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IN DEFENSE OF MODERATION: AVOIDING OVERREGULATION OF "SPECIAL PURPOSE ENTITIES"

by

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Financial marketplace events involving alleged corporate misuse of off-balance-sheet special purpose entities ("SPEs") to finance company debt or manage the balance sheet have led to calls from many quarters for reforms in the regulation and reporting of off-balance-sheet financing activities by corporate enterprises. The attention now being focused on off-balance-sheet activities is of no small interest to the financial services industry, which relies more than most industry sectors on the use of SPEs for balance sheet management, risk-reduction and fee generation purposes. The banking sector also has a large stake in the outcome of legislative, regulatory, and professional accounting developments in this area. This interest has been fueled by recent administrative actions taken by the Federal Reserve Board and other federal financial regulators to address alleged accounting and reporting irregularities in the use of SPEs for balance sheet management and other corporate purposes. In addition, it now is clear that the Federal Reserve Board, the Securities and Exchange Commission ("SEC"), and other federal financial regulators are undertaking a targeted review through the examination and inspection process of off-balance-sheet financing activities involving the use of SPEs.

The principal federal banking agencies — the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Office of Thrift Supervision — by and large have been silent, however, on their broader regulatory intentions with respect to SPE activities. The SEC also has thus far not been specific on changes that it believes are needed in the reporting of SPE structures in the financial statements of SEC-reporting companies, although the agency has plainly signaled that more disclosure of these activities in some manner is needed.

The current regulatory interest in off-balance-sheet activities and the lack of authoritative guidance thus far, however, is creating anxiety in the financial services industry, which is concerned that overly aggressive regulatory action might compromise the usefulness of what has proved to be a valuable structural tool in financial management and other activities. This anxiety is being fueled by the Financial Accounting Standards Board's ("FASB") ongoing effort to rewrite the accounting rules for off-balance-sheet/SPE financial reporting in a way that may well make it more difficult for financial institutions to use these structures and still avoid consolidating them in their financial statements. But while action by the accounting profession to revise the financial reporting rules for off-balance-sheet activities through the use

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of SPEs now seems a virtual certainty, there is much less certainty about what the financial regulatory agencies may do to address any regulatory issues that they might have. Some financial institutions, however, appear to be curtailing their use of SPEs in the short term in the belief that future governmental (or accounting) action of an undetermined nature may put in regulatory jeopardy SPE structures that would pass muster under the existing rules.

This marketplace uncertainty at one level suggests that the federal financial agencies should come forth with more definitive views on the use of SPEs by financial institutions. But on closer examination, the advisability of broad regulatory action on SPEs loses a lot of its logical appeal. In fact, a very good case can to be made that there is no demonstrated need for the financial regulatory agencies — including the SEC — to take dramatic action with respect to SPE usage. A case can also be made that the agencies should take nothing more than targeted action to address those areas where the use of SPEs might present higher levels of financial risk to sponsoring financial institutions and their shareholders. Immoderate regulatory action to curtail the use of SPEs, in fact, may do much more harm than good.

What is the case against broad regulatory action? First and foremost, notwithstanding the current outcry over the alleged abuse of SPEs, the evidence thus far suggests that SPE misuse, if any, has been confined to a small number of instances. By contrast, the financial services industry has been routinely using SPEs for entirely legitimate purposes without any credible indication that this use has resulted in widespread inaccurate financial reporting by financial institutions or a concealment of balance sheet risk. Indeed, financial institution financing and balance sheet management activities involving the use of SPEs have become extremely widespread (to the tune of over a trillion dollars of such SPE assets currently in existence). Their use has greatly benefited the financial markets and the banking industry by enabling participants to improve their liquidity, reduce balance sheet risk, and allocate that risk to capital markets participants who are willing to assume that risk. In short, the diverse and intelligent uses of SPEs and similar off-balance-sheet devices in securitization and other structured financing transactions has been a demonstrably powerful tool in enabling financial organizations of almost all sizes to improve their overall asset quality, earnings, liquidity, and capital ratios. Hence, the federal banking agencies, which at the end of the day are essentially in the risk management and oversight business, should be cautious — as should the SEC — about acting in a manner that could generally compromise the appropriate uses of these techniques.

Second, the federal financial authorities already have in place meaningful regulatory tools that enable them to address financial reporting and disclosure deficiencies created by SPE activities. In the case of the federal banking agencies, these agencies have an elaborate regulatory scheme — the risk-based capital rules — that is designed in large part to quantify, capture, and protect against substantially the same types of financial risks to a banking organization created by off-balance-sheet exposures that are of more general public concern these days. In fact, after many years of government-industry debate, the federal banking agencies recently adopted a series of significant changes to the U.S. risk-based capital rules that were specifically designed to ensure that a banking organization's regulatory capital properly supports the retained risks of assets on and off the organization's financial statements in securitization and other structured finance transactions. As these rules become fully effective, they are requiring banking organizations to maintain more risk-based capital against a broad variety of credit exposures of varying kinds (residual exposures, standby guarantees, credit derivative exposures, and other forms of financial "recourse") that are acquired or retained in SPE and other off-balance-sheet securitization transactions. It would therefore be unfortunate were the regulatory authorities effectively to renounce — or subordinate — their reliance on this prudential scheme by taking drastic action to address the perceived abuses found in a small universe of "questionable" off-balance-sheet transactions involving the use of SPEs.

In the case of the SEC, the agency has express authority under the registration and periodic reporting requirements of the Securities Act of 1933 and the Securities Exchange Act of 1934 to improve the quality

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of corporate disclosure relating to SPE activities of public issuers, including new authority under the Sarbanes-Oxley accounting reform legislation. Section 401 of the new legislation directs the SEC to adopt rules requiring public issuers to disclose all "material" off-balance-sheet transactions and arrangements. The SEC therefore will soon act to increase the transparency of public companies' financial statements, and require more extensive disclosures concerning their off-balance-sheet exposures, through rulemaking action under its enhanced authority to require additional disclosures about off-balance-sheet activities. Further, the financial services industry has already taken steps to increase the disclosure of off-balance-sheet activities in their financial reports through more disclosures in financial statement footnotes and management's discussion and analysis. The results of this can be seen in recent periodic reports filed with the SEC.

Third, the regulatory issues surrounding the consolidation of off-balance-sheet SPE transactions are equally matters of financial accounting, and regulatory action should not be taken without regard to current accounting profession developments that could have a significant impact on SPE activities. FASB has published an Exposure Draft of an interpretation of Accounting Research Bulletin No. 51 pertaining to consolidated financial statements. The Exposure Draft addresses SPEs that have no voting interests or otherwise are not subject to control through ownership of voting interests. Under the approach set forth in the Exposure Draft, business enterprises would be required to consolidate SPEs that lack "sufficient independent economic substance" and therefore do not qualify as a separate economic entity for accounting purposes if the enterprise has a controlling financial interest in the SPE. The proposed interpretation would require a "primary beneficiary"[1] to consolidate an SPE where it supports the SPE's activities through the holding of a significant "variable interest" in the SPE, and the SPE lacks sufficient independent economic substance.

FASB's deliberations have generated significant and spirited public discussion. FASB now appears to be wrestling with a number of important issues relating to this project, including the appropriate transition period for existing SPEs subject to the new interpretation, how to address certain types of SPE transactions (such as qualifying collateralized debt obligation and similar structures), and the treatment of multi-seller SPE facilities (such as asset-backed commercial paper conduits). FASB has scheduled a public hearing on the Exposure Draft for late September 2002, and has indicated that it wants to adopt a final interpretation by the end of 2002. If adopted in its current form, the proposed interpretation could materially tighten the criteria for the off-balance-sheet reporting of SPE transactions, and generally make the use of these vehicles more difficult across the board.

Putting aside the merits of the FASB initiative — and the arguments against precipitous action in the case of SPEs apply just as much to FASB as they do to the financial regulators — the federal regulatory agencies could create substantial confusion were they to create a regulatory position on SPE transactions that proved to be materially different than any new accounting standards adopted by FASB. This possibility should be less of a concern in the case of the SEC, because that agency requires all reporting companies to comply with generally accepted accounting principles ("GAAP"). By the same token, the federal bank regulators have the legal authority to create regulatory accounting and reporting rules for regulated financial institutions under the federal banking laws that are different than GAAP. But the advisability of doing so, especially while the question of the GAAP financial reporting of off-balance-sheet activities may be in flux, is a very different question, and regulatory action at the present time would at best be premature and could create harmful discrepancies between regulatory and financial reporting standards that are not justified by any compelling need to make broad regulatory changes.

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[1] "Primary beneficiary" could be broadly defined and reportedly could include, among others, a transferor of financial or other assets, a lessee, an administrator, an investor or swap counterparty.

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In the final analysis, a general regulatory challenge to the use of SPEs by financial services organizations is neither necessary nor advisable. Fortunately, there have been some encouraging informal indications that the federal regulators neither intend to overturn the use of SPEs where they are properly structured and used in securitization of structured financing transactions, nor rewrite GAAP for banking organizations to tighten the substantive financial accounting requirements for the deconsolidation of SPEs. Further, the enhanced off-balance-sheet transaction disclosures mandated for public issuers by the Sarbanes-Oxley Act may have the beneficial effect of reducing the perceived regulatory need to substantively regulate corporate off-balance-sheet activities.

At the same time, certain types of SPE transactions and activities probably will continue to attract more regulatory scrutiny where these transactions present unusual risk-reward allocation characteristics and thus may be of particular concern to the federal regulators. For instance, the transfer of low-quality assets to a third-party SPE as a device of moving those assets off the balance sheet, or dampening earnings or market volatility associated with those assets, may draw more supervisory attention than, for example, SPE transactions involving investment-grade assets. Similarly, certain structured finance transactions or facilities may subject the sponsoring banking organization to a closer regulatory review of the allocation of the substantive risks and rewards of such transactions. These transactions include those that: (i) involve defaulted or low-quality asset "put" or buyback features; (ii) are purely private transactions that are not subject to the external discipline of the capital markets (whether in the form of independent third-party investor or rating agency participation); or (iii) do not have a clearly defined business purpose.

Even if there are financial reporting and risk management issues involving the use of SPEs of the sort noted above, the SEC and the financial regulators have at their disposal a variety of devices short of forcing SPE financial statement consolidation to address these issues, or otherwise substantively restricting the use of off-balance-sheet financing techniques. And certainly, if the expected changes in GAAP interpretations result in some SPE transactions coming back onto a financial institution's balance sheet, these changes may have a restraining influence on the temptation to use SPE structures for "illegitimate" transactions.

The appropriate response of the financial services regulators to the SPE situation, therefore, should be one of moderation and restraint. The use of SPEs in the financial sector has become sufficiently central to financial institutions' risk and financial management activities that a general regulatory disruption in their use could have material and adverse effects on the industry and the financial marketplace as a whole. Further, there is no regulatory benefit to forcing consolidation, or otherwise restricting the use, of SPEs created in properly-structured transactions that are supported by appropriately reasoned legal and accounting opinions and certifications, and where the financial institution sponsor/transferor has allocated adequate capital to any risk that is retained. By the same token, SPE transactions that present higher risk profiles (e.g., those involving low-quality assets, relatively high risk retention levels, or transactions with asset buyback elements) can be effectively addressed simply by requiring increased disclosure or more regulatory capital in individual cases. Finally, for those few SPE financing or balance sheet management transactions where there has been no transfer of risk to a third party, the requirement to consolidate should simply be a matter of accurate financial reporting under GAAP that requires no further regulatory response.

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