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"Transparency in Accounting: Proposed Changes to Accounting for Off-balance Sheet Entities"

Thank you Chairman Reed, ranking member Allard, and members of the committee, for the opportunity to testify today. I am pleased to appear before you to discuss the role of the accounting transparency and off-balance sheet entities precipitating the credit crisis, as well as possible legislative options for accounting reforms. I am Joseph Mason, Herman Moyse, Jr./Louisiana Bankers Association Professor of Finance at Louisiana State University and Senior Fellow at The Wharton School, and these are my personal views. Before joining academe, I studied consumer credit, bankruptcy, and structured finance as a Senior Financial Economist at the Office of the Comptroller of the Currency, and have since advised bank and securities market regulators as well as many industry groups and the press on the recent market and economic difficulties.

It is useful to teach securitization using the notion of a pool of assets segregated from the seller[1] and funded by tranches of bonds and equity. The standard approach is to emphasize the intent to segregate the assets from the seller in a bankruptcy remote subsidiary to achieve a lower cost of financing in a sort of "super-collateralized" loan arrangement. Securities representing claims against the collateral pool are then structured and sold as asset-backed or mortgage-backed securities.

Of course, that simplified paradigm does not accurately reflect real-world practice. In the real world, a number of intricacies erode the nature of the true sale. First, the bottom securities in the structure of the securitization absorb losses first, so the majority of risk is effectively distilled into those bottom elements. Bank regulators realized this some time ago and approved policy to

[1] I will use the term seller throughout to refer to the originator of the loans or the originator of the pool of loans. Sometimes the term sponsor is used interchangeably with seller, though I will find it useful to use seller later on in my written testimony when discussing loan servicing performed by the seller, in which case the seller is a seller-servicer. Such circumstances are important because the most egregious problems have occurred with seller-servicers.

deal effectively with the situation in 2001 and with variations on the theme (most famously promulgated by Enron) in 2003.

Second, "representations and warranties" have become a mechanism for subsidizing pool performance, so that no asset- or mortgage-backed security investor experiences losses – until the seller, itself, fails and is no longer able to support the pool. Regulators, policymakers, and market participants again and again feign surprise when the seller fails and call for bailouts on the basis of the purported systemic risk, if only because of the lack of their own attention to the arrangements.

Third, "gain-on-sale" accounting creates paper earnings from securitizations that create the appearance of solid financial performance for firms that can be posting big cash losses due to operations. Regulators, policymakers, and even managers have known of this problem for decades now, but again continue to feign surprise when such firms fail, suddenly changing from record "earnings" to bankruptcy (because the accounting "earnings" are not real *cash* earnings).

I. Asset Securitizations and Traditional Accounting Measures

While many other intricacies exist, it is important to realize that the market has been aware of all of these situations for some time now. In 1997, Moody's published their classic special report on their internal methods for making sense of accounting for securitizations. Since the industry was small at the time, Moody's maintained an aggressive stance on clarity and accuracy. Even then, however, Moody's found it necessary to adjust earnings and leverage ratios for the less palatable aspects of securitization accounting.

In 1997, Moody's Investors Service wrote that "…the simple act of securitizing assets can affect the appearance of the income statement and balance sheet in a profound manner without,

in many cases, significantly altering the underlying economics of the [seller]. Under gain on sale accounting, income statements reflect the present-value of lifetime earnings from assets in a single quarter, predicated on numerous assumptions and calculations. Reported earnings may give a false sense of the long term ability of the company to repay debt. Reported balance sheet leverage declines as securitized assets are treated as "sold" for accounting purposes, although there may be little, if any, risk transference." (*Alternative Financial Ratios for the Effects of Securitization*, Moody's Investors Service, September 1997)

With respect to earnings, Moody's adjusted the standard ratio used to express the ability of companies to pay, or "cover," interest expense from operating earnings, EBITDA coverage, which is the ratio of earnings before interest, taxes, depreciation, and amortization to interest expense. According to Moody's this ratio may give a false sense of security when calculated for sellers. In particular, Moody's maintains, "…the inclusion of gain on sale in the numerator of this ratio is inappropriate as [those] gains cannot be used to pay interest expense. To adjust for this, [Moody's] simply deduct[s] any gain on sale from earnings when calculating EBITDA coverage. The result is adjusted EBITDA coverage. (Moody's Investors Service, "*Alternative Financial Ratios for the Effects of Securitization*," September 1997, p. 9)

To adjust leverage for securitizations, Moody's added the securitizations back onto on-balance sheet debt. Then Moody's adjusted common equity by reversing gains from securitizations (gains-on-sale) and adding back excess spread as income to common equity. Adjustments are also made for the different accounting methods firms would be subject to if they did not account for securitizations as sales. Moody's leaves it to the analyst to make additional adjustments to these calculations. According to Moody's, the result is that the equity base for the effective leverage calculation is increased by the credit loss reserve related to a securitization,

effectively giving sellers credit in their equity base for loss reserves, without requiring them to establish an appropriate loss reserve. (Moody's Investors Service, "*Alternative Financial Ratios for the Effects of Securitization*," September 1997, p. 8)

In documents dating all the way back to 1987, Moody's points out that while, "…the practices developed by the accounting and regulatory world are useful starting points for the credit analyst…, these guidelines often do not fully capture the true economic risks of a securitized asset sale to the originator's credit quality." Hence, Moody's maintains that their own focus is not on whether a sale of assets is arbitrarily put on or kept off the balance sheet, but rather on "…assessing the fundamental residual credit risks left with the originator from the asset sale and the amount of the firm's equity base that should be allocated to support the transaction." (Moody's Investors Service, "Asset Securitization and Corporate Financial Health," December 1987, p. 3) Moody's continues, "Because of different accounting treatment, any direct comparison of results with financial services companies that do not securitize their assets becomes misleading." (*Alternative Financial Ratios for the Effects of Securitization*, Moody's Investors Service, September 1997, p. 1)

Hence, more than two decades ago market insiders fully realized that standard accounting rules are not applicable to securitizing firms.

II. Retained Interests and Risk Distillation

Recently, there have been repeated calls to supposedly align incentives of sellers and investors, as well as borrowers, by having sellers retain some risk in their securitizations. The reality is that they have always retained risk, and that retained risk is precisely the problem.

Old pass-through securitizations are about risk transfer. In those deals, the pool of loans is funded by a single set of securities that represents identical interests in the pool. That is, the securities all absorb losses equally.

Modern securitization is about creating a senior subordinate security structure wherein some securities absorb risks before others, making those others safer (and higher-rated). In senior-subordinate structures, essentially all the risk is distilled into the roughly 10% or less of subordinate bonds. Hence, the senior bonds can achieve an (often real) AAA rating.

Suppose we sell a pool with a 2% expected loss rate, meaning we fully expect 2% of the pool value to be lost to foreclosures after recovery. If losses are less than 2%, the "first-loss" piece can be valuable. If losses climb to more than 2%, the piece is worthless. Certainly, no investor will buy an interest in that almost guaranteed 2% first-loss piece, so the seller has to retain that on their own balance sheet. Economically, the average risk level retained by the seller is the same whether the pool is securitized or not.

In the past, the seller (if it is a commercial bank) would hold the Basel-required 8% capital against the 2% first-loss piece retained on the balance sheet. Recognizing that the piece was almost a guaranteed loss, in 2001 bank regulators required banks to hold 100% capital against the first-loss piece. Nonetheless, the first expected loss portion of the deal was already retained by sellers, so in fact now *requiring* sellers to retain that piece will change nothing.

Those retained interests are indelibly related to the "variable interest entity" that is the foundation of the proposed FASB revisions. Prior to financial engineering, ownership (and therefore on-balance sheet treatment) was dictated by voting interest: if a firm owned more than 50% of voting equity shares, they clearly owned the firm.

With financial engineering (as demonstrated by Enron), all that changed. The first attempt to establish ownership in financially-engineered construct was attempted in FASB140, which stipulated that if somebody ***else*** did not own at least 3% of the funding liabilities and equity, you had to carry it on your own books. Of course, Enron found this requirement very easy to obviate by lending someone else money to buy the 3% and then selling the rest with Enron guarantees of the securities' performance, thus retaining a substantial first-loss stake in the arrangement.

Under FIN46, created to revise the rules that were used to create the failed Enron structures, the 3% rule became the 10% rule. The entities used by Enron were labeled "Variable Interest Entities" (VIEs) and others "Qualified Special Purpose Entities" (QSPEs), which were excluded from the 10% rule because they are thought to be what FASB termed "passive securitizations."

Hence, a key problem with us today is that the purportedly "passive" credit card, mortgage, home equity, auto loan and other qualified SPEs (QSPEs) were not passive at all. That trouble is worsened when those "passive" structures are allowed to manipulate pool value through servicing and direct replacement of loans in the pools.

III. True Sale and Risk Transfer

Let's start with a simple notion of a "true sale." Then, we can talk about active interests to support the sale and intermediate notions in the real securitization world.

To form a view of the objective "truly passive" sale, it is useful to use the automobile analogy. Suppose I sell you my car. I give you the car and receive cash in return. You drive away. If the engine falls out two weeks later you are out of luck. Classical caveat emptor applies.

That is a true sale. From an accounting perspective, we can clearly take the car off the balance sheet and replace it with the cash at the time of the sale.

Now suppose I give you a warranty at the time of sale: for six months, if anything happens I will give you your money back. I should probably keep some amount of cash on hand to satisfy the obligation should you run into trouble. From an accounting perspective, it would make sense that I should not close the sale until the six months have passed. That is, I should hold reserves against the possibility that the car will break down. The entire car is still "on-balance sheet" (as a contingent liability) but so is the cash so we have no effect until the warranty expires.

Now, adding complexity, suppose that I give you a warranty that states I will fix the car – not give you your money back – if anything goes wrong. Perhaps I don't have to reserve against the entire price of the car now, but only the cost of repairs. That could make sense, but the maximum cost of repairs is still the total value of the car. Even if I could estimate the probable cost of repairs, I may still want to remain aware of the total possible liability involved in honoring the warranty.

Back in the early development of securitization, and indeed still today with most Real Estate Mortgage Investment Conduits (REMICS), the underlying situation is that of the first example of the true sale above. A pool of loans is purchased from the seller and financed through RMBS. The pool is passive in the sense that the seller is legally restricted from swapping loans into and out of the pool.

But as different securitization structures and paradigms developed, sellers and investors saw the capacity for greater arbitrage through manipulating pools, rendering the passive view of many securitizations revealed in even FASB's view toward its FIN46 post-Enron reforms obsolete. In 1989, early credit card securitizations showed the path forward. Because credit card

accounts are, on average, outstanding less than a year it is necessary to structure a “revolving” period so that the pool of loans can be funded by bonds of longer maturity than the loans, themselves. During the revolving period, old credit card loans that have been paid off are replaced with new loans so that the pool balance remains relatively constant. Since the early 1990s, there were concerns with “cherry picking” the new accounts to be added so as to increase the credit quality of the pool. While such practice has never been officially confirmed or denied, it has appeared as if regulators allow such practices to encourage stable funding for the industry.

But the idea of selling the loans while not really passing along the full risk of the loans’ performance was too attractive for the rest of the world to pass up. Hence, Enron embarked on a similar endeavor, “selling” something for accounting purposes while retaining the economic risk. Of course, the risk was truly borne by Enron until the firm failed, resulting the spectacular disentangling of myriad funding conduits and instruments implemented in the process and sold throughout the world.

While FASB’s FIN46 revised accounting rules to preclude another Enron, it specifically exempted consumer credit securitizations from its rulemaking. Having had their future demonstrated so clearly by Enron, however, non-bank financial firms like New Century, investment banks like Bear Stearns, and even some banks and thrifts pursed the same strategy. Those firms sold pools of mortgages that bore little resemblance to the early REMIC structures. In the private-label RMBS, loans that didn’t perform well were repurchased in a ready and fluid fashion, more akin to an inappropriately off-balance sheet covered bond than any sort of passive true sale securitization envisioned by FASB.

Many sellers have voluntarily provided additional support to preserve the performance and bond ratings of their structured transactions. (Moody’s Investor’s Service, “The Costs and

Benefits of Supporting "Troubled" Asset-Backed Securities: Has the Balance Shifted?" January 1997) Still, it would be egregious to maintain that securitization transfers no risk at all. After all, in the event of catastrophic asset quality problems, the seller may choose NOT to support a troubled deal, notwithstanding any legal responsibility to do so. In such a case, the asset-backed bond investors and any third-party credit enhancers, such as a bond insurer, would absorb the residual losses. By contrast, a portfolio lender would have to absorb all losses.

Trouble begins in this paradigm, however, when loan performance sours beyond the ability of the seller to support pool performance out of regular operating earnings. Then, the seller has to either increase earnings or stem losses. Since the seller's earnings primarily rise through MAKING NEW LOANS TO GENERATE UNDERWRITNG FEES, the seller accelerates underwriting. Since better-qualified borrowers will most likely obtain cheaper loans from financially sound lenders, the seller targets down-market consumers – subprime borrowers – for the new business.

Of course, less creditworthy borrowers mean more losses. So the deterioration in loan performance that prompted the decline is met with more deterioration in loan performance. As the firm tumults down the death spiral, they attempt to modify loans using repayment and forbearance plans, while aggressively reaging[2] loans to classify as much of the portfolio as "performing" as possible. Some lenders, upon realizing that they were unable to generate enough repayment and forbearance plans to feed the reaging process, resort to "amnesty" programs, wherein they merely wrote off the past due balance and called the loan current once again –

[2] Reaging refers to the criteria for classifying a previously delinquent loan "current" again. Conservative reagers (including commercial banks, by FFIEC rulemaking) require an account to post three consecutive on-time payments to be classified as current again. Aggressive reagers (non-bank finance companies) can choose to reage on the mere promise of a payment. Aggressive reaging has been found to have played a role in many of the mortgage firm failures in the crisis.

sometimes without the delinquent borrower even knowing their loan had been awarded this "amnesty"!

Loan swapping under "representations and warranties," therefore, together with loan modifications carried out through ongoing servicing allow the seller to readily absorb the loan risk that was purportedly sold. Hence, Nomura notes that, "…without audits or third-party oversight, an ABS servicer in financial distress may manipulate amortization triggers, divert deal cash flows, or otherwise misappropriate assets. (Nomura, "ABS Credit Migrations 2004," December 7, 2004, p. 41)

The financial prospects for a seller that is unable to muster the resources to voluntarily support a securitization are grim. Such a seller would likely no longer receive any excess spread from the securitization trusts and might have difficulty raising external cash due to uncertainty over the asset quality of its serviced portfolio. Such a seller would surely not be able to issue again in markets any time soon. Hence, the seller can be reasonably expected to fail outright in the near term (Moody's Investors Service, "Bullet Proof Structures Revisited: Bankruptcies and a Market Hangover Test Securitizations' Mettle, August 30, 2002, p. 3)

Bondholders often have a legal right to replace the primary servicer with a backup servicer, since, "…the performance of securitized assets can be impaired by actions taken by a servicer in financial distress, but they usually need to do so *before* bankruptcy. The bankruptcy court may not allow replacement of the servicer since servicer rights may be viewed as a property right of the debtor's estate. Investors thus may have no choice but to continue with the original servicer even if the quality of its servicing is poor. Even if the servicer is willing to give up servicing rights, those can often be difficult to transfer because they are tainted by the servicer's malfeasance, often of too little value for a follow-up servicer to maintain on any reasonably

profitable basis. (Moody's Investors Service, "Bullet Proof Structures Revisited: Bankruptcies and a Market Hangover Test Securitizations' Mettle, August 30, 2002, p. 4; Nomura, "ABS Credit Migrations 2004," December 7, 2004, p. 41)

Servicing rights also create difficulties for a bankruptcy trustee – including the Federal Deposit Insurance Corporation – who seeks to liquidate the assets of a failed seller/servicer. The loan servicing rights are often the final asset remaining in the firm and the substantial potential for servicer malfeasance as the seller /servicer approaches bankruptcy can deteriorate their value significantly. Thus, firms like IndyMac are difficult to liquidate because no other servicer is willing to service the portfolio without substantial remuneration to insulate them from the losses and legal ramifications of unwinding the potential fraud and malfeasance left over from the previous distressed servicer. That is why the FDIC was left servicing the NextBank credit card portfolio, and that is most likely the case at IndyMac as well (and some of that is probably behind Bank of America's purchase of Countrywide at a very favorable price).

Since there is so little to recover from a failed seller/servicer, the FDIC, itself, has maintained that it may disallow "true sale" status if it desires to seize those "truly sold" assets to recover deposit insurance outlays. Indeed, the legal status of securitizations remains unsettled. One of the most intriguing cases in the history of structured finance, In re LTV Steel Corporation, tested the fundamental tenet that assets can be isolated from the bankruptcy of their seller through a "true sale." According to Moody's Investors Service, "…in December 2000, LTV Corporation (LTV), an integrated steel maker, and its operating subsidiaries filed for protection under Chapter 11. LTV entered bankruptcy court without a DIP loan in place. Instead, LTV requested and the court granted permission to use the cash generated from two of LTV's

securitizations in order to stay in business - despite the previous sale of these assets to two SPVs."

Even the court failed to see the logic in the securitization and was inclined toward allowing the estate to seize the securitized pools, maintaining, "[T]here seems to be an element of sophistry to suggest that Debtor does not retain at least an equitable interest in the property.… To suggest that Debtor lacks some ownership interest in products that it creates with its own labor, as well as the proceeds to be derived from that labor, is difficult to accept." (Memorandum Opinion, U.S. Bankruptcy Court for the Northern District of Ohio, Feb. 5, 2001) The case, however, was never ruled upon, therefore the issue of true sale – itself the keystone of securitization – remains contentions.

In summary, "true sale" as it has been practiced does not make sense. To get at any meaningful FASB reforms, we need to go back to the principle of true sale. I sold you the car. Caveat emptor. Retaining servicing rights are like maintaining the car after the sale. Loan swap agreements are simple warranties. In order to improve accounting standards, therefore, we have to put a limit on the amount of money that can be spent on maintenance, i.e., loan servicing, after the sale. While FASB has maintained that acting under representations and warranties is not optional, they are interpreting that optionality only in the strict legal sense. There is always the "real" option of simply refusing to support the pool representations and warranties. While that may result in some lawsuits, in reality those can be beaten back for several years giving the firm a chance to restore performance and eventually meet their contractual obligations. Hence, we also need to financially value the option in the warranty.

The problem is a tragic collision of economics, finance, and accounting, where economic risk is placed where it is difficult to value financially and even the most complex accounting

rules do not apply. While that does not augur for prohibiting any of the above arrangements in the long term, it does provide a rationale for constraining financial product developments so that they do not grow systemically large before finance and accounting can properly characterize their risks and returns. Hence, there may be reason to curb the over-reliance on financial innovations – certainly within the realm of financial institutions that receive Federal and State safety net protection – and require public reporting of such exposures and values to better align incentives for innovation with the need for financial stability.

IV. Gain on Sale Accounting and Perceived Profitability

Any discussion of necessary accounting reforms would be incomplete without a section of gain-on-sale accounting.

FASB'S August 11, 2005, Revision of Exposure Draft Issued June 10, 2003, "Accounting for Transfers of Financial Assets, an amendment of FASB Statement No. 140," (Financial Accounting Series No. 1225-001), explains gain-on-sale. Summarizing, in order to facilitate "gain-on-sale accounting," the firm (1) estimates the value of the thing they want to sell with a financial model. Then, the firm (2) receives some money and other items in the actual sale of that thing. Next, in what is the real arbitrary aspect of gain-on-sale accounting, the firm gets to (3) record the difference between their own valuation of the thing that they sold and the value of the cash and other items received in the sale as cash revenue.

Difficulties in the high-LTV home-equity loan crisis of the late 1990s were largely attributable to aggressive gain-on-sale accounting. When firms, realizing the risks of gain-on-sale accounting and the false earnings conditions they represented to investors, sought to pull back from gain-on-sale and become more conservative, they were told by FASB that they if the

firm adopted an unreasonably conservative approach that would be considered earnings manipulation.

According to Moody's:

> *In the late 1990's, several subprime home equity and auto lenders encountered financial difficulty arising in part from explosive growth patterns, in part from using securitization as a source of funds, and in part from overly aggressive use of gain on sale accounting. Such accounting methodology made these companies look much stronger financially on paper than they actually were. Companies that used gain on sale accounting included, among subprime mortgage issuers, Contifinancial Corp., Southern Pacific Funding Corp., Cityscape, and United Companies Financial Corp.…. Once the effect of gain on sale accounting was removed from financial statements, leverage ratios were often high. These companies also had weak capital positions compared to more diversified finance companies.* (Moody's Investors Service, "Bullet Proof Structures Revisited: Bankruptcies and a Market Hangover Test Securitizations' Mettle, August 30, 2002, p. 14)

The problem with gain-on-sale accounting is, therefore, that the revenue booked is not real cash. Hence, many recently-failed mortgage companies and similar firms associated with previous securitization fiascos have *never been cash-flow positive in their entire corporate lives*. Thus, the financial world was recently littered with hundreds of firms with exceedingly high stock values that had never actually earned positive cash profits in a manner typical of a classic bubble.

V. Summary and Conclusion: Everything Old is New Again

None of the problems above are anything new, unique, or unknown, nor is their manifestation in today's credit crisis. The only thing that increased the severity of the crisis this time around is the sheer scale of the operation, which rose from less than $1trillion in the late 1990s to some nearly $10 trillion today.

Rating agencies' characterizations of past crises eerily presage the present crisis. In 2001, Moody's wrote, "The seller's capital structure, its diversity of funding sources, types of assets, and the business factors motivating its securitizations are all important considerations. The examples of deals gone 'bad' reveal that an over-reliance on securitization as a funding source is an important risk factor. The overuse of securitization coupled with aggressive gain-on-sale accounting was a particularly lethal combination…. New or unusual asset classes pose particular risks as well." (Moody's Investors Service, "Bullet Proof Structures Revisited: Bankruptcies and a Market Hangover Test Securitizations' Mettle, August 30, 2002, p. 1) The current crisis merely wrapped all the most influences into one, and applied them to nearly all collateral types in the market.

In conclusion, while FASB continues to try to pigeonhole securitization accounting into simple on- and off-balance sheet classifications, the issue is far more complicated due to other legacy accounting treatments surrounding the entire securitization process, as well as securitizations' unsettled legal status. We cannot expect any resolution to on- and off-balance sheet treatment by continuing to implement the dichotomous approach used so far. Nor can we expect securitization accounting to improve much without removing other perverse incentives in gain-on-sale accounting and true sale status. Much work remains to be done to adequately characterize securitizations in a credible and transparent manner. Nonetheless, we have had

several decades to get the work done, already. It is time to clean up reporting for the structured finance marketplace, which has proven so useful in deepening capital of the banking system to fund myriad consumer and commercial loan products – before the financial crisis gets even deeper.