

SECTION II: STANDARDS FOR ACCOUNTING CONSOLIDATION

A. Introduction

It is widely recognized that a major contributing factor to the credit market crisis was the manner and extent to which risks associated with certain classes of off-balance sheet activities at many financial institutions may not have been adequately encompassed within firms' risk monitoring and risk mitigation frameworks. Thus, when contingent risks arising from such off-balance sheet activities were triggered, this gave rise to elevated contagion risk and large write-downs at many financial institutions.

To a very considerable extent, both the demand for and the supply of the structured credit products that were often housed in off-balance sheet special purpose vehicles were driven by the "reach for yield" investment phenomenon, which characterized the three to four year period leading up to the credit market crisis. In some cases (for example, securitizations), regulatory arbitrage was a factor since Basel I (the prevailing capital standard when the build-up of these activities occurred) called for little or no explicit capital charges for certain arrangements with off-balance sheet vehicles.

A similar phenomenon existed for loan commitments. In the cases of conduits and SIVs, substantial maturity mismatches were common as long-term assets were being financed by short-term asset-backed commercial paper, encouraged by the implicit belief that ready access to such financing would always be there. And, in the case of many bank-sponsored conduits there were explicit arrangements whereby the sponsoring bank was committed to provide back-up financing in the event that commercial paper financing was not available. In other cases, these arrangements were regarded by market participants as implicit and based on the belief that reputational risks were such that sponsors would provide back-up financing even in the absence of an explicit arrangement.

Clearly, an important contributing factor was the idiosyncratic consolidation rules under U.S. Generally Accepted Accounting Principles (US GAAP). There are various relevant accounting standards under US GAAP which determine whether an entity is on or off the balance sheet. These rules are extraordinarily complex and their interpretation can only

be mastered by highly skilled and experienced professionals. The discussions on pages 41, 47 of this Report provide several examples of the workings of US GAAP consolidation rules. These examples are designed to provide insight into the application of these rules for readers who are not experts in this field.

For the purpose of this introduction, it is sufficient to note that securitization vehicles considered to be “Qualifying Special Purpose Entities” (QSPEs) receive off-balance sheet treatment even if the sponsoring entity provides credit enhancements by retaining a significant residual interest in the securitization trust (*i.e.*, the sponsor is expected to absorb the majority of the risks and rewards). The rationale for off-balance sheet treatment is that the vehicle is passive and therefore the sponsor does not control it.

Currently, the Financial Accounting Standards Board (FASB) is in the very advanced stages of preparing to issue for public comment further revisions to the current consolidation rules. It is widely expected that the proposed revisions will substantially modify the existing rules in ways that will require many vehicles that currently qualify for off-balance sheet treatment under current US GAAP to come onto the balance sheet of sponsoring institutions.

As an extension of this discussion, it should be noted that for banks and other financial institutions that operate under International Financial Reporting Standards (IFRS), the International Accounting Standards Board (IASB) is also re-examining its consolidation standards. The Policy Group encourages the FASB and the IASB to work together on cross-border convergence of accounting standards with a more principles-based orientation in this area.

Obviously, the new US GAAP consolidation rules – assuming they take the general form that is expected – will have profoundly important implications for many institutions in terms of balance sheet size and may have a material impact on regulatory capital requirements for certain institutions. However, the consolidation of off-balance sheet vehicles will not, in most circumstances, have a major impact on regulatory capital requirements for institutions using risk-based capital standards such as Basel II. This is because the risk absorbed by the sponsors, for example via their retention of the residual interests in a

securitization trust, is already appropriately captured in explicit capital charges under Basel II.

For affected institutions, the accounting changes will have an impact on reported leverage ratios which will, in many cases, rise appreciably. This will be consequential to institutions that are subject to regulatory leverage constraints, notwithstanding the fact that risks carried by these institutions may already be subject to capital charges. This result is peculiar since, by definition, changes in accounting conventions are not economic and therefore should not generally have economic consequences. This is still another example of the fact that leverage ratios tell us a lot about arithmetic but little about financial and economic reality.

The Policy Group is mindful of the profoundly important and demanding implications of the likely revisions to the US GAAP consolidation rules. Nevertheless, the Policy Group endorses, in principle, the direction of these changes provided they are (1) principles-based, (2) convergent with IFRS, and (3) accompanied by suitable disclosure and transition rules regarding regulatory capital which will provide flexibility in the implementation of these rules over a reasonable period of time.

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The following is a technical discussion on accounting consolidation, its effects on financial reporting, and the Policy Group's recommendations for improvements to consolidation accounting and disclosure. In formulating its recommendations on accounting consolidation, and as discussed in other parts of this Report, the Policy Group elected not to address the issue of fair value accounting.

B. Basics of Consolidation

Consolidation is the process by which the financial statements of a parent are combined with those of its subsidiaries, as if they were a single economic entity. Consolidated results are considered more useful in the decision-making process of users of financial statements, such as investors and creditors. For example, consolidation of a traditional operating subsidiary provides more accurate information on the revenues and expenses

of the parent so that users have a better understanding of how net earnings were achieved. Consolidation of a securitization vehicle provides information on the use of leverage in financing a securitization. Because consolidation policies determine when an enterprise's involvement with another entity gives rise to a parent-subsidary relationship, consolidation principles become vitally important to financial statement reporting.

Consolidation can, however, obscure those assets and liabilities that are truly impacting the economic performance and financial position of the consolidated enterprise. For example, the assets and liabilities, revenues and expenses, and cash flows of a subsidiary are typically reported in the financial statements of the parent, as if the parent is at risk for the entire change in value of those assets and liabilities, even though this may not be true as an economic matter. Additionally, assets financed via non-recourse debt are often aggregated with assets for which the enterprise is fully exposed to risk. Moreover, as consolidation increases the size of the balance sheet, the aggregation of similar items can obscure individual amounts. Consequently, transparent display, reporting, and footnote disclosures in the financial statements are crucial to providing a clear picture of the consolidated enterprise.

C. US GAAP Consolidation Rules

Under US GAAP, there currently are three consolidation models for determining when a parent-subsidary relationship is present, each based on the type of entity an enterprise is involved with. The three types of entities are: (1) voting entities, (2) variable interest entities (such as special purpose entities (SPEs)), and (3) QSPEs.

1. Voting Entities

Consolidation policy under US GAAP for voting entities was codified in 1959 with the issuance of a standard that requires an enterprise to consolidate an entity it unilaterally controls through majority voting interests. If no investor has the ability to control a voting entity, no one consolidates.

To illustrate the consolidation analysis under US GAAP for a voting entity, consider the following example:

Example 1 – Traditional Business

Facts:

An entity is a business with employees, assets and activities that produce revenues and expenses.

The entity is sufficiently capitalized with equity and its owners have the ability to make decisions in proportion to their ownership interests.

The owners are exposed to first loss and have the rights to receive any residual returns.

Analysis:

Under US GAAP, this entity is analyzed for consolidation under a control model as described above. An owner having majority control (typically, through ownership of voting common stock) would consolidate in this example.

The standard for voting entities was written for traditional businesses, long before the advent of structured finance and special-purpose entities. Therefore, no guidance existed for consolidation of structured finance or special purpose entities for which voting power was not meaningful in determining control. Over time, practice developed and certain bright-line rules were enacted that related to specific fact patterns involving SPEs.¹ In practice, these brightlines were analogized to many different situations, and sometimes

¹ A common example of a bright-line rule created during this period relates to off-balance sheet leasing transactions where a minimum of 3% of third party equity was determined to be substantive for purposes of analyzing whether an SPE should be consolidated. Enterprises would transfer real property to an SPE, obtain third party financing, and obtain 3% equity from a third-party investor. The resulting accounting analysis would enable the enterprise to report the real property and financing as an operating lease, that is, off-balance sheet rather than an on-balance sheet financing.

inappropriately used by enterprises to structure entities to avoid consolidation. This created the need for specific rules governing SPEs or, as they later became known, “variable interest entities”.

2. Variable Interest Entities

The concept of a variable interest entity was introduced in 2003, in the wake of Enron. At the time, regulators were pressing for updated accounting guidance that would address the abuses observed in the accounting for SPEs. In response, the FASB issued an interpretation of the 1959 standard, which effectively created a new model for consolidation. The model identified the characteristics of what the FASB termed a “variable interest entity” (VIE), an entity consolidated based on risks and rewards, to differentiate it from a “voting entity” – an entity that would continue to be evaluated for consolidation based on “voting control”.

A VIE is a separate legal entity that has any of the following characteristics: (1) insufficient US GAAP equity to absorb “expected” losses, that is, not “actual” losses, (2) owners are shielded from losses or returns are capped, or (3) an inability by owners to make substantive decisions that drive the success of the entity.

A variable interest holder has an interest in a VIE that absorbs some or all of the expected losses or gains of the entity. Examples of variable interests include common and preferred shares, partnership interests, subordinated debt, guarantees, and certain derivative instruments. A variable interest holder absorbing the majority of expected losses or gains of a VIE consolidates the entity. The determination of expected losses or gains is based on a formula² and requires scenario analysis of projected cash flows or changes in fair value. The analysis can be performed on a qualitative basis when the

² To illustrate the formula for calculating expected losses with a simple example, consider an investment of \$100 with only two expected outcomes: the investment can return \$200 or zero. Each outcome has a 50% probability. The expected (probability-weighted) cash flows from the investment are therefore \$100 [(\$200 x 50%) + (\$0 x 50%)]. The expected loss and gain from the investment (probability-weighted variance around the mean) is negative \$50 [(\$0 - \$100) x 50%] and positive \$50 [(\$200 - \$100) x 50%], respectively. If the fair value of US GAAP equity is less than \$50, then the equity of the entity would be “insufficient” and the entity would be deemed a VIE. A variable interest holder absorbing the majority of the \$50 of expected losses would consolidate the VIE. If no variable interest holder absorbs the majority of the \$50 of expected losses or gains, no one consolidates the VIE.

facts are clear and conclusive. However, in other cases (for example, multi-seller Asset-Backed Commercial Paper conduits (ABCP Conduits)) the analysis can require calculations involving complex models that generate thousands of scenarios.

The VIE analysis is performed at the date of initial involvement with an entity and reconsidered only upon certain events. Actual losses in excess of expected losses are not a “reconsideration event,” even if losses significantly reduce the value of equity. Examples of reconsideration events include additional investments into the entity, refinancing of existing debt, and significant changes to governing documents or business activities. CDOs, SIVs, and ABCP Conduits are examples of entities that are typically structured as VIEs.

To illustrate the consolidation analysis under US GAAP for a VIE, consider the following example:

Example 2 – Asset-Backed Commercial Paper Conduit (“ABCP Conduit”)

Facts:

A company sells receivables to an ABCP Conduit managed by a sponsoring bank.

The ABCP Conduit issues commercial paper (CP) to investors to finance the acquisition of the receivables. Repayment of the CP is dependent on receivable collections and the issuance of new CP upon maturity.

The sponsoring bank’s responsibilities can include serving as the ABCP Conduit’s administrative agent, CP placement agent, program-wide credit support provider (for example, a guarantee or letter of credit) and, importantly, as the CP backstop liquidity provider.

The sponsoring bank arranges the sale of “first loss notes” to third party investors. These notes are insignificant in size (generally 10 basis points) and are structured to absorb a majority of the ABCP Conduit’s expected losses. These notes would not be recognized as US GAAP equity.

Analysis:

Under US GAAP, the ABCP Conduit would be considered a VIE because it lacks sufficient US GAAP equity. Initially, the sponsoring bank would not consolidate the ABCP Conduit because it does not have a majority of the expected losses and gains as a result of the sale of the first loss notes to third parties. The sponsoring bank's power to control the ABCP Conduit would not be considered in the analysis because the VIE model is based solely on an analysis of risk and rewards. Because of the revolving nature of the CP issuance, the sponsoring bank may be required to reconsider, on at least a quarterly basis, whether it holds a majority of the expected losses and gains through its program-wide credit support and backstop liquidity facilities.

The VIE model contains several scope exceptions, none more significant than the exception for QSPEs.

3. Qualifying Special Purpose Entities

SPEs are generally used in securitizations to achieve legal isolation in the event of bankruptcy. These entities are generally created with a single purpose and have very limited operational duties and discretionary powers, that is, they generally are passive in nature. The operations of SPEs are generally limited to collections of principal and interest on passive assets and distributions of the cash flows to the beneficial interest holders in the entity based on a predefined formula.

In connection with an accounting standard issued in 1996, the FASB decided that transfers of financial assets to SPEs that meet the above description and certain other "qualifying" criteria, would receive off-balance sheet or "sale accounting" treatment. Although QSPEs generally have several characteristics of VIEs, QSPEs were specifically excluded from the VIE consolidation model, given their passive nature. As a result, no party consolidates a QSPE. In practice, securitization vehicles that hold credit card receivables, automobile loans, residential mortgages and commercial mortgages are generally structured as QSPEs so as to benefit from the off-balance sheet treatment.

To illustrate the consolidation analysis under US GAAP for a QSPE, consider the following example:

Example 3 – Residential Mortgage Securitization

Facts:

A sponsoring bank sells a pool of residential mortgage loans to a bankruptcy remote securitization trust (Trust).

The sponsoring bank provides credit enhancement through the retention of a residual interest in the Trust.

The residual interest is expected to absorb the majority of the risks and rewards of the mortgage loans. The sponsoring bank also retains the right to service the mortgage loans, but the entity is otherwise passive.

The Trust issues tranching debt securities to finance the purchase of the mortgage loans. There is no substantive equity issuance.

Principal and interest collections on the mortgage loans are distributed to holders based on a predetermined formula designed to achieve specified credit risk profiles for each tranche.

Analysis:

US GAAP currently states that no party consolidates a QSPE. If the Trust is a QSPE (as is typically the case for residential mortgage securitizations), the sponsoring bank would receive off-balance sheet treatment, irrespective of its ability to service the assets and its holding of the residual interest. If the Trust is not deemed a QSPE, the Trust would be deemed a VIE, and the sponsoring bank generally would consolidate the Trust because, as the holder of the residual interest, the sponsoring bank has a majority of the risks and rewards of the Trust.

A significant issue raised in the development of the QSPE model was the level of discretion required to service the assets held by a QSPE. The issue of servicer discretion was highlighted during the current subprime residential mortgage crisis as assets defaulted at higher than expected rates and greater discretion was required to service what were previously deemed “passive” assets. The possibility of heightened servicer discretion has called into question the QSPE model.

D. US GAAP Disclosure Rules

There currently is no single framework for disclosure of off-balance sheet activities in US GAAP. Rather, disclosure rules are promulgated on a standard by standard basis, usually in response to a perceived weakness highlighted by an event in the marketplace. Current disclosure requirements, although numerous and complex, are heavily prescriptive and generally rules-based. Therefore, disclosures are generally not applied by analogy to situations that do not have a specific “rule” for disclosure. Disclosure requirements also tend to overlap in certain areas (generally, where more accounting guidance was provided by standard setters), and gap in other areas. This creates unnecessary complexity and is not conducive to providing clear and transparent disclosures.

Consider the following example of the limitations associated with current disclosure rules under US GAAP:

Example 4 – Disclosure of Retained Interests in Securitizations

Disclosure Requirement:

The disclosure requirements for retained interests from securitization activities include disclosure of the fair value of such retained interests at the reporting date, the weighted average maturities and sensitivities to changes in key valuation assumptions, disaggregated by type of instrument (for example, mortgages vs. corporate debt).

Disclosure Limitations:

This disclosure does not provide a comprehensive view of enterprise-wide risk. Particularly, the scope focuses only on retained interests and does not consider an

enterprise's purchased interests. Retained interests are generally a small subset of total assets for a financial institution. Further, the scope specifically excludes related hedges, and fair value sensitivities do not account for simultaneous changes in inputs.

Similar limitations exist in various other standards that require specific disclosures about financial instruments and related risks, such as, but not limited to, disclosure regarding VIEs and derivative guarantees.

E. Current Developments in US GAAP Consolidation and Disclosure Rules

The FASB is in the process of amending its consolidation standard for VIEs and QSPEs, with a goal of issuing final standards with an effective date in 2010. Additionally, disclosure requirements will be enhanced with an effective date as soon as possible.

The FASB is proposing to eliminate the concept of QSPEs. Moreover, the consolidation model for VIEs is expected to become more qualitative in nature, specifically related to the assessment of whether a variable interest holder has control over a VIE, either through substantive decision-making power or exposure to a majority of the risk and rewards. This assessment will no longer be limited to inception and specific reconsideration events but will be analyzed each reporting period. The amended US GAAP consolidation model is expected to generally align with the current IFRS model,³ that is, an assessment of control and risk and rewards.

³ IFRS has a single model for consolidation: the control model. The IFRS control model has two parts, both of which must be met in order to conclude that one entity controls another. A controlling entity must have the power to govern the financial and operating policies of an entity, so as to obtain benefits from its activities. IFRS provides additional control indicators to consider when determining whether control over an SPE exists. These indicators include the concept of control described above as well as a consideration of which party absorbs a majority of the risks or rewards. The indicators are considered in the context of all relevant factors. Judgment is used to conclude which party in substance has control over the SPE. Acknowledging current events in the financial markets, the IASB is also in the process of updating its standard on consolidation. The changes are expected to endorse and clarify the current stated principles and focus on application guidance to improve comparability.

The result of these changes is expected to significantly increase the recognized balance sheets of financial institutions that sponsor and underwrite securitizations. This will be primarily due to the elimination of the QSPE model. The increase in balance sheet size will highlight the need for adequate financial statement presentation and disclosures to disaggregate and explain the consolidated balance sheet, for example, linking consolidated assets with related consolidated liabilities.

There also will be income statement effects, as consolidation will increase reported revenues and expenses. Consolidation could also impact reported earnings if it results in the elimination of previously recognizable profits or losses, which would now be viewed as intercompany in nature and therefore not recognizable under US GAAP. Additionally, these changes are expected to have broad implications for many other areas outside of financial reporting such as regulatory capital ratios, debt covenants, and other contractual obligations.

F. Recommendations for Consolidation and Related Disclosure Principles

The current consolidation rules under US GAAP have not been wholly effective at providing decision-useful information to the capital markets. Moreover, the current financial statement disclosure rules have been inadequate in bridging the gap between the consolidated financial statement and an enterprise's economic exposure to risks.

The current US GAAP consolidation rules lack a single principles-based model for consolidation. Rather, an enterprise is required to first assess which consolidation model is applicable to its interest in an entity and then determine whether an entity should be consolidated based on the rules within the applicable model. The rules for consolidation across those models are not symmetrical: one model is based solely on control, one model is based solely on risk and rewards, and the third is a scope exception for passive SPEs. It is understandable, therefore, that users of US GAAP consolidated financial statements are confused about the meaning of reported amounts in consolidated financial statements.

Additionally, the framework for each of the models is rules-based and at times focuses less on the substance of an enterprise's involvement with an entity and more on its form. A clear example of this would be the rule for calculating expected losses under the VIE model, where a quantitative outcome determines control without any further qualitative analysis of other known control factors. Moreover, the VIE model does not require reconsideration of the consolidation analysis at each reporting period. Therefore, a VIE remains off-balance sheet under an initial consolidation conclusion, even if the assumptions initially applied were not predictive of actual results.

US GAAP has prescriptive disclosure requirements on exposure to VIEs, retained interests in QSPEs, and derivative instruments. However, each rule does not build on a principle that requires a holistic look at the reporting enterprise. Therefore, these rules have not been entirely successful in providing users of the consolidated financial statements with a complete picture of a financial institution's exposure to risks. Looking ahead, the developing changes to the consolidation rules are expected to result in a significant increase to the balance sheets of financial institutions. As a result, robust and holistic disclosures will be required to enable users to dissect the information reported in the consolidated financial statements.

Recognizing the pressing need for changes to the US GAAP consolidation and disclosure rules, the Policy Group recommends as follows:

Recognition Framework Recommendations

- II-1.* The Policy Group endorses, in principle, the direction of the changes to the US GAAP consolidation rules provided that the changes are (1) principles-based, (2) convergent with IFRS, and (3) accompanied by suitable disclosure and transition rules regarding regulatory capital which will provide flexibility in the implementation of these rules over a reasonable period of time.

- II-2.* The Policy Group recommends adoption of a single, principles-based global consolidation framework that is based on control and the ability to benefit from that control. The analysis of whether an entity (the

investor) has a controlling interest in another entity (the investee) should be based on:

- the investor's power over the investee, including the ability to make decisions that determine the success of the investee;
- the degree of investor exposure to the risks and rewards of the investee, including through guarantees, commitments and all other explicit and implicit arrangements between the two entities; and
- the design and sponsorship of the investee, including the degree to which the activities of the investee expose the investor to commercial, legal, regulatory, and reputational risks.

II-3. The Policy Group further recommends that the new consolidation framework require a reassessment of the consolidation analysis each reporting period based on changes in the control indicators specified in the preceding recommendation.

II-4. The Policy Group encourages standard setters and industry participants to work together toward achieving the goals discussed in this section on a global basis as soon as possible.

Disclosure Framework Recommendations

II-5. The Policy Group recommends that standard setters and industry participants consider a holistic and principles-based approach to disclosure of off-balance sheet activities similar to that found in international standards. The disclosure framework should be fully integrated with enterprise-wide disclosures across the full spectrum of risks: market, credit, liquidity, capital, operational, and reputational.

Enterprise-wide disclosure should be supplemented with detailed information that links to enterprise-wide disclosures and that changes in response to changing risks and uncertainties; for example, in the current environment, disclosures about residential and commercial real estate and leveraged loan exposures.

- II-6.* The Policy Group recommends that firms provide tabular disclosures about the effects of restrictions on the use of consolidated assets, non-recourse liabilities, and minority interests.

The following are some examples of consolidated assets and liabilities for which additional disclosure may be necessary in order to bridge the gap between the amounts reported in the consolidated financial statements and an enterprise's economic exposure to risk:

- risk exposure to consolidated assets absorbed by minority investors;
- linking of consolidated assets to non-recourse financings on a disaggregated basis; and
- hedges and other risk management tools used to limit or participate in exposure to consolidated assets or liabilities.

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