

Creative Thinking

and Elbow Grease

FASB's post-Enron crackdown on funding of assets with collateralized notes and bank-sponsored CP conduits has no easy solutions.

May Ease FIN 46 Compliance

In January, the Financial Accounting Standards Board (FASB) released FIN 46, an interpretation of Accounting Research Bulletin No. 51 (ARB 51), which addresses consolidation of so-called variable interest entities. The impetus was primarily Enron and its accounting abuses with respect to special purpose entities (SPEs).

FIN 46 specifically relates to the funding of assets through collateralized notes funded by commercial paper conduits (CP conduits). A number of issues and efforts have emerged since then, as financial professionals come to grips with this new round of FASB action.

The stakes are high. According to research by Wachovia Securities, there were \$726 billion assets in CP conduits outstanding by year-end 2002, primarily bank-sponsored. Even the few non-bank sponsored CP conduits usually obtain their liquidity facilities from banks.

Remarkably, there were only \$9 billion in outstanding CP conduit assets in 1988. The rapid growth of corporations utilizing CP conduits as an efficient funding source has been sparked primarily by a low cost of funds available through this bank-sponsored capital markets funded technique.

Here's How it Works

The funding process typically works this way. A corporation creates a wholly-owned SPE and sells some type of cash-flow assets to this SPE (thus taking those assets off its balance sheet).

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The SPE sells a security to a CP conduit, collateralized by the cash-flow assets. The CP conduit sells commercial paper (CP) to capital market investors to finance its purchase of the collateralized security. The funds flow back to the selling corporation via a chain that links CP investors, CP conduits and the SPE issuance vehicles.

Because the selling corporation is essentially anonymous to the ultimate investor in this scenario, corporations can access capital markets for financial liquidity via CP conduit securitizations affecting the primary or secondary market for its other capital market issues, including any unsecured commercial paper.

Eligible Assets

Examples of typical eligible CP conduit cash flow assets include accounts receivable,

leases and loans. Accounts receivable represent about one-third of all CP conduit assets and can be found on almost any corporation's balance sheet.

CFOs often consider these assets, typically short-term, to be the best non-cash asset on the balance sheet. After all, goodwill assets can be flaky or tough to quantify, while plant, equipment and inventory might be illiquid.

As a direct result of FIN 46 and assuming no ameliorating action due principally to the nature of bank credit enhancements and equity-like variable interest cash flows, CP conduits must be consolidated on the sponsors' balance sheets.

The problem: Such consolidation will likely decrease availability and increase the cost of financing via asset-backed securitizations funded by CP conduits. In broader

terms, a potential swing in excess of \$700 billion of assets onto the balance sheets of banks might cause huge, adverse ramifications affecting the way corporations access the capital markets.

One Exception

One glaring exception, at least for the near term (probably through the end of 2004), is non-U.S. banks. They are typically subject to International Accounting Standards (IAS) and not FASB. Allegedly, the Office of the Comptroller of the Currency (OCC) might provide temporary regulatory relief to banks, buying time for them to find a solution to accommodate consolidation implications. By itself, this potential action by the OCC suggests the magnitude of implications and problems that FIN 46 poses for both the banking community and

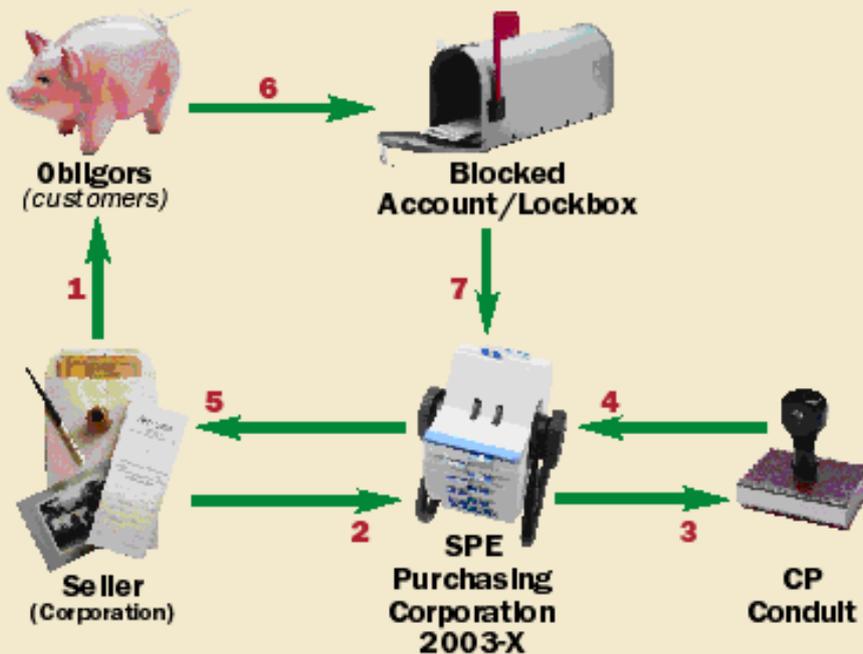
corporations.

Unrelated to CP conduits or any financing transaction, a somewhat strange consequence to FIN 46 was recently revealed in an SEC filing by Cisco Systems Inc. The company said it would take a non-cash charge of up to \$500 million in connection with an acquisition, as a result of FIN 46 consolidation requirements. Other such situations may well exist across corporations of all types and sizes.

Beyond Subtle Nuances

Generally, new accounting rules are relevant to a rarefied group of accountants and finance professionals responsible for implementing the technical nuances. In the instance of FIN 46, the consequences may prove to go well beyond subtle adjustments and will likely

Financial Engineering Construct



- 1 Seller invoices Obligor for goods or services provided.
- 2 Seller sells eligible receivables to SPE Purchasing Corporation.
- 3 SPE Purchasing Corporation issues Funding Note to CP Conduit.
- 4 CP Conduit buys funding note and remits cash to SPE Purchasing Corporation.
- 5 SPE Purchasing Corporation sends cash to Seller.
- 6 Obligor send money to blocked account/lockbox.
- 7 Blocked account/lockbox sweeps collections daily to SPE Purchasing Corporation.

Source: Finacity Corporation



require the attention of many corporations that heretofore have not considered its significant ramifications on the cost and availability of capital.

Banks Face Lower Return on Equity

Banks have essentially employed 0.8% capital to support CP conduit activities. As such, if a stereotypical investment grade customer received funding at CP + 25 basis points (bps) prior to FIN 46, the bank sponsor would generate a return-on-equity (ROE) in excess of 30% (80 bps of equity capital returning 25 bps).

With the advent of FIN 46, the same CP spread (25 bps) will produce substantially lower ROEs (800 bps of equity capital returning 25 bps = 3.1%) comparable to government bonds. Based on the \$726 billion of assets outstanding at year-end 2002 in CP conduits, banks would require more than \$50 billion in additional equity to support such activities.

Seeds of a Solution

Creative thinking and elbow grease are assisting bank sponsors in FIN 46 compliance, while also attempting to achieve off-balance sheet treatment. So far, there are no silver bullets. However, you should know that most bank sponsors are considering three principal routes:

- 1) *Take no evasive accounting action and simply consolidate.* This route will translate into significant adjustments in pricing and/or credit standards to justify additional capital. JPMorgan Chase's CFO indicated on a recent earnings conference call that

the bank is resigned to simply bringing the assets back on the balance sheet, at least for now. For some CP conduits, this scenario could be tantamount to exiting the CP conduit business, a path already chosen by one significant player.

- 2) *Form cooperative equity ventures between bank sponsors so risks and rewards are shared sufficiently, and no single entity is required to consolidate.* This approach will likely require sponsors to relinquish control and subject themselves to the discipline (or lack thereof) and performance of unrelated partners. In addition, daunting restructuring of existing paperwork might be necessary.
- 3) *Sell off enough equity (first-loss risk) to third parties to justify to auditors that consolidation should transfer with the sale of variable cash flows.* This route will probably require: 1) an auditor-approved algorithm for sizing the minimum equity sell-off necessary to support deconsolidation, 2) the ability to adequately evaluate, control and monitor risks, and 3) significant third-party equity capital. Regulatory approval might also be required. A subtlety is that the first-loss risk could be provided through a liability construct, such as a guarantee, as opposed to an equity investment.

Let's examine this third option more closely.

Solutions

Create an entity to purchase equity interests (first-loss cash flows) from existing CP con-

duits pursuant to Paragraph 14 of FIN 46:

14. An enterprise shall consolidate a variable interest entity if that enterprise has a variable interest (or combination of variable interests) that will absorb a majority of the entity's expected losses if they occur, or both. An enterprise shall consider the rights

alized by the transferred assets. The SPE usually remits the proceeds to the seller.

The CP conduit equity, distinct from the SPE equity, is subject to certain risks and rewards, and thus is described as a so-called variable interest. Bank sponsors generally retain variable interests, which absorb performance losses of assets

Consolidation will likely decrease availability and increase the cost of financing.

and obligations conveyed by its variable interest and the relationship of its variable interests with variable interests held by other parties to determine whether its variable interests will absorb a majority of a variable interest entity's expected losses, receive a majority of the entity's expected residual returns, or both. A direct or indirect ability to make decisions that significantly affect the results of the activities of a variable interest entity is a strong indication that an enterprise has one or both of the characteristics that would require consolidation of the variable interest entity. If one enterprise will absorb a majority of that entity's expected residual returns, the enterprise absorbing a majority of the losses shall consolidate the variable interest entity.

In typical CP conduit-funded, asset-backed securitizations, sellers form their own SPE and sell assets to their wholly owned SPEs. Invariably, this SPE creates and sells to a CP conduit a security collateral-

before CP investors incur them — thus the associated descriptor “first loss.” Per Paragraph 14, the consequence is that the entity deemed to retain the variable interest risk must consolidate.

There are two component steps:

- 1) *Resolution of an algorithm to size the amount of equity necessary to be transferred, which results in off-balance sheet treatment for the seller*

This is a very complex task. First, the accounting profession hasn't stated its willingness to delineate an algorithm based on the requirements. FIN 46 doesn't provide precise guidance and accountants seem uncomfortable to go out on a limb.

Some accounting professionals have sought clarifying guidance from FASB, but so far, received limited response. FASB Staff Positions (FSPs) recently provided some insight on how fees a variable interest



entity pays to a guarantor of the entity's assets or liabilities affect determining the variable interest entity's primary beneficiary.

While this provides some guidance, it doesn't outline for the seller how to size equity for off-balance sheet treatment. There are mixed hopes that FASB will provide additional guidance.

Also, the role and perspective of bank regulators needs to be accommodated. Any acceptable algorithm will need to be grounded heavily in fact and analytic support, focusing on past and predicted losses.

The amount of equity should be at least large enough to absorb expected losses. A multiple of expected losses might even be required. No equity investor would reasonably purchase an investment expecting

it to absorb 100% of losses, leaving no remaining value.

One of the problems is evaluating past credit loss experience for any given CP conduit. Often, when an adverse credit event occurs, the bank sponsor has simply purchased the troubled assets out of the CP conduit at a price of par and managed the consequences on its own balance sheet.

In some situations, the ultimate resolution of a challenged asset pool might take years to unfold. Thus, the true risks and credit losses experienced by CP conduits have been masked.

Even if a CP conduit and its sponsor fully disclosed past performance, they might be hard-pressed to reconstruct the facts. Further, significant large-scale risk events have usually resulted from fraud. Due to the

very discontinuity of fraud, past performance may not be much of a predictor.

Recent apparent fraud includes the failure of National Century, in which bank-sponsored CP conduits funded several hundred million dollars of allegedly hypothecated assets with disastrous consequences. The dollar amounts involved represent several percent of the afflicted CP conduit assets. The CP investors weren't adversely impacted — the bank sponsors paid the piper.

There has been a spate of trial balloons on the appropriate size for an equity transfer. The most recent amount floated was 0.1% (10 bps) as noted in *Business Week* April 28, 2003. This author suggested that amount and other suggested percentages are too

small and any eventual methodology will result in higher requirements.

Whatever the ultimate first-loss size requirements, the incremental cost to CP conduits will probably be at least several basis points, possibly more, assuming appropriate equity returns.

On the issue of risk and return, most banks seem to reject sharing risks with other bank sponsors. If risks were truly as limited and predictable as banks claim, why wouldn't they share them with other institutions?

Bank-sponsored CP conduits employ credit professionals to evaluate transactions and monitor portfolio exposures. If CP conduits sell risks, we need mechanisms to maintain credit disciplines.

Of course, the rating agen-



cies are also involved in the credit review process as the CP issuances of CP conduits are rated, typically A1/P1. It's noteworthy that borrowers that obtain funding from CP conduits invariably retain, assume or guarantee certain risks. Certainly, the rating agencies could be an important participant in developing reasonable loss assumptions and equity sizing algorithms.

2) Implementation of a credit and fraud risk monitoring and detection platform.

Ongoing credit performance monitoring and fraud detection is difficult and requires a sustained effort. Sophisticated asset performance transparency, coupled with a comprehensive

third-party, asset-servicing platform, doesn't exist currently for any CP conduits. But such components will probably be required for equity investors.

CP conduits currently operate with a black-box approach to investor reporting. Tracking risks behind the typical CP conduit curtain is characterized paradoxically as both crucial and yet, as practiced, inherently imperfect.

Third-Party Support

To the extent that an asset pool and/or servicer involved in a CP conduit becomes distressed, an equity investor could require a third party to step into the breach and support any servicing challenges that develop.

Further, some entity, possibly the back-up servicer,

might be expected to provide additional fraud detection through collateral verification, both up-front and ongoing (especially pertinent for revolving asset structures).

Fraud is the single biggest source of unexpected and difficult-to-prevent losses. Most servicing of assets in CP conduits is conducted by the very party borrowing against the assets, thus causing a fox-in-the-henhouse problem.

An equity investor might require a third party to administer lockboxes and/or blocked accounts, thereby controlling cash and its appropriate allocation on behalf of all constituents, such as CP investors, borrowers and the equity investor.

Given the sheer size of CP conduit liabilities outstanding, it may not be overly dramatic to note that the very availability and cost of financial capital for corporations might be impacted severely if solutions aren't successfully developed and implemented. CP conduit-funded, asset-backed securitizations, in the absence of tangible progress toward solving FIN 46 challenges, will likely face substantive dislocations resulting in higher costs for corporations. The seeds of any such solutions have been planted and market participants need to see what's ultimately harvested.

Final Thoughts



Adrian Katz currently serves as CEO and director of Finacity Corporation, a joint venture company with Amroc Investments, ABN AMRO, Bank of America, EULER American Credit Indemnity, Kleiner Perkins Caufield & Byers, Bain & Company and Texas Pacific Group. Katz has 18 years of experience both on Wall Street and as a lender.