FASB 166 and 167 Implications for Securitization

“Who would have thought that boring old accounting rules have such powerful implications?”
...Elizabeth Warren, Harvard law professor and Chair of the Congressional Oversight Panel.

The Financial Accounting Standards Board issued two Statements (which is how they change accounting rules) in June that will have powerful implications for banks and other securitization sponsors.

FASB Statements 166 and 167 are effective for fiscal years beginning after November 15, 2009. The new rules apply to all transactions—new issue and existing transactions.

The punch line of these new accounting rules is that virtually all securitizations that were originally structured to be off-balance sheet for accounting purposes will be required to be brought back onto the sponsors’ or other controlling parties’ balance sheets.

Most US mortgage securitizations were structured as “true sales” for GAAP, tax and legal purposes. In the typical deal, the sponsor would transfer the subject assets to a subsidiary structured as a “Qualified Special Purpose Entity.” The sponsor would retain limited defined rights to deal with the assets thereafter. Generally the objective was to remove the assets from the sponsor’s balance sheet and have the debt not appear at all. Post-transaction, the sponsor’s balance sheet would show only the value of any interest retained in the pool, such as a residual, sub piece, servicing rights. The sponsor would also utilize what was generally referred to disparagingly as “gain on sale accounting” and would immediately take into income the present value of the stream of cash flow expected to be received from the retained interest over its remaining life. Accountants and lawyers stayed up into the wee hours (and bankers held up on the turn) to make sure that deals were structured to comply with the complexities of the accounting “sale” rules.

All that changes with FASB 166 and 167. The concept of the QSPE is eliminated and with it the exemption from balance sheet consolidation. Now all parties involved with a QSPE will need to evaluate whether they have (a) the power to direct the activities that most significantly impact the entity’s economic performance (e.g., a servicer) and (b) the right to receive benefits or absorb losses that are significant to the entity (e.g., a bondholder). If you have both (a) and (b), then you consolidate.

Which means that instead of the sponsor’s balance sheet showing the fair value of the interests that they retained in the deal—residual, bonds, servicing rights—the sponsor will now be required to “gross up” its balance sheet and include the underlying securitized assets in its assets and include the securitization debt in its liabilities, with appropriate loss reserves and the like. In the case of a typical term securitization, the consolidating party can elect to bring the assets and liabilities on to its balance sheet at either their UPB or at their “fair value” (under Statement 159, which allows you to mark-to-market both assets and liabilities). But if the consolidator elects to use fair value accounting, it must use it for all the VIEs that it consolidates onto its balance sheet.

The FASB was never really happy with its “true sale” rules that allowed a securitizer to “sell” assets but yet retain control over, and upside on, those same assets. The concept of QSPEs came in as a post-
Enron fix and was intended to allow passive financial assets to be isolated from the securitization sponsor. To qualify as a QSPE, the vehicle was supposed to be on auto-pilot and to have no on-going activity other than basically collect-the-checks-and-pass-them-on. The game was probably over when SIV sponsors and credit card issuers facing deteriorating asset performance over the last 18 months or so said accounting be damned and provided extraordinary support to their programs by contributing additional receivables and capital, rather than let them die an off-balance sheet death. And the FASB’s back was broken in the mortgage space with the aggressive push to modify defaulting loans inside of deals that had been accounted for as off-balance sheet.

While all issuers and deals are potentially affected by the change in accounting rules, most of the attention has been focused on banks, in large part because of the impact on regulatory capital. Most banks retained servicing rights and some portion of the capital structure on the deals they sponsored. The change in accounting rules means that hundreds of billions of dollars of assets and liabilities will be brought back on banks’ already weakened balance sheets—ABCP, ABS, CMBS and RMBS.

So far, the banking regulators do not appear inclined to grant a stay of execution. In mid-September, the Fed, FDIC, OCC and OTC issued joint proposed rules that would require banks to be in compliance with their leverage and risk-based capital requirements come January, based on their newly grossed up balance sheets, with no grace period or phase-in for implementation. The comment period for the proposed banking rules closed October 15 and final rules are expected shortly.

Some of the pain has already been taken by the sponsors of revolving structures referred to above who provided support to their programs. But absent a last minute reprieve by the regulators, we should expect banks to be out in the next few months raising boatloads of capital so they can continue to hold their securitized assets—or, alternatively, selling those assets and/or related control rights, or a combination of both.

As noted above, under the new rules, consolidation is predicated on a person having both control over, and the right/obligation to receive the significant benefits/losses from, the former QSPE (now just a “Variable Interest Entity”). As a result, a sponsor/servicer could avoid consolidation by selling the securities it retained in the deal and thereby no longer be entitled to “benefits/losses” from the VIE. For this analysis, senior bonds are viewed the same as subordinated interests and count toward the benefit/loss prong of the test. Continuing to hold only the servicing rights (assuming it is a normal servicing fee) would not be sufficient to require consolidation.

Alternatively, a sponsor could dilute its power to control the VIE—such as by selling servicing rights. The “power to direct” prong of the consolidation test would not require the sponsor/servicer to sell 100% of the servicing rights on a deal—although that would clearly work. To avoid consolidation, it should be sufficient for the sponsor/servicer to sell servicing rights on a portion of the deal in question such that it no longer exercises power over the majority of the loans in the deal. It is this majority control feature of the consolidation analysis that may keep a number of Street firms from having to consolidate conduit mortgage securitizations they issued—where the conduit purchased whole loans from multiple originators on a servicing retained basis and no one originator represented a majority of the loans in a single deal. Another restructuring option for a sponsor/servicer would be to bring in a “partner” with whom to share control. If the sponsor/servicer shares the power to direct the significant activities of the VIE with an unrelated 3rd party (by requiring joint instructions to act), then the control prong of the test is not satisfied and consolidation is avoided.
While the discussion above speaks in terms of banks as securitization sponsors, the new accounting rules apply to non-bank deals as well. For example, non-bank sponsors of securitizations who are required to consolidate will likely find themselves in technical default under their corporate debt indentures and bank borrowing facilities. Most corporate debt agreements have events of default that test against the borrower’s leverage and total indebtedness. Those covenants will no doubt be breached when the liability side of the borrower’s balance sheet is grossed up with securitization debt. And the borrower will be forced to seek waivers at a time when lenders are looking to avoid or at least re-price risk. As a side note, securitizations done by mortgage REITs are less likely affected by the change in accounting rules since most of those deals were originally structured to be on-balance sheet.

And in some deals, it may be someone other than the sponsor/servicer who is required to consolidate the securitization assets and liabilities onto its balance sheet. Whichever party is determined to have exposure to the significant benefits and losses of the VIE and has the power to direct significant activities of the VIE is the party who consolidates. And the correct party to consolidate can change over time. For example, in deals where a monoline insurer is now paying claims and has the right to replace the servicer, it may be the monoline that is required to consolidate the deal onto its balance sheet—as the party most exposed to the losses of the VIE and having the power to control via servicer kick-out rights.

Taken together, these new accounting and banking rules will require banks to raise massive amounts of additional capital and/or sell assets. That’s just in respect of their outstanding deals. Going forward, the new construct will likely increase the cost of credit to consumers and businesses. And as the ASF pointed out in their comment letter, the one-size-fits-all approach taken by the regulators creates perverse incentives for banks to not transfer risk (since the capital treatment would be the same no matter the amount of contractual risk transferred) and to provide implicit support to deals where that is not now the case (since the regulators appear to be treating all banks the same).