed flow of funds to a trust would drastically decrease the value of certificates sold to investors and quite likely severely curtail willingness to partake of future securitizations.

The only appropriate method to accomplish loan restructuring or debt relief given the widespread use of securitization structures would be for the originating lenders to repurchase from investors their interests in

the asset-backed securities. Given lenders' current problems, even with the Federal bail out funds that are being used, in part, to provide renewed liquidity for banks, it is almost impossible to imagine that this could be done to any meaningful extent. Any other actions to alter the debtors' obligations would fundamentally impact the markets, whose continued functioning is vital for long term economic stability. Immediate, large negative reactions would be inevitable, beginning with rating downgrades for trust-issued securities. Market liquidity would be severely harmed — the precise opposite effect of what is the goal of current Government policy.

What Will Be The Fate Of Securitization Accounting?

It is important that the practice of securitization be recognized as not being the sole, nor even a major contributing cause of the current financial crisis. This is not to argue that ways to improve upon the financial practices and the accounting for securitizations may not be possible. Improved transparency in financial reporting is a major goal, but this need not result in across-the-board elimination of QSPE accounting for those arrangements that are structured in accordance with strict, rational requirements. Overreaction should be avoided, as the effects will have long term implications on financial institutions and market participants that have relied on securitization as a legitimate and effective tool to inject liquidity into the economy. As with the parallel debate over "fair value accounting," short term political objectives should not be allowed to dictate financial reporting theory.

FASB has proposed eliminating or severely limiting the use of off-balance sheet securitization, as a result of political discussions about abrogating contract obligations and rights, as well as due to concern that "off-balance sheet" financings were causing lack of transparency in financial reporting. FASB intends to contemplate the extent to which it will alter existing regulations FAS 140 and a related standard, FIN46(R), *Consolidation of Variable Interest Entities*, over the next year. The fact that FASB did not rush to change current rules by year-end 2008 is a positive sign that it may resist demands to end "off the balance sheet" structures and force banks and other reporting entities to put billions of dollars of "sold" debt back onto their statements of financial position.

In the mean time, FASB responded to financial statement user demands for greater transparency by recently releasing a FASB Staff Position (FSP) that amends FAS 140 and FIN46(R) to require expand disclosures by public companies. This would appear to be a wiser approach, and it is to be hoped that this will be the last word on this debate. ■