

## **Back on to the Balance Sheet: The Future Face of Securitization:**

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When Enron filed for bankruptcy, a major controversy about the use of special purpose entities erupted. I had then commented that the whole idea of special purpose entities, as non-substantive entities that simply served to hive off the assets of an originator and insulate them from the reach of the bankruptcy court, was ill-founded. Special purpose vehicles are admittedly non-substantive – they lack commercial substance. They are pools of assets, given the corpus of a legal entity. No asset can exist without its beneficial owner, and the majority beneficial owner of the asset has to put the assets on its balance sheet. Hence, the whole idea of off-balance sheet securitization needed a fresh look.

I had recommended that bankruptcy proofing, and off-balance sheet treatment, are two distinct things. Bankruptcy proofing is a case of special priority of a certain class of creditors upon bankruptcy of the entity. This is something that may be granted by either the law or, in common law countries, by contract. For instance, even a provision in the constitutional documents may provide for over-riding priority to a particular class of creditors.

However, off-balance sheet treatment is the consequence of the so-called “true sale”, which was designed primarily for bankruptcy-proofing the assets. Whether the sale will be accepted as true sale for bankruptcy purposes or not, the so-called sale is more of a tale, as it lacks several significant features of a commercial sale of assets. The retention of first loss risk, residual returns, retention of servicing on terms which do not look arms-length, etc. are several such features.

However, Wall Street has been conducting securitization on the true sale doctrine, pushing assets into special purpose entities (SPEs). The ownership of the SPEs, their purported independence, etc all look very queer. First, in order to ward off a claim for consolidation for the SPE with the originator, the SPE has to be shown to be “independent”. This is, by itself, strange though, since the very purpose of existence of the SPE is to subserve a particular transaction. In order to be bankruptcy remote, the SPE must not have significant capital – hence, one comes up entities with a legal capital of \$2, holding assets and liabilities of \$ 1 billion each. Since it has to be independent, the SPE must not be owned by the originator or any affiliates – hence, arrangements are made to park the \$ 2 legal capital of the SPE with some public charity, which, quite ridiculously, declares that it intends to do the good of mankind with the \$ 2 capital it holds in the SPE.

The Enron episode exposed these weird SPE structures, and therefore, the US standard-setters decided that consolidation rules applicable to SPEs cannot be based on legal capital: they must be based on whoever held the “real” or beneficial interest in the SPE, which was given the nomenclature of “variable interest”, with such SPEs being called “variable interest entities” (VIEs). In case of VIEs, a new consolidation rule was

promulgated, called FIN 46, later revised into FIN 46R. This would have, on the face of it, brought all securitizations on the balance sheet – hence, a new concept called “qualifying special purpose entities” (QSPEs) was brought in, and made a part of the securitization accounting standard FAS 140. Essentially, a QSPE had to be a passive, non-discretionary entity, not making investments in assets other than passive financial assets. If the SPE is a QSPE, it would then qualify for exemption from FIN 46R, thereby exempting most securitization transactions, except managed CDOs and conduits, from the scope of the consolidation rule based on variable interest.

Hence, despite FIN 46R, most securitization transactions have remained off-the-balance sheet.

The subprime debacle has exposed, one more time, the volatilities and vagaries of off-balance sheet accounting. Since the securitization accounting standard has to cause assets to be off the books, the gain or loss arising out of the “sale” of the assets has to be captured on the day of sale. This gain/loss would conceivably include all future residual profits, or losses that might arise to the seller. Hence, the need to estimate the residual profits, first level losses, servicing rights, etc. None of these valuations are easy, as these valuations are affected by at least 3 critical inputs – default rates, prepayment rates and discounting rates.

Given the subjectivity of the valuation based on the above assumptions, if one person does a valuation of residual interest, it is invariably possible for another person to come and challenge the valuation. Every valuation of residual interest can be challenged, and in fact, in every accounting investigation, has been challenged.

In the meeting of the Financial Accounting Standards Board on 2 April, 2008., one of the questions discussed was to do away with the concept of QSPEs. Evidently, if QSPEs are done away with, securitization SPEs will get covered by FIN 46R, and therefore, will get consolidated with the balance sheet of the person holding majority of variable interest, typically the seller.

The approach that the FASB has thought of is not new, though it will be new for the US standards. It is called “linked presentation”. The linked presentation approach existed under a UK standard called FRS 5, before UK decided to scrap its independent standards and adopt international standards IFRS. A linked presentation is on-the-balance sheet, but not as gross assets and gross liabilities. The net of the value of the assets, minus the value of external liabilities, is what stays on the books of the seller. Thus, in terms of values, the balance sheet of the seller will still have only the residual interest, but the assets will not be completely off-the-balance sheet, as they will be reflected in the annexed linked presentation.

Yet another reason why the new face of securitization will be on-balance sheet is the emerging popularity of covered bonds. Covered bonds, as an instrument of asset-backed funding, have existed for centuries in Continental Europe. It is a liability, backed by an identified pool of assets. Unlike in case of securitization, it is not a static pool, but a

dynamic one. In other words, all the borrower has to ensure is the maintenance of a particular asset cover – the assets may be added or taken out of the security pool. It is an on-balance sheet method of funding, granted the benefit of bankruptcy remoteness by specific law.

Though there is no specific law on covered bonds in the USA, the USA has already had some covered bond transactions. As the Treasury Secretary Paulson recommended legislative steps to promote covered bonds, it is quite likely that covered bonds would be the new instrument to provide much-needed liquidity to the mortgage market.

The future face of securitization is an on-balance-sheet funding instrument.