Securities Litigation REPORT

March 2009 ■ Volume 6 ■ Issue 3

Running the Numbers

Debt is in the Details–What CFOs and Attorneys Need to Know about Securitization Accounting and Recent Amendments to FAS 140 Disclosure Requirements

BY BARRY JAY EPSTEIN & ELAINE VULLMAHN

Barry Jay Epstein, Ph.D., CPA, is a Partner in the Chicago-based firm, Russell Novak & Company LLP, where his practice is concentrated on technical consultations on GAAP and IFRS, and as a consulting and testifying expert on civil and white collar criminal litigation matters. Dr. Epstein is the co-author of Wiley GAAP 09, Wiley IFRS 09, Wiley IFRS Policies and Procedures, and other books. Elaine Vullmahn, MBA, CPA is a Senior Litigation Accountant with Russell Novak & Company, LLP, specializing in internal control matters and litigation consulting. Contact: BEpstein@RNCO.com.

Securitizations are structured finance arrangements that pool and then repackage the cash flows emanating from groups of homogeneous assets, the interests in which are then sold to investors. It involves granting investors rights to the cash flows from specific assets of an originating financial entity or other sponsor, without exposing them to the credit and other risks associated with the sponsoring entity itself. This structure, when properly executed, protects investors from the effects of a bankruptcy of the sponsor. It also may have highly desirable financial reporting ramifications for the sponsor, especially the ability to display a lower debt-to-equity ratio, thus permitting the sponsor to enjoy a lower overall cost of capital. These results can only be achieved when the conduit—a special-purpose financing entity (SPE)—intermediates the securitization transaction in such a way that a so-called "true sale" of the securitized assets will have occurred.

If properly structured under current GAAP—a feat that requires the assistance

CONTINUED ON PAGE 3

Article REPRINT

Reprinted from the Securities Litigation Report. Copyright © 2009 Thomson Reuters. For more information about this publication please visit www.west.thomson.com

WEST®

© 2009 Thomson Reuters. This publication was created to provide you with accurate and authoritative information concerning the subject matter covered, however it may not necessarily have been prepared by persons licensed to practice law in a particular jurisdiction. The publisher is not engaged in rendering legal or other professional advice, and this publication is not a substitute for the advice of an attorney. If you require legal or other expert advice, you should seek the services of a competent attorney or other professional.

For authorization to photocopy, please contact the Copyright Clearance Center at 222 Rosewood Drive, Danvers, MA 01923, USA (978) 750-8400; fax (978) 646-8600 or West's Copyright Services at 610 Opperman Drive, Eagan, MN 55123, fax (651)687-7551. Please outline the specific material involved, the number of copies you wish to distribute and the purpose or format of the use.

For subscription information, please contact the publisher at: west.legalworkspublications@thomson.com

West Legalworks™ offers you more

With over 200 events annually, West Legalworks gives you more opportunities to learn from our over 2,000 world-class speakers and faculty. Choose from any one of our events covering business of law, practice of law, and other legal and business topics.

See what we have in store for you. Visit us at westlegalworks.com/events.

WEST®

Editorial Board

MANAGING EDITOR:
GREGG WIRTH

CHAIRMAN:
JOSEPH M. MCLAUGHLIN
Simpson Thacher & Bartlett LLP,
New York, NY

BOARD OF EDITORS:

Corporate Governance, Risk Management & Professional Responsibility:

JONATHAN C. DICKEY
Gibson, Dunn & Crutcher LLP,
Palo Alto, CA

Regulation, the SEC, and the Department of Justice:

MARK RADKE
LeBoeuf, Lamb, Greene & MacRae, LLP
Washington, DC

The Courts, Electronic Discovery, & Plaintiffs' Issues:

ANDREW B.WEISSMAN
Wilmer Cutler Pickering Hale & Dorr LLP
Washington, DC

ALAN SCHULMAN
Bernstein Litowitz Berger & Grossmann LLP
San Diego, CA

LAWRENCE BYRNE
White & Case LLP,
New York, NY

JAMES BENEDICT
Milbank, Tweed, Hadley & McCloy
New York, NY

WAYNE M. CARLIN
Wachtell, Lipton, Rosen & Katz
New York, NY

PAUL H. DAWES
Latham & Watkins LLP,
Menlo Park, CA

JORDAN ETH
Morrison & Foerster LLP
San Francisco, CA

JOY A. KRUSE
Lieff Cabraser Heimann & Bernstein, LLP
San Francisco, CA

HEATHER FOX
SVP & Chief Underwriting Officer
National Union Fire Insurance
Company of Pittsburgh, PA
New York, NY

JONATHAN M. HOFF
Cadwalader, Wickersham & Taft LLP
New York, NY

KARIN KRAMER
Howrey LLP,
San Francisco, CA

GRACE LAMONT
PricewaterhouseCoopers
New York, NY

ALFRED J. LECHNER, JR.
Lerner, David, Littenberg,
Krumholz & Mentlik, LLP
Westfield, NJ

PAUL LOMAS
Freshfields Bruckhaus Deringer
London

LINDA MULLENIX
Professor of Law University of
Texas School of Law
Austin, TX

JOHN F. SAVARESE
Wachtell, Lipton, Rosen & Katz
New York, NY

SHERRIE R. SAVETT
Berger & Montague , P.C.
Philadelphia, PA

ROBERT A.WALLNER
Milberg Weiss LLP
New York, NY

MICHAEL R. YOUNG
Willkie Farr & Gallagher LLP
New York, NY

Securities Litigation Report
West Legalworks
195 Broadway, 9th Floor
New York, NY 10007

© 2009, Thomson Reuters

One Year Subscription ■ 10 Issues ■ $498.00
(ISSN#: PENDING)

Please address all editorial, subscription, and other correspondence to the publishers at west.legalworksregistration@thomson.com

For authorization to photocopy, please contact the Copyright Clearance Center at 222 Rosewood Drive, Danvers, MA 01923, USA (978) 750-8400; fax (978) 646-8600 or West's Copyright Services at 610 Opperman Drive, Eagan, MN 55123, fax (651) 687-7551. Please outline the specific material involved, the number of copies you wish to distribute and the purpose or format of the use.

West Legalworks offers a broad range of marketing vehicles. For advertising and sponsorship related inquiries or for additional information, please contact Mike Kramer, Director of Sales. Tel: 212-337-8466. Email: mike.kramer@thomson.com.

This publication was created to provide you with accurate and authoritative information concerning the subject matter covered. However, this publication was not necessarily prepared by persons licensed to practice law in a particular jurisdiction. The publisher is not engaged in rendering legal or other professional advice, and this publication is not a substitute for the advice of an attorney. If you require legal or other expert advice, you should seek the services of a competent attorney or other professional.

Copyright is not claimed as to any part of the original work prepared by a United States Government officer or employee as part of the person's official duties.

of qualified attorneys as well as accountants—a SPE will ultimately be the holder of the securitized assets and the issuer of the debt instruments sold to investors; both these assets and associated debt obligations will be eliminated from the sponsoring entity's statement of financial position. Current U.S. GAAP governing the accounting for such transactions is set forth principally by the Financial Accounting Standards Board's (FASB) Statement of Financial Accounting Standards (FAS) No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. Understanding the mechanical requirements of FAS 140 is critical to evaluating whether sponsoring entities are achieving correct financial reporting.

Recent changes to GAAP have expanded the disclosures required for entities engaging in securitization transactions. Much more significant, however, are proposed changes—suggested largely in reaction to the sub-prime mortgage default crisis and related credit market meltdown that began in 2008—that may, if enacted, effectively eliminate the accounting reasons for the popularity of securitization. These would leave intact the other, legal motives for such transactions, but would heavily impact the financial statements of entities that previously engaged in securitizations and make this device far less attractive as a vehicle for future financings, possibly diminishing investors' interest in supporting the mortgage and other asset-backed securities markets. These unintended consequences could affect housing finance for years to come.

The Allure of Securitization

Securitization has become, in recent decades, an increasingly efficient and attractive financing option for entities that either purchase or generate large volumes of receivables. Despite being a time-consuming and complex process, entities are willing to undertake the arduous tasks required for securitizations because of the multiple benefits that many entities have been able to reap from it. Properly structured under current rules, securitizations allow sponsoring entities to isolate the underlying assets (such as mortgage loans) in separate legal entities, together with the related debt issued to investors; remove both those assets and the debt from the sponsoring entities' balance sheets; and generally preserve or even improve the credit rating of the sponsors, because the additional leverage achieved is not reflected in the sponsors' balance sheets.

The market for asset-backed securities, including debt secured by cash flows from mortgage loans, car loans, credit card receivables, health care receivables, and commercial bank loans, now exceeds the traditional corporate debt market in size. There is no doubt that favorable accounting treatment has been a major reason for the growth in popularity of this market, although the real (economic and legal) features have also been highly attractive. Recent and proposed changes to financial reporting rules may lessen the allure of securitizations, however, and create great disruption to the markets for existing securitization debt and even for the straight debt of sponsoring entities.

FASB's recent amendment to FAS 140 does not impact the heart of the standard, which is to provide instruction on how to utilize a "two-step" structure for securitizations. Rather, the recent FASB Staff Position (FAS 140-4 and FIN 46[R]-8) merely satisfies financial statement users' demands for greater transparency, which is seen as an interim solution as FASB pursues its quest to resolve fundamental and far-reaching questions about the extent to which off-balance sheet accounting should continue to be permitted. Preparers and auditors will have to take added steps to ensure that the expanded disclosure requirements are complied with, however. Other proposed changes, on the other hand, will likely have much greater, negative impact on the utilization of securitizations as financing vehicles.

Anticipated Changes in Accounting for Securitizations

The extreme turmoil in the credit markets, which began in the U.S. sub-prime mortgage debt markets and has now spread to the entire world (largely because of the extensive investments made by foreign governments and private parties in both U.S. treasury and private sector securities), has focused at-

© 2009 THOMSON REUTERS

tention on certain alleged abuses in securitizations. Coupled with concerns arising from previous, widely-publicized frauds involving off-balance sheet accounting—such as Enron's employment of so-called partnerships to conceal huge amounts of parent company debt obligations and losses—this has led to calls for the complete elimination of off-balance sheet financings effected via qualified special purpose financing entities (QSPEs). If this is done, and imposed retroactively, it would force most financial institutions and many commercial enterprises to recognize hundreds of billions of dollars of debt obligations (and the related securitized assets) in their balance sheets. Among other alarming ramifications, this could trigger widespread debt covenant violations, which would create further chaos in the already frightened and fragile credit markets.

Indeed, a number of amendments to FAS 140 have been proposed in recent years, the effect of which would have been to further tighten restrictions on the permitted actions of QSPEs, which must essentially be passive entities. None of these were adopted, but the changed credit environment has now caused FASB to propose substantially raising the "de-recognition threshold" (i.e., the ability for sponsors to move the securitized assets and related debt off their balance sheets) for most securitizations, the effect of which would be to cause the transferred assets and the related trust obligations to remain on the sponsors' balance sheets. A related proposed change to FIN 46[R]—the standard that governs the need to consolidate so-called variable interest entities, which currently contains an exclusion for QSPEs (thus preserving the ability to effect off-balance sheet financings)—would virtually assure that even the most carefully structured QSPEs would need to be consolidated by sponsors in their GAAP-basis financial reports.

Great pressure is being exerted on FASB, by both the political establishment (which is putting part of the onus for the accelerating pace of mortgage defaults and other debt restructurings on securitization accounting) and by the many entities that employ securitization, which understandably are concerned that any diminution in the attractiveness of this technique will significantly reduce their access to low cost capital. Realistically, the recommended changes will have to be resolved in the near term (ideally, before first quarter 2009 financial reports have to be prepared), but there should first be vigorous and reasoned debate about these proposals, which will be made more challenging because of both the extreme complexities of this topic and the macro-economic forces currently at work.

The concerns over the long-term ramifications of eliminating or severely limiting the use of off-balance sheet securitization are very real, but are beyond the scope of this article, which instead focuses on how securitizations can be properly structured under existing rules, particularly to obtain the desired financial reporting results that are widely sought. Given the severe consequences that result from a failure to properly execute such arrangements, both lawyers and accountants should be alert to these key structural concerns.

Securitization Overview

Securitization structures are designed to satisfy investors' desires to minimize the risk of suffering a loss due to a bankruptcy by the originating or sponsoring entity. If assets are transferred through a "true sale," and not simply collaterally assigned, they are presumptively removed from the sponsor's estate. In a "true sale" the sponsor relinquishes control of the future economic benefits embodied in the assets being transferred. To accomplish this, according to FAS 140, the transfer of assets to a SPE can be accomplished in one of several ways, each of which is designed to put the securitized assets beyond the reach of the creditors of the ultimate transferor and (if there is an intermediate party) of the proximate transferor.

When properly established, a SPE is wholly independent and considered "legally isolated." Consequently, once assets pass from the sponsor to the SPE in a "true sale" transaction, those assets are no longer available to either the sponsor or the sponsor's creditors. In other words, this physical and legal separation effectively protects investors in the securitization trust's obligations from the sponsor's

© 2009 THOMSON REUTERS

claims to those assets, as well as any of the sponsor's creditors in case of bankruptcy.

The primary advantages to the sponsor are that, by isolating the assets being securitized, they can generally obtain lower cost financing for the securitized assets they created or acquired, and their balance sheet leverage will be less than if they retained the assets and incurred the necessary debt financing directly. In order to achieve these benefits, the sponsor must place the assets in an essentially passive entity (whose only missions are to collect interest and principal on the securitized assets and pay interest and principal on the debt issued to finance the acquisition of those assets from the sponsor), and the sponsor must have tightly constrained rights and obligations, if any, relative to the assets sold. Failure to strictly adhere to these requirements disqualifies the SPE from "off the books" financial reporting under current GAAP, and might also expose the trust investors to the very risks they sought to avoid.

Implications of the FAS 140 Revisions

While FASB is separately considering whether to limit or completely do away with off-balance sheet securitizations, it issued a FASB Staff Position at the end of 2008 to amend FAS 140 and FIN 46(R), Consolidation of Variable Interest Entities, altering certain existing disclosure requirements. This FASB Staff Position became effective for the first reporting period (interim or annual) ending after December 15, 2008. FASB reasoned that the interim amendment was necessary to satisfy growing concerns about transparency that have largely arisen as a consequence of the recent turmoil in the credit markets triggered by the housing price collapse that began in 2007. Publicly-held entities that are subject to the requirements of FAS 140 and FIN46(R) are now required to provide additional disclosures about their involvement with variable interest entities. Specifically, the amendment states that affected reporting entities should provide financial statement users with an understanding of the following:

- a transferor's continuing involvement in financial assets that it has transferred in a securitization or asset-backed financing arrangement;
- the nature of any restrictions on assets reported by an entity in its statement of financial position that relate to a transferred financial asset, including the carrying amounts of such assets;
- how servicing assets and servicing liabilities are reported under FAS 140; and
- how the transfer of financial assets affects an entity's financial position, financial performance, and cash flows in the case of securitization or asset-backed financing arrangements accounted for as sales when a transferor has continuing involvement with the transferred financial assets and transfers of financial assets accounted for as secured borrowings.

Understanding the Mechanics of Securitizations to Satisfy FAS 140

FAS 140 discusses both "one-step" and "two-step" securitization approaches. These are both commonly found to be effective, under present U.S. law, to successfully isolate and protect assets placed into a securitization trust. Regarding the preferred "two-step" structure, FAS 140 suggests the following procedures.

Step One

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

© 2009 THOMSON REUTERS

the transferor or the transferor's creditors even in bankruptcy.

SPE Specified

A special-purpose entity (SPE) is a legal vehicle, such as a corporation, trust, or partnership, which is created for a limited purpose. The originating financial entity (sponsor) should take several decisive measures during the initial design phase. These actions are necessary to ensure the SPE is structured properly and that it is wholly independent from the sponsor. The independent SPE may engage in only specific activities and cannot be under the control of the sponsor. Thus, the sponsor should guarantee there is a separation provision in the legal document that establishes the SPE. Additionally, the document should deny the sponsor the unilateral ability to dissolve or terminate the SPE.

Once created, the SPE should conduct its business in a manner independent from that of the sponsor. If this is not accomplished, it would be red flag that the SPE was not properly structured and might not be deemed "legally isolated." In order to appear autonomous, the sponsor should have insignificant influence over the SPE's financial and operating polices. Transactions between the sponsor and SPE should be carried out at "arm's length," meaning that even though the two parties are related, they should conduct transactions as if they were unrelated, so that there is no question of a conflict of interest. When assets are transferred between the sponsor and SPE, they should each properly characterize the transaction as a "true sale" for the purpose of legal, tax and accounting measures. It would also be advisable for the sake of appearance that the sponsor has limited to no responsibility to provide guarantees to the SPE (this being the condition most commonly stretched or violated in such arrangements).

True Sale Defined

State law governs sales transactions. However, bankruptcy courts have jurisdiction in equity to interpret sales transactions. Thus, it is important in both substance and in form for the assets transferred from the sponsoring entity to the SPE to be able to be deemed by a finder of fact as final and removed from the sponsor's estate. To achieve this distinction, securitized assets must be treated and recognized as a "true sale." In other words, for legal, accounting, and/or sales purposes the securitization transaction must be deemed as a disposal of assets and not as a mere shifting of asset location or as a financing transaction.

"Off-balance sheet securitizations" are the normal mode of securitizations. The so-called "on-balance sheet securitizations" are actually secured borrowing arrangements, generically identical to the collateralized borrowing commonly engaged in by many companies. "On-balance sheet securitization" can be useful to maintain greater flexibility to take actions, such as repurchases, that would have been precluded with "off-balance sheet securitization" accounting, but of course this obviates the other advantages of traditional securitizations, such as improvements to the sponsor's debt-equity ratio and the ability to recognize gains at inception.

The accounting for so-called "on-balance sheet" securitizations has only minimal complexities, as the underlying receivables (loans or leases) are merely used as collateral for the reporting entity's borrowings. In a true "on-balance sheet securitization" the assets are pledged to the repayment of the debt, and the debt obligations have no claim to other assets of the obligor as a source of repayment, thus salvaging one major virtue of the securitization process. However, terms such as pledging and on-balance sheet securitization are not always used precisely in practice, and the exact requirements for achieving on-balance sheet securitizations are matters to be resolved by qualified legal counsel.

With "on-balance sheet" securitizations, the receivables (mortgage loans, etc.) and the associated debt obligations remain on the entity's balance sheet as, respectively, the sponsor's own assets and liabilities. The receivables that serve as collateral are subject to seizure upon default. No gain may be recognized at inception, and income is recognized ratably (as interest) over the terms of the receivables. Thus, the pattern of earnings is markedly different than for real (off-balance sheet) securitizations, where the initial transfer to

© 2009 THOMSON REUTERS

the trust is deemed a "true sale" of the receivables, with immediate gain (or loss) recognition, if warranted by the terms of the transaction.

In order for the sponsor to reflect this sale and recognize an immediate gain in the transfer of the underlying assets, the transfer should be made to the SPE at market value. When properly structured, the transaction is legitimate, although some critics have argued that the opportunistic timing of these transactions can distort the true earnings of the sponsor—one form of "earnings management," albeit not financial reporting fraud. As discussed above, this and other criticisms have led to the current proposal to largely eliminate off-balance sheet securitization accounting from the financial reporting standards.

Credit and Yield Protection Restrictions

The gain on the "true sale" of loans to the securitization trust is calculated by reference to the excess of the sum of cash received or due from the trust plus the value of any retained assets, over the carrying value of the assets transferred to the trust. Sponsors most commonly do retain a residual interest in order, among other reasons, to provide a "first loss" protection for ultimate QSPE debt holders, thereby lowering their risk of loss and accordingly lowering the rate of interest that must be paid to them. The lower the expectation of residual asset value, as impacted by expected credit losses to be absorbed (in some manner) by the sponsoring entity, the lower will be the gain on sale, on a dollar-for-dollar basis.

A structure might be utilized whereby the transferor retains a limited exposure in the form of a requirement to repurchase certain non-performing loans sold to the trust. This responsibility must be strictly limited, and it should be a red flag for potential misuse of the securitization process if an entity commits to maintain responsibility for too great a fraction of the bad debts suffered by the trust. The relevant financial reporting standard (FAS 140) only permits "gain on sale" accounting if virtually all risks and rewards of ownership of the receivables are transferred to the trust.

If the transferor does retain an obligation to repurchase non-performing assets, the risk of loss will have to be reflected by the transferor at the date of the securitization transaction. The existence and amount of such an obligation is a matter of facts and circumstances, affected as much by the transferor's historical behavior as by the formal terms of the trust agreement. Accounting, driven by substance rather than mere form, would recognize the transferor's estimated liability for repurchases based on historical actions, where these departed materially from the nominal obligations under the terms of the trust agreement.

Regardless of whether borrowing against financial assets is accomplished "on-balance sheet" or "off-balance sheet," the entity creating the receivables will usually have to suffer the consequences of loan losses (i.e., bad debts), in their entirety or up to a contractually agreed limit. Only if loans are transferred without recourse will the transferee have to shoulder those losses—but the price paid to the transferor will, in an informed market, reflect the anticipated rate of defaults to be suffered. If actual loss rates borne by the transferee (the trust, which would generally then result in losses to the trust's debt holders) are greater than expected, this will likely result in a reluctance of investors to engage in further transactions with the transferor, unless the terms of subsequent transactions are adjusted. Simply put, in a fully informed market (as implied by the efficient markets hypothesis) the sponsoring entity, which is the originator of the securitized assets, will ultimately bear the risk of economic loss deriving from asset quality.

Step Two

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 by other means, such as a stand-by letter of credit) 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.

QSPE Specified

The second phase of executing off-balance sheet securitizations that are compliant with FAS 140 requires having the SPE transfer the assets to another entity referred to as a qualified special purpose entity, or QSPE. The QSPE is most commonly structured as a trust. As with the SPE, the QSPE must have a legal standing distinct from that of the sponsor. The sponsor should also be prohibited from dissolving or terminating the QSPE. Furthermore, the transferring of assets to the QSPE should not give either the sponsor or the SPE significant influence over the entities' financial and operating policies.

Obtaining a Favorable Credit Rating

Achieving the principal purpose of securitization would be undermined if the sponsor's creditworthiness was taken into consideration in determining the value of the securitized assets. The key to the securitization's transformative power rests with the ability of the securitized assets to be independent of the sponsoring entity. The credit quality of the underlying assets must be solely based on the quality of the assets plus any credit enhancements (e.g., the "first loss" risk retained by the sponsor, a stand-by letter of credit, et al.) backing the obligations.

Ideally, a sponsor should be transferring assets to the SPE that are suitable for the intended investors. This means there should be a sufficiently large pool of homogenous assets to facilitate the statistical analysis that would permit accurate loss estimation. Often it is advantageous for those loans to be diversified across a mix of geographic, sociological, and economic strata. If that is not possible or practical, then it will comfort the investors if the sponsor is able to account in detail for the history of loans closely similar to those being transferred. Investors and financial guarantors alike are understandably interested in being able to evaluate a stable history of securitizations with regard to such key indicators as rates of defaults, other delinquencies, and prepayments.

The sponsor should not transfer encumbered assets into the SPE. This means that the sponsor should not attempt to pass on assets that serve to fulfill its other financial or regulatory covenants. The sponsor should also refrain from selling assets that are encumbered by third parties. Aside from potential legal ramifications, there could be severe consequences for investors if they were to unknowingly acquire burdened securities, and those assets were later called to satisfy some preexisting obligation. Such a development would, at the least, make the sponsor's future securitization offerings less appealing and more expensive to accomplish.

The ability to have a rating agency assign a rating to securitized assets corroborates the assertion that the assets are isolated from the risks affecting the sponsor's direct obligations. Acquiring a rating by a reputable agency, such as Moody's, Standard & Poor's, or Fitch, enhances the marketability of the assets and, in the current environment, is an absolute necessity. These rating agencies conduct thorough investigations before assigning quality ratings to the securities, although in the recent market melt-down the effectiveness of these reviews have been questioned.

In conducting such reviews, the rating agency is concerned with the organizational and management structure of the SPE and thus will be alert for indications that either the SPE or the assets have not been effectively isolated from the sponsor. Likewise, the rating agency will want to evaluate the established business controls and procedures. The SPE should maintain adequate loan documentation and be able to explain the bases for its own valuations of the assets. Of course, these and other criteria are evaluated as a whole, together with the history of financial performance of the assets.

Independent credit ratings are sought by investors to enable them to compare risks across differ-

 © 2009 THOMSON REUTERS

ent kinds of debt. Investors can also use the ratings to compare alternative financial instruments having different rating levels. Above all, obtaining a rating provides reasonable assurance that there will be a market in which to sell the instruments backed by securitized assets, should that later be necessary.

If one or more credit enhancement techniques are used, the cost of financing the assets can be further reduced. Credit enhancement can be achieved through internal, external, or a combination of both means. Internal credit enhancements would include direct recourse, over-collateralizations, and reserve or spread accounts. External (or third-party) credit enhancements could include cash collateral accounts and financial guarantees. By utilizing some form of credit enhancement, the resulting trust securities are made more attractive and thus more liquid than the underlying receivables.

Concluding Observations

Securitizations have been much in the news currently, and those comprised of mortgage loans have widely been held responsible for the asserted inability of otherwise willing bankers to restructure "underwater" loans, to reduce the burden on struggling homeowners. Allegations have also been made that assets placed into the securitization trusts were commonly of lower quality than advertised, and that rating agencies recklessly granted investment grade ratings to trust securities backed only by low-quality assets. The implications are that fraud may have been widespread in the lending of mortgage funds, in the documentation supporting many of these loans, in the ways these were packaged into mortgage-backed securities, in the manner that these derivative securities were rated, and in how they were ultimately sold to investors here and abroad. Most importantly, there is popular and political sentiment that the entire process has not only contributed to the current crisis, but also that securitizations as currently practiced may actually be an obstacle to the resolution of the problem.

While the prospect of eliminating or severely limiting the use of off-balance sheet securitization is increasingly being promoted as a means to resolve these abuses, there remains the need for attorneys and accountants, in particular, to better understand the fundamentals of FAS 140, to preserve the ability to use this valuable technique under current rules, and to advocate for its retention as a legitimate and important vehicle to provide liquidity for the vital debt markets that underlie our economy.

© 2009 THOMSON REUTERS