Big Changes to Securitization Accounting

The Financial Accounting Standards Board (FASB) has finalized the much-anticipated amendments to its Statement 140 and Interpretation 46(R). The amendments to Statement 140 are set out in Statement 166, which changes the accounting standards that determine whether a transfer of receivables in a securitization or otherwise should be treated as a sale or as a financing.[1] The amendments to Interpretation 46(R) are set out in Statement 167, which changes the standards used to determine whether reporting entities should consolidate the types of special purpose entities (SPEs) commonly used in securitizations (among other entities).[2] For calendar-year reporting entities, both sets of amendments take effect on January 1, 2010.[3]

The new Statements make sweeping changes in the accounting consequences of securitizations:

- Many banks, finance companies and other entities that currently achieve sale treatment in securitizations of their receivables will apparently no longer be able to do so using many traditional "plain vanilla" structures, especially those where originators (or their affiliates) both retain economic residuals and service the receivables.
- Many sponsors of asset-backed commercial paper (ABCP) conduits are likely to be required to consolidate the conduits, as currently structured.

Most importantly, the new Statements:

- Remove the concept of a "qualifying SPE" from Statement 140 and remove the "scope exception" for qualifying SPEs from Interpretation 46(R). The provisions that are being removed are relied upon by many entities that securitize receivables and by investors in securitizations in order to avoid consolidating the issuing entity. In their absence, transferors and some investors will have to consider whether to consolidate issuing entities under the guidance in Interpretation 46(R) (as modified by Statement 167); and
- Amend Interpretation 46(R) to establish a qualitative test that determines whether an entity should consolidate a "variable interest entity" — a category that includes most of the issuing trusts used in off-balance sheet securitizations of auto and credit card receivables, as well as private label mortgage securitizations, among others.

The New Consolidation Standard

The new qualitative test for consolidation looks at whether an enterprise has:

- Power to direct the activities of the subject variable-interest entity that most significantly impact the entity's economic performance; and
- Either the obligation to absorb losses of the entity, or the right to receive benefits from the entity (or both) — each being potentially significant to the variable interest entity.

Consolidation is only required if both factors are present. Statement 167 indicates that only one enterprise, if any, is expected to meet the first (power) factor, so no more than one enterprise should be required to consolidate any particular variable interest entity. Since each enterprise has to make its own determination, however, it is possible that there will be inconsistent determinations, which could, at least theoretically, lead to more than one enterprise consolidating a variable interest entity.

Currently, many sponsors of ABCP conduits avoid consolidation because, under a quantitative test (which is eliminated by Statement 167), the holders of expected loss instruments issued by the conduits are treated as the "primary beneficiaries" of the conduits.

The new qualitative tests appear to require consolidation of more conduits by their sponsors, among other things.

Statement 167 includes guidance on some features that may affect the determination (referred to below as the "power determination") of whether a particular enterprise has power to direct the activities of the subject variable interest entity that most significantly impact the entity's economic performance (referred to below as "controlling economic power"). This guidance[4] includes:

- The power determination is not to be affected by the existence of "kick-out rights" or "participating rights" unless a single enterprise (including its related parties and *de facto* agents) has the unilateral ability to exercise them. Kick-out rights are defined as the ability to remove an enterprise that otherwise has controlling economic power. Participating rights are defined as the ability to block actions through which an enterprise otherwise exercises controlling economic power. FASB acknowledges that the treatment of kick-out rights and participating rights in this context differs from their treatment elsewhere in accounting literature but believes that the distinction is warranted.
- A single enterprise (including its related parties and *de facto* agents) that has the unilateral ability to exercise kick-out rights or participating rights may be the party with controlling economic power.
- Protective rights held by other parties do not preclude an enterprise from having controlling economic power. Protective rights include approval or veto rights on fundamental changes (e.g., mergers), the ability to remove an entity with a controlling financial interest upon its bankruptcy or breach of contract (which are typical "servicer defaults" in securitizations) and restrictive covenants that limit an entity's operating activities.
- If power is shared among multiple unrelated parties such that no one party has controlling economic power, then no party should consolidate. The Statement also includes some guidance on when power will be deemed to be shared for this purpose:
  - » Power is shared if two or more unrelated parties together have the controlling economic power, and if decisions about those activities require the consent of each of those parties.
  - » If power is not shared in the sense described above, but the activities that most significantly impact the entity's economic performance are directed by multiple unrelated parties and the nature of the activities that each party is directing is the same, then the party, if any, with the power over the majority of those activities will be considered to have controlling economic power.
  - » If the activities that impact the entity's economic performance are directed by multiple unrelated parties, and the nature of the activities that each party is directing is not the same, then the party that has the power to direct the activities that most significantly impact the entity's economic performance must be identified. The Statement indicates that a single party must be identified as having this power, and that party so identified will be deemed to have controlling economic power.
- The fact that an enterprise is involved with the design of an entity does not, by itself, establish that the enterprise has controlling economic power, but according to the Statement, such involvement may indicate that the enterprise had the opportunity and incentive to establish arrangements that give it controlling economic power.
- The Statement also recommends scrutiny of situations in which an enterprise's economic interest in a variable interest entity is disproportionately greater than its stated economic power. Although this factor is not intended to be determinative, the Statement indicates that the level of an enterprise's economic interest may be indicative of the amount of power the enterprise holds.

Statement 167 leaves in place (sometimes with refinements) existing guidance on a number of other matters, such as when fees paid to decision makers will be considered variable interests,[5] when variable interests in specified assets of a variable interest entity will be considered variable interests in the entity itself[6] and when variable interest entities may be "siloed."[7] Statement 167 also adds to FIN 46(R) a new Appendix C that analyzes several fact patterns to provide examples of the application of the revised guidance.

Statement 167 does not provide for any grandfathering. Once it comes into effect, both pre-existing and new structures will be analyzed under its terms.

Accounting for Transfers

Statement 166 preserves the three-part test for sale treatment in paragraph 9 of Statement 140, but revises each of the three parts:

- Paragraph 9(a), which requires legal isolation of transferred assets, has been revised to incorporate some guidance about the need for isolation from both a transferor and its consolidated affiliates, which already appeared elsewhere (in paragraph 27). This revision emphasizes the guidance but does not appear to make substantive changes to it. Importantly, the new guidance continues the carve-out from paragraph 27 that permits transferors to achieve legal isolation using two-step transfers of the type common in many securitizations. Paragraph 83, which provides additional detail on two-step transfers, also remains in place, without any significant changes.
- Many transactions that have relied on two-step transfers have also relied on the special rules relating to qualifying SPEs to avoid having the transferor consolidate the transferee in the second transfer (which was often a qualifying SPE). As discussed above, the elimination of the scope-out for qualifying SPEs in FIN 46(R) (by Statement 167) will put many of those transactions back on the transferor's balance sheet and limit the ability to achieve off balance sheet treatment going forward. However, where the ultimate transferee is not consolidated with the transferor for other reasons, a two-step transfer will apparently still be effective to satisfy paragraph 9(a) (so long as both transfers cover entire financial assets or participating interests, as discussed below).
- Paragraph 9(b), which generally requires that a transferee have the right to pledge or exchange the transferred assets, has been revised to eliminate references to qualifying SPEs. However, the references to qualifying SPEs have been replaced by more generic references to SPEs used in asset-backed financing, so the substance of paragraph 9(b) is not significantly changed. The paragraph will still generally permit transferability of "beneficial interests" (defined in this context to include debt instruments) to substitute for transferability of the transferred financial assets when the transferee is a securitization SPE.
- Paragraph 9(c), which denies sale treatment if the transferor retains effective control over the transferred financial assets, has been revised in several ways, but we do not expect these changes to affect many traditional securitization structures. The first change clarifies that, if transferability of beneficial interests is substituted for transferability of the financial assets, as permitted by paragraph 9(b), then the terms of paragraph 9(c) apply equally to effective control over the beneficial interests. As before, effective control is deemed to exist under repo agreements (which are generally excluded from sale treatment) or where a transferor has a call on specific transferred assets (though the latter is now limited to situations where the call right provides a more-than-trivial-benefit to the transferor). In addition, put rights granted to transferees are now deemed to give the transferor effective control if the put price is so favorable to the transferee that it is probable that the transferee will exercise the put.

Statement 166 also amends Statement 140 so that only an entire financial asset, or a portion of a financial asset that meets the definition of a participating interest, will be eligible for sale treatment.[8] This change will primarily affect accounting for loan participations, and will limit sale treatment generally to *pro rata* participations. However, it also affects two-step securitization transactions where the second step transfer is in the form of a senior undivided interest in a pool of receivables. An undivided interest of this type would fail the new "unit of account" rule, since it is neither an entire financial asset nor an eligible participating interest.

Regulatory Consequences

Current US rules permit banks to calculate their risk-based capital requirements without giving effect to consolidation of conduits under Interpretation 46(R). However, there is currently no comparable relief for consolidation of issuing entities in term market securitizations, nor is there comparable relief for the calculation of the regulatory leverage ratio for either

conduits or formerly qualifying SPEs. It remains to be seen what, if any, action US bank regulators will take in response to the new Statements.

The Federal Reserve has issued a press release[9] stating that it is reviewing regulatory capital requirements associated with the new Statements. For the present, the Federal Reserve has advised banking organizations to take into account the full impact of FAS 166 and 167 in their internal capital planning processes and to assess whether additional capital may be necessary to support the risks associated with vehicles affected by the new Statements. The press release also indicates that the recent stress tests assessed the capital adequacy of banks using assumptions consistent with the standards ultimately included in the new Statements.

Endnotes

1 Statement of Financial Accounting Standards No. 166, Accounting for Transfers of Financial Assets, an amendment of FASB Statement No. 140, available at http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1175801890297.

2 Statement of Financial Accounting Standards No. 167, Amendments to FASB Interpretation No. 46(R), available at http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1175801890297.

3 In each case, the effective date is stated as the beginning of each reporting entity's first fiscal year that begins after November 15, 2009, and earlier application would be prohibited.

4 See paragraphs 14C-14G of FIN 46(R), as amended by Statement 167.

5 Paragraph B22 of FIN 46(R), as amended by Statement 167.

6 Paragraph 12 of FIN 46(R) (not amended).

7 Paragraph 13 of FIN 46(R) (not amended).

8 Paragraph 8B of Statement 140, as added by Statement 166.

9 Federal Reserve Press Release (June 12, 2009).

10 This publication was not prepared or reviewed by accountants. It is based on our understanding of the accounting treatment of transactions where we act as legal counsel.

If you have any questions with regard to the new Statements or any other matter raised in this Client Update, please contact any of the following lawyers.[10]

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