Implications to Regulatory Risk-Based Capital from the Implementation of FAS 166 and FAS 167

(Abridged Version)

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Executive Summary:

On June 12th, 2009, the Financial Accounting Standards Board ("FASB") published Statements of Financial Accounting Standards No. 166 and 167 ("FAS 166 and 167"). These new standards amend Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* ("FAS 140"), and FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities* ("FIN 46(R)").

The new standards become effective in 2010 and will serve to address some of the weaknesses in accounting and disclosure relating to off-balance sheet transactions.

Historically, the criteria for determining sale treatment of an off-balance sheet transaction under Regulatory Accounting Principles ("RAP") has been linked to the criteria used to determine sale treatment under Generally Accepted Accounting Principles ("GAAP"). Should such a linkage continue to be applied in the wake of FAS 166/167, a significant amount of the $11.5 trillion[1] of currently outstanding Asset Backed Securities ("ABS") and Mortgage Backed Securities ("MBS") will be returned to issuer balance sheets, **potentially requiring hundreds of billions of dollars of additional risk-based capital to be held against those assets, thereby exacerbating the pro-cyclical tendencies within our financial system, that serve to impede this country's economic recovery.**

To mitigate the impact, many financial institutions *whose risk profiles in substance remain unchanged* will be forced to either raise additional capital or further reduce loan balances. Such actions will have negative effects on the economy in that they will respectively cause increased costs of credit and reduced supply, impeding recovery of the U.S. housing market and potentially stifling the broader economic recovery.

In addition to depressing regulatory capital ratios by significantly increasing risk-weighted assets in the denominator, consolidation will affect the numerator by requiring recognition of potential future losses in the form of a larger loss allowance. This could result in the accounting change having an even more severe impact on capital ratios than anticipated. As a consequence, some issuers to feel compelled to elect Fair Value accounting as the basis for measuring assets and securities that are returned to their balance sheets. Such a basis of valuation – because it discounts expected losses and accounts for expected revenues – may be both less capital intensive and more consistent with historical treatment of off-balance sheet securitization. While a fair value ("FAS 159") election is permitted under FAS 166 and 167, such an approach would present inconsistencies with the current treatment of similar on-

[1] The source of this data is SIFMA as of Q2 2009. This included $6,623.3 billion of agency MBS or Collateralized Mortgage Obligations (CMOs), $2,325.3 billion of non-agency MBS, $354.7 billion backed by home equity loans, $307.5 billion backed by credit card loans, $241.5 billion backed by student loans, $132.0 billion backed by automobile loans, $18.9 billion backed by manufactured housing and $1,479.0 billion backed by miscellaneous other receivables. The $1,479.0 billion miscellaneous category includes collateralized debt obligations (CDOs) and numerous smaller asset classes. The assets underlying the CDOs include other asset-backed securities (CDOs of ABS), some or all of which might be viewed as double counting with other ABS outstandings.

balance sheet assets and securities and would create a potential need for a large-scale overhaul of the current regulatory risk-based capital framework.

In order to ensure that issuers react to the potential consolidation of assets and securities in a manner that prevents any detrimental impact to the nation's economy, while simultaneously allowing the joint agencies sufficient time to consider revisions to the current risk-based capital rules and to engage the industry in meaningful dialogue without feeling rushed to present a solution, we recommend: that implementation of FAS 166 and 167 be delayed for at least one year [2]; and that banking regulators consider ways to prevent unintended consequences of the transition to new accounting standards for institutions whose risk profiles remain unchanged and whose capital is today considered more than adequate.

We also recognize that the issuance of a Notice of Proposed Rulemaking ("NPR") from the joint supervisory agencies is imminent. With this in mind, we would make the following requests:

i. Should the implementation of FAS 166 and 167 not be delayed, we would recommend that regulators, concurrent with the issuance of the NPR, provide short-term guidance aimed at preventing issuers from taking actions before the rule-making process has been concluded – *specifically we propose a 6-month grandfathering period, extending regulatory off balance sheet treatment until June 30, 2010 to allow the NPR process sufficient time to evaluate permanent risk-based capital treatment of securitizations and any associated longer-term transition relief.*

ii. The rule-making timeline be appropriately set to provide regulators with time to develop a more comprehensive set of rules to:

    a. Evaluate, with support from the industry, the full extent of risk transfer across the securitization industry and, where appropriate, divorce RAP and GAAP criteria – *specifically we propose the current requirement for GAAP sale treatment as a pre-requisite for RAP sale treatment be removed from the existing risk-based capital rules.*

    b. Assess the impact to issuers of having to create loan loss reserves against assets for which there is no contractual risk of loss – *specifically we propose loan loss allowances pertaining to securitized assets be given Tier I credit for risk-based capital purposes.*

    c. Give specific consideration to other unintended consequences of the new accounting standards, such as disallowable Deferred Tax Asset ("DTA") balances – *specifically we propose a 3 year exception for any DTA balances created as a consequence of FAS 166 and 167 related loan loss allowance build, whereby such additional DTA balances are granted Tier I credit throughout the exception period.*

[2] Any postponement would not include already implemented changes to disclosure requirements

d. Deal with new fair value rules and allow institutions time to plan changes to capital levels and structures with both a fuller understanding of the accounting and regulatory end-game and in a less punishing capital markets environment – *specifically we propose new regulatory risk-based capital requirements are written in a manner that will be neutral to the basis upon which they are valued under GAAP.*

e. Evaluate the risks associated with different asset classes and securitization structures and to appropriately differentiate risk weightings according to such risks – *specifically we propose future risk weightings of securitized assets bias any relief towards more simple structures that transfer risk in a straightforward manner and that contractual recourse obligations are weighted more heavily than non-contractual obligations.*

Summary arguments pertaining to the above requests are highlighted below:

Detailed Recommendations Related to Notice of Proposed Rulemaking and Transition Guidance:

We recommend that regulators, concurrent with the issuance of the NPR, provide short-term guidance aimed at enabling issuers to avoid taking actions that would be adverse to the nation's economic recovery, before the rulemaking process has been concluded:

With the issuance of any NPR being only 4 months in advance of the implementation of FAS 166 and 167, it is unlikely that the rule-making process, including any transition guidance, may be concluded early enough to prevent issuers from taking aggressive steps to maintain their capital levels.

In order to extend the 4 month window, should the implementation of FAS 166 and 167 not be delayed, we would recommend that regulators consider a 6-month grandfathering period, whereby all off balance sheet transactions outstanding at December 31, 2009 are deemed to continue to be off-balance sheet for regulatory risk-based capital until June 30, 2010. This is a simple measure, which would allow the rule-making timeline to be appropriately set to provide regulators with time to develop a more comprehensive set of rules, with full industry participation.

Such rules will need to give full consideration to the following factors:

The new accounting rules have moved away from risk transference as a basis for off-balance sheet treatment and it is therefore appropriate for regulators to reassess RAP and GAAP criteria:

While we appreciate that regulatory risk-based capital rules may need amendment to prevent some of the capital arbitrage activities that have occurred in the past, especially relating to some of the more opaque and complex structures that were in part responsible for the current financial turmoil, the existing policy of linking RAP to GAAP feels inappropriate post implementation of FAS 166 and 167.

The current FAS 140 and FIN 46(R) standards focus on risk retention as their consolidation criteria whereas the new accounting standards use control as the primary criteria. As a matter of policy, we believe that regulatory risk-based capital rules should be founded upon risk retention and therefore the new standards are inappropriate for the purposes of determining risk-based capital. We would further contend that to re-assess capital adequacy as a consequence of an accounting change could challenge the credibility of the U.S. regulatory risk-based capital rule making process from a policy perspective. Any proposed increases to systemic capital levels should be based upon a grounded assessment of the economic risk that an issuer bears, as opposed to its prescribed accounting treatment.

Additionally, the current regulatory risk-based capital rules post FAS 166 and 167 implementation will actually cause more capital to be held against assets system-wide than would have been held had the assets never been securitized. We believe the systemic amount of risk pre-securitization is equal to the systemic risk post-securitization and therefore, while we are supportive of some increase to systemic capital levels as a consequence of the increased risk demonstrated over the last 2 years, we would caution that the new accounting standards are in danger of causing overcapitalization within the system.

The continued linkage between RAP and GAAP will also result in a competitive disadvantage for U.S. financial institutions, particularly versus European banks whose regulators divorce regulatory capital requirements from accounting sale.

Furthermore, some of the institutions that will be most affected by this accounting change are already reliant upon the U.S. government to support capital shortfalls. Six trillion dollars of the $11.5 trillion assets referenced above are issued by governmental agencies including Fannie Mae and Freddie Mac. Coupled with those banking institutions and finance companies that are also reliant upon TARP and other government liquidity programs, **the incremental burden on the U.S. taxpayer to bridge any capital deficiencies has the potential to equal or exceed the amounts already committed by taxpayers via the TARP, TALF, PPIP, and other programs**.

The current regulatory risk-based capital framework needs to be adjusted to assess the impact to issuers of having to create loan loss reserves against assets for which there is no contractual risk of loss:

On the basis that securitization issuers are not susceptible to the full amount of the losses on an asset and that loan loss reserves serve a similar function to capital, we would propose that loan loss allowances pertaining to securitized assets be given specific Tier I credit for risk-based capital purposes.

The current regulatory risk-based capital framework does not adequately address the quasi-capital nature of loan loss allowances. While building forward-looking loan loss allowances to cover probable and estimable losses does not necessarily reduce the level of unexpected losses, the building of allowances is by its very nature pro-cyclical and – whenever we approach the turn of the credit cycle – creates the highest level of risk-bearing capacity just when capital is most expensive and the need for it proves to be the least important. Current capital guidelines severely restrict the credit given for this ebb and flow relationship between expected and unexpected losses and, when allowance and capital are aggregated together, can cause potential for a pro-cyclical increase in capital to cause redundant capital to be built at the peak of a recession rather than upon the initial entrance into a worsening economic cycle.

The accounting consolidation of potentially trillions of dollars of assets together with their associated build of loan loss allowance will exacerbate this pro-cyclical conundrum at the point in the economic cycle where systemic capital levels are expected to be at already strained levels.

This issue is further compounded by the fact that loan loss reserves are an accounting driven concept derived under the application of Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* ("FAS 5").

However, FAS 5 was written without consideration of the securitization market and therefore without regard to the specific linkages between securitized assets and the related asset-backed securities.

Application of FAS 5 against a securitization transaction will require a loan loss reserve to be created by the issuer against a risk of loss for which the issuer bears no contractual obligation. We would contend that while the accounting requirements related to loan loss provisioning may create a nonsensical and misleading entry in the financial statements of an issuer, the regulatory agencies should assert their power in looking through GAAP treatment of the provision and recognizing that a provision that protects an issuer from a non-existent risk of loss should be treated as capital.

The rule-making process needs to give specific consideration to other unintended consequences of the new accounting standards, such as disallowable DTA balances:

Most financial institutions carry DTAs on their balance sheets as a consequence of timing differences between taxable income and book income recognized under GAAP.

Specifically, in the case of loan loss allowances, banks will recognize an expense for the full amount of any allowance at the time the allowance is booked. However, banks only receive an income tax deduction for losses at the time they are actually written off. The deferral of this tax relief is recognized under GAAP as a DTA balance.

While the recognition of the DTA under GAAP is already subject to stringent auditor verification that the asset will be realized, existing regulatory risk-based capital rules restrict the amount that may be viewed as Tier 1 capital. DTAs that are dependent upon future taxable income are limited based upon expected earnings over the forthcoming year and 10% of the bank's Tier 1 capital.

We believe these regulatory restrictions are too limiting as the recognition of the asset under GAAP is already subject to prudent auditor evaluation. We would therefore contend, in the case of DTAs, that the GAAP standard of recognition is appropriate for risk-based capital purposes.

Upon the implementation of FAS 166 and 167, the building of additional loan loss reserves during a period where loan loss reserves are already at historically high levels and institutions' earnings are similarly subdued will cause the creation of additional DTAs on a company's balance sheet, which will not be allowable for regulatory risk-based capital purposes.

Notwithstanding the current limits surrounding DTAs, *we would propose a temporary three-year exception relating to DTA balances that are created as a consequence of the additional loan loss reserves created as a direct result of FAS 166 and 167, whereby such additional DTA balances are treated as "allowable" for regulatory risk-based capital purposes*

The rule-making process needs to deal with new fair value rules and allow institutions time to plan changes to capital levels and structures with both a fuller understanding of the accounting and regulatory end-game and in a less punishing capital markets environment:

The forthcoming FAS 166 and 167 are subject to further evolution over the next few years as FASB continues with proposed changes to asset valuation standards and IASB continues with projects around both consolidation and valuation. This leaves the potential for GAAP treatment of securitized assets to be subject to repeated change. We believe potential for fluctuation of an entity's capital adequacy to be driven by repeated changes to accounting standards will undermine confidence in an already fragile banking industry and make it extremely difficult for financial institutions to act with any degree of certainty.

FAS 166 and 167 offer three alternative valuation methodologies. If the current linkage between RAP and GAAP is maintained, there is potential for different capital assessments to be made against identical economic risks, based purely on an issuer's elected valuation methodology. For instance, some issuers may adopt fair value accounting, recognizing FASB's apparent focus on moving to a fuller fair value environment. However, regulators are not well prepared for a large scale move of accrual book assets into a fair value treatment and may not like the implications to capital or to consistency across institutions which make different elections.

Future regulatory risk-based capital rules need to evaluate the risks associated with different asset classes and securitization structures and to appropriately differentiate risk weightings according to such risks:

Recent policy statements and testimony issued by various regulatory agencies have made it clear that issuers should, post FAS 166 and 167 implementation, expect to bring any assets consolidated under GAAP back onto their balance sheet for risk-based capital purposes. As stated previously, we agree that systemic levels of capital do need to be increased across the securitization industry. However, we would recommend that future regulatory risk-based capital guidance differentiates appropriately across the multiple asset types and structures in the market place, notably:

- Simple structures that transfer risk in a straightforward manner should be differentiated from more opaque structures and re-securitizations, which have demonstrated an increased level of risk.
- Appropriate differentiation of those structures that include “mandatory support obligations” e.g. mandatory liquidity puts versus the potential for “optional support” should be made, i.e. more capital should be required for mandatory recourse obligations versus optional or implicit recourse.
- Even for those issuers that have previously supported transactions e.g. some credit card issuers and ABCP conduits, it should be recognized that there is no continuing obligation to support transactions beyond existing levels. Asset risk weightings, while being increased from current levels, should therefore reflect the absence of any ongoing support obligations.

Conclusion:

For the reasons identified above, we would propose that actions are necessary to prevent an unnecessary burden being placed today upon an already struggling economy. Preferably such action would be to delay the implementation of FAS 166 and 167 until January 2011, giving banks an opportunity to build capital in a less punishing economic environment, simultaneously allowing FASB to align its current position with its longer term goals surrounding fair value accounting and international convergence. This would also allow additional time for regulators to develop a more fulsome framework based on a complete understanding of where GAAP is headed.

As a less preferred alternative, we would advocate that regulators implement some combination of grandfathering and a suitable transition period to ensure that the immediate capital needs deriving from the new accounting standards are not subjected to pro-cyclical effects. This would allow banks to build capital in a controlled and deliberate manner and avoid the potential for increased costs and a reduced supply of credit at a time when the economy can ill afford such impacts.