TESTIMONY OF

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BEFORE THE

SUBCOMMITTEE ON SECURITIES, INSURANCE AND INVESTMENT
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

HEARING ON

TRANSPARENCY IN ACCOUNTING: PROPOSED CHANGES TO ACCOUNTING FOR OFF-BALANCE SHEET ENTITIES

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I. Introduction

Chairman Reed, Ranking Member Allard and Members of the Subcommittee on behalf of the American Securitization Forum (ASF)[1] and the Securities Industry and Financial Markets Association (SIFMA)[2], I appreciate the opportunity to testify today on

[1] The American Securitization Forum ("ASF") is a broadly-based professional forum of participants in the U.S. securitization market. Among other roles, ASF members act as issuers, underwriters, dealers, investors, servicers and professional advisers working on securitization transactions. More information about ASF and its involvement in financial accounting matters may be found at www.americansecuritization.com. ASF is an adjunct forum of SIFMA.

[2] SIFMA brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. Additional information concerning SIFMA, its members and activities may be found at www.sifma.org.

transparency in accounting, specifically in connection with proposed changes to accounting for off-balance sheet entities under U.S. generally accepted accounting principles (GAAP). We commend you for holding this hearing on this timely and important topic.

I am here today representing the views of ASF and SIFMA, whose members collectively include securitization issuers, investors, financial intermediaries and other institutions involved in the U.S. securitization market. Over the years, our organizations and members have interacted extensively with FASB on issues relating to securitization accounting and financial market accounting matters. Specifically with reference to accounting for securitizations and off-balance sheet entities, we have submitted detailed comments and recommendations on multiple previous FASB proposals, participated in public roundtable meetings and educational sessions sponsored by FASB, and have engaged in an ongoing dialogue with federal regulators and other policymakers.

II. The Role of Accounting Standards in Securitization Transactions

Transparent, timely and accurate accounting is of critical importance to the quality and utility of financial reporting for securitization transactions, and to the efficient functioning of the financial markets generally. We therefore strongly support the need for high quality accounting standards governing when financial assets may be removed from a transferor's[3] balance sheet, as well as accounting standards governing consolidation and financial reporting for off-balance sheet entities.

As the Committee is aware, FASB has projects underway to revise relevant accounting standards in these areas under U.S. GAAP. These include FAS 140, which deals with accounting for transfers of financial assets, and FIN 46R, which governs consolidation of special purpose entities. In basic terms, FAS 140 governs when financial assets transferred by an entity should be considered as a sale for accounting purposes (in which case those assets are removed from the transferor's balance sheet) versus when that transfer should be considered as a secured borrowing for accounting purposes (in which case the assets remain on the transferor's balance sheet). FIN 46R governs when assets transferred to a special-purpose entity – as further described below, typically a stand-alone entity that exists solely to facilitate a financing transaction – must nevertheless be consolidated on the balance sheet of another entity.

These accounting standards are important in a variety of commercial and financial market contexts. They are of particular relevance to the world of securitization and structured finance, where on- or off-balance sheet accounting treatment for transactions may have significant business and economic consequences.

Securitization and structured finance are terms that include a wide range of capital markets transactions that provide funding and liquidity for an equally wide range of consumer and business credit needs. These include securitizations of residential and commercial mortgages, automobile loans, student loans, credit card financing, equipment loans and leases, business trade receivables, and the issuance of asset-backed commercial

[3] "Transferor" refers to the entity that transfers financial assets into a special purpose entity (which may be an off-balance sheet entity) that issues securities, the payments upon which are supported primarily by cashflows generated by the financial assets.

paper, among others. Collectively, securitization represents by far the largest segment of the debt capital markets in the United States, with over $10 trillion mortgage and asset-backed securities currently outstanding.

Securitization transactions can take a variety of forms, but most share several common characteristics. First, securitizations typically rely on cashflows generated by one or more underlying financial assets (such as mortgage loans), which serve as the principal source of payment to investors, rather than on the general credit or claims-paying ability of an operating entity. Securitization thus often allows the entity that originates or holds the assets to fund those assets more efficiently, since cashflows generated by the securitized assets can be structured, or “tranched,” in a way that can achieve targeted credit, maturity or other characteristics desired by investors. To realize this efficiency, most securitizations rely on transaction structures that isolate the assets that are the principal source of investor payments from other assets that may be held on an originator's balance sheet. Second, to achieve this isolation of assets, many transaction structures utilize a special purpose entity, or SPE (also sometimes referred to as a special purpose vehicle, or SPV), which exists solely to hold assets that are transferred to it for purposes of securitization, and to issue securities to investors that are backed by cashflows produced by those assets.

Historically and today, many (but not all) securitizations that utilize SPEs to isolate assets for purposes of financing those assets in capital markets transactions qualify for off-balance sheet accounting treatment under relevant U.S. GAAP accounting guidance, including the current versions of FAS 140 and FIN 46R. Common securitization transaction structures – including the segregation of assets in off-balance sheet SPEs – are long-established, extensively disclosed and well-understood by investors and other securitization market participants. The funding efficiencies that can be realized via securitization (including off-balance sheet financing) are ultimately passed through to borrowers – both consumers and businesses – who have access to a wider range of credit at lower cost. This is because the sale of assets via securitization and removal of those assets from the transferor's balance sheet generates capital and liquidity that can be used for additional asset origination, often at funding costs that are superior to those available from other financing techniques.

III. Views on Current Accounting Standards Projects Affecting Off-Balance Sheet Entities; Potential Market Impacts

FASB is presently engaged in projects that would significantly revise current accounting standards under FAS 140 and FIN 46R. On September 15th, 2008, FASB issued comprehensive proposed revisions to FAS 140 and FIN 46R, with public comments due by November 14th. FASB's current projects represent the latest phase in an almost continuous dialogue that has taken place regarding revisions and adjustments to these standards ever since they were initially issued. In the case of FAS 140, there have been multiple revisions projects, technical amendments, FASB staff positions and other guidance proposed and enacted since the original adoption of FAS 125 (the predecessor standard to FAS 140) in 1995. FIN 46 has experienced a similar history. Shortly after the original adoption of FIN 46 in January 2003, FASB revised the standard via the adoption of FIN 46R in December 2003, and there have been ongoing interpretative, operational and practical issues surrounding the application of this standard since that time. In early 2008 FASB announced its current projects to revise FAS 140 and FIN

46R, and established a deadline for implementing theses changes. That deadline was subsequently extended to January 2010.

We agree that given the importance of FAS 140 and FIN 46R, the continuing policy debate about the appropriate accounting treatment and financial reporting and disclosure standards for off-balance sheet entities, and the continuing difficulties that have been encountered by both preparers and users of financial statements in applying these standards in a clear, consistent, operational and transparent manner, that a comprehensive revisitation and revision by FASB is in order. We also recognize that FASB and other policymakers believe that speedy and decisive actions are necessary in response to the ongoing credit and liquidity crisis confronting our nation's financial markets. However, we are very concerned that FASB's current course of action and timetable, in which it appears that FASB may adopt far-reaching changes to FAS 140 and FIN 46R in the near term without considering other, and possibly superior accounting frameworks, may have serious and unintended consequences. We believe that a 60-day public comment period[4] does not provide adequate time to consider the proposed revisions and other possible alternatives, before final decisions are made on how current accounting standards will change.

To the extent that FASB's current proposals result in abrupt revisions to existing derecognition guidance and/or the widespread consolidation of securitization SPEs, these outcomes would likely swell the balance sheets of affected entities, impairing financial ratios and financial covenant performance and regulatory capital tests. Without sufficient time to consider appropriate regulatory, rating agency and other responses to

[4] The effective comment period is less than 60 days for organizations like ours, who intend to participate in FASB's public roundtable meeting on November 6th to discuss the proposed changes

such far-reaching changes in accounting, regulated entities will face potentially significant capital constraints, and both regulatory and unregulated entities will face substantial challenges (and their capital raising efforts will be complicated) by being forced to explain dramatic changes in their financial statements to investors and lenders, with potentially little or no change to the economics of the subject transactions. As further discussed below, significant accounting changes that are unrelated to changes in the economic or risk profile of securitizations may lead not only to capital constraints, but also to a diminution of credit and liquidity available to consumers and businesses generally.

Moreover, accounting policy changes under U.S. GAAP without meaningful convergence of international accounting standards in this area risks a prolonged drain on the time and resources of FASB and industry members alike, as further changes to derecognition and consolidation policies are virtually certain to result from the eventual convergence process. In this context, we note that the International Accounting Standards Board ("IASB") recently issued its own proposed staff guidance on these topics, which differs from the approach suggested in FASB's current proposals.

Given that the SEC has recently proposed a roadmap for U.S. public companies to adopt International Financial Reporting Standards (IFRS) as early as 2010, we believe that these revisions projects should be coordinated with the IASB. The IASB also has a project on its agenda to develop a new standard on derecognition and ultimately, the two Boards will seek to issue a converged standard. We believe that implementing these short term revisions and then a different converged standard in several years would be very costly and burdensome for preparers. The two Boards should coordinate to issue a converged standard instead of issuing these short term revisions.

We appreciate that FASB extended (in response to recommendations from industry participants and others) their originally-announced deadline for completing these revisions projects by one year. However, we remain very concerned that FASB is nevertheless moving forward with proposed revisions that could have dramatic and far-reaching consequences, without allowing for a full discussion and deliberation of possible policy alternatives. Given what is at stake, we believe that a more thorough and deliberative process is essential, and will produce better outcomes for accounting policy, the economy and the markets in both the short and long term.

Banks, finance companies and other entities, possibly including Fannie Mae and Freddie Mac, that currently do not consolidate the issuing entities used in securitizations may be required to consolidate some or all of those entities. The affected transactions may include many garden variety transactions (such as prime mortgage loan, credit card, student loan and retail automobile loan securitizations) that have not been contributing factor to the current credit and liquidity crisis. From this perspective, the revisions being contemplated affect large markets that provide substantial funding for U.S. consumers and businesses. As of December 31, 2007, the aggregate outstanding balance of potentially affected transactions include:

- $7.2 trillion mortgage-related securities;
- $2.5 trillion other asset-backed securities (excluding asset-backed commercial paper); and
- $816 billion asset-backed commercial paper

Although we cannot presently estimate which or how many of these transactions would be affected by the proposed changes, consolidation of even a significant fraction would be a momentous change, with significant market and economic consequences.

These could include a material reduction in the availability and increase in the cost of credit, precisely at the time that the availability of capital, credit and liquidity are severely constrained throughout the financial markets.

IV. FASB Should Proceed Carefully and Deliberately in Considering Changes to Existing Standards, and Should Consider Other Alternatives, Including "Linked Presentation"

While we agree that changes in disclosure and financial reporting by entities engaged in securitization transactions that involve on- and off-balance sheet entities should be pursued, we believe that it is essential for FASB to take the time necessary to produce a standard that will result in an improvement in accounting in these areas, rather than merely produce a change for the sake of change, or to meet an arbitrary deadline for making those changes.

As noted above, FASB has been involved in multiple projects relating to securitization accounting in recent years. There are a number of reasons why these initiatives have required the expenditure of significant time and resources to resolve. Among others, the subject transactions are often complex; the market is relatively young and has evolved and grown rapidly; and FASB and the IASB have historically taken different approaches in this area, which are the subject of an ongoing international accounting standards convergence project. Undue haste to revise accounting standards applicable to securitization transactions and off-balance sheet entities will be counterproductive if it prevents FASB and other policymakers from giving full consideration to other accounting policy options, direct and indirect consequences of proposed accounting policy changes, and possible compensating adjustments to bank capital rules and other regulations.

It is important to remember that over-consolidation of SPEs can be just as confusing to users of financial statements as under-consolidation. We believe that a binary, "all-or-nothing" approach to consolidation (where an entity consolidates either all or none of the assets transferred to a securitization SPE) can produce these distorted effects. To prevent this from happening, we believe that more nuanced approaches should be considered, and in particular, approaches that (1) enable users of financial statements to differentiate between assets that are truly controlled by the consolidated reporting entity versus those that have been isolated from that entity and its creditors, and (2) appropriately recognize differences between and among prevailing structures used for various asset classes. For several years, ASF has advocated "linked presentation" as a concept with great potential as part of a final resolution of current issues and ambiguities surrounding securitization accounting. Unfortunately, FASB has indicated that it does not have sufficient time to consider the relative merits of a linked presentation approach prior to moving forward with the current, proposed revisions to FAS 140 and FIN 46R. We disagree, and strongly advocate that FASB engage in a full exploration of linked presentation – among other possible alternatives – as part of the current round of accounting policy changes.

Briefly, under a linked presentation approach, the liabilities that are issued in securitizations would be shown on the asset side of the balance sheet, as a deduction from the amount of securitized assets. Linked presentation in essence results in an on-balance sheet financial statement presentation, as it would provide users with all relevant information regarding transferred assets directly on the balance sheet.

The principle behind this approach is that to the extent a transfer of financial assets qualifies as a sale under FAS 140, and those assets have been legally isolated from the transferor, it is more appropriate and relevant to present as a liability on the balance sheet of the transferor only the amount of recourse that exists to the general assets of the transferor. Where legal isolation has been established, the transferor no longer has access to the transferred assets, and the cash flows generated by those assets would be used only to repay the related obligations. In this circumstance, we believe that it would be inappropriate to require the transferor to consolidate on its balance sheet *all* of the assets and liabilities of the securitization SPE, as clearly the transferor is neither fully entitled to the benefits of those assets nor fully exposed to those liabilities. Although significant additional work will be needed to define the conditions under which linked presentation may be used, and to specify the elements of this approach, we continue to believe that a linked presentation model along these broad conceptual lines is worth pursuing. ASF and SIFMA stand ready to work with FASB and other policymakers to develop an effective and operational linked presentation model.

V. Conclusion

Once again, ASF and SIFMA appreciate this opportunity to convey our views. We stand ready to work with the Subcommittee, FASB, regulatory agencies and our members to develop and implement sound and operational accounting standards governing securitization transactions, and would be pleased to provide any additional information that may be helpful in achieving that goal.