



Securitization Adds Up The Cost of Accounting Reform

At its worst, argue some market participants, FAS 166 and FAS 167 will spell the death of securitization. But beyond the hyperbole, what do the proposed changes to accounting standards really mean for securitization and for the broader economy? And can the industry successfully make its case to lawmakers and regulators that the new accounting regime will do more harm than good? Leading industry figures recently gathered at ASF headquarters to debate and discuss the road ahead.

The Panel:

The Moderator

Antony Currie – American Securitization

The Accountant

Ann Kenyon – Deloitte

The Advisers

Craig Shallcross – LCP Capital
Debbie Toennies – JPMorgan

The Issuers

Richard Johns – Capital One
Gregg Silver – First Financial
Funding & Investment

The Lawyers

Jason Kravitt – Mayer Brown
Kenneth Marin – Chapman and Cutler

ABS gives them the lowest cost of funding, and they may all decide to go that route.

I can understand where Jamie is coming from. My suspicion, though, is that JP is not going to walk away totally from the ABS market.

Antony Currie: What's the thinking at JPMorgan, Debbie?

Debbie Toennies: My understanding is that, as Richard pointed out, it will depend on where spreads are at the time and the relative advantage of that form of financing as an alternative source of liquidity to the company.

Jason Kravitt: Issuers have had many reasons for securitizing. The four biggest were balance sheet management, capital management, liquidity and risk transfer. The accounting changes ought normally to affect only balance sheet management, not capital management. But since the federal bank regulators have put out a proposal more closely tying capital to accounting, accounting now is like a comet that drags all the dust and rocks behind it.

But you still have risk transfer, and you still have liquidity, and while I agree that you've got to look at your overall circumstances and decide when it's advantageous to fund in the securitization market or not, liquidity isn't just about tapping the cheapest finance. It may be that you have sufficient volume that you need to have alternative forms of liquidity. You attract different investors to buy unsecured CP or term debt to those who invest in ABS.

Kenneth Marin: There is a lot of doom and gloom among banks about securitization prospects — and rightfully so given the developments at FASB and the FDIC's NPR.

But that's not the case outside the banking world. For many non-bank finance companies, consolidation of securitized assets is not a major concern. So long as there are no debt-to-equity ratio covenants in their corporate debt agreements that would be impacted by a change in balance sheet accounting, and so long as these companies are not pre-occupied with optics in their financial reporting, FAS 166 and 167 are not major impediments. Liquidity, diversity of funding and risk transfer are the main drivers for securitizing in the non-bank world, so we may see a robust securitization market return for these types of companies as the capital markets continue to thaw.

Ann Kenyon: While Ken's point is correct for many non-bank securitizers, there are many who are concerned that these transactions are coming back on balance sheet—they think that it is just bad financial reporting. Additionally, many are concerned that the regulatory capital ramifications will also result in making their facilities more expensive.

Antony Currie: Is the FDIC's decision to grant a six-month reprieve on raising capital against assets that are being brought back on balance sheets helpful?

Richard Johns: It's a question of what the moratorium means. Is it just a grandfathering of existing transactions, or will you continue to get off balance sheet treatment for whatever you do in the following six months? Will the moratorium extend just to risk-weighted assets, or will it also make an adjustment for the loan loss allowance and maybe give an exception to loan loss allowance as it pertains to securitized assets and adjust your Tier 1 capital as a consequence?

If they do things like that and also signal that beyond the six-month moratorium there will be a transition period that takes you to a point where the economy has begun to recover — in other words, well into 2011, instead of ending at the end of 2010 — you then have the ability for issuers to recognize that they will not have to raise capital now to deal with that issue.

Because if we put ourselves in a time machine and accelerate forward to January 1, 2011, are loan loss reserves going to be significantly different than on January 1, 2010? My suspicion is no, given that recent economic data seem to indicate, for example, that unemployment is topping out at 10%. Reserves may be a little lower as you look ahead to the remainder of 2011, but you are going to be in a situation where the capital effect of adding risk-weighted assets combined with the loan loss allowance is still going to be detrimental.

Issuers are not going to wait until the end of the reprieve in June before they act. They're going to act now. They already have. Look at the amounts raised in common equity and the hybrid markets. And balance sheets are being shrunk across the banking industry. If the regulators or the administration think they can wait until six or even 12 months down the line before taking action, it's not good news.

Ann Kenyon: The uncertainty is ultimately not helpful. To Jason's point, some organizations significantly impacted by the accounting changes might take a wait-and-see approach, and, if so, that may not benefit the credit markets.

Gregg Silver: Any kind of delay — and the longer the better — means that banks have more chance to create new capital without going to the markets. Holding retained earnings is far cheaper than going to the market and getting equity that way.

Antony Currie: And some actions banks are taking now might even be perpetuating the problem. A lot of banks have ramped up the amount of cash and liquid assets like mortgages on their balance sheets in the last year as they sit and wait to see how the rules shape up.

Richard Johns: Yes, the system's paralyzed by indecision at the moment. And sure, I recognize there's a lot of focus on why we should disclose what's off balance sheet, et cetera,

Antony Currie: Are new accounting rules killing off securitization? JPMorgan chief Jamie Dimon cited them on the bank's second-quarter earnings call last July when he said the firm, as of 2010, probably wouldn't issue any more credit card securitizations, largely because of new accounting rules.

Richard Johns: It really is a question of whether you need liquidity or not. If you look at what has driven securitization over the years, it's a combination of being able to avail yourself of low-cost financing combined with the capital relief and the ancillary earnings benefits from not having to hold loan loss allowance against assets that you have no contractual obligation to absorb losses for.

The latter two go away with the introduction of FAS166, FAS167 and the associated notice of proposed rulemaking (NPR). So it comes down to whether you need to use securitization as a funding tool. If we assume that the NPR comes down as the final rule in substantially the same form as it is now, then combined with FAS 166 and 167, you land in a situation where if you have alternative forms of liquidity that offer lower-cost funding than ABS, then you almost have an obligation to your shareholders to avail yourself of that liquidity. JPMorgan is probably coming from a perspective where they, as opposed to a lot of other institutions, have a pretty good liquidity outlook.

We're in a similar position at Capital One. If the cost of funds of securitization comes in dramatically, then we may look at it. But when you have branch deposits offering significantly lower cost of funds and you have to hold the same amount of capital against the assets funded by deposits as you would against assets funded by securitization, then why wouldn't you opt for the deposit funding?

For other issuers, it depends on what maturities are coming due, not just in ABS land, but in corporate and bank debt — and whether they are a bank or not. That's going to make a big difference. If they're not depository institutions, they may feel that even at wide spreads

but good God, if there was ever a time in history when people were aware of the risks of securitization, it's now. If there are still people who don't read the financial statements and don't look at the risks off balance sheet, they should think twice about whether they should be investing.

Stepping back from these rule changes would be an opportunity, what with all these TARP monies committed and all these sound bites about the cost to the taxpayer, to do



LCP Capital's Craig Shallcross

something that doesn't involve the government putting its hand in its pocket. It's a way to create some relief that will stimulate lending and reduce the cost of credit and help get this economy back on track. I get all the arguments from FASB and the regulators as to why they're going where they're going. But those are vastly outweighed by the potential impact to the economy of the new rules.

Jason Kravitt: Richard made a very good point about taxpayer money: Congress is worried that the economy is not improving fast enough, that unemployment isn't coming down fast enough, so they're thinking about spending another \$150 billion that we don't have. Letting securitization do its job would do far more for employment and the economy than spending another \$150 billion.

It's madness, and to say that a phase-in or a postponement is a solution flies in the face of Logic 101. If an action is wrong, phasing it in doesn't make it right. It may limit the negative effect, but phasing it in it doesn't turn it into something good if the rules don't make sense in the first place.

Antony Currie: What would you suggest be done to mitigate some of the effects of the rule changes?

Jason Kravitt: First of all, decouple risk-based capital from accounting. That used to be a very tough argument to make as accounting was focused on risk, and risk-based capital was focused on risk, or supposed to be focused on risk.

To make matters even clearer, the regulators all stated that the principal difference between Basel II and Basel I was the focus on real risk and the elimination of the arbitrages

that existed because Basel I didn't focus on real risk. Decoupling risk-based capital from a standard based on control seems the height of logic in terms of mitigating the negative effects.

The chairman of FASB has made at least two speeches where he stated that risk-based capital and accounting are different, their rules are produced for different purposes, neither one should be superior or trump the other and they should be dealt with separately instead of being tied to each other. And this is the man who makes the accounting rules. Now, unfortunately, the NPR more closely ties the risk-based capital outcome to accounting. The next idea would be to work very hard to find ways to keep things off the balance sheet in structures that will become acceptable to the market and are within the spirit of the rules. I don't think that it's impossible to do, though the new rules have made things much more difficult. But there are structures that can work — and the regulators should look at them with an open mind.

Finally, the disclosure that's required now, to go along with consolidation, is detailed enough for an equity analyst who works hard enough to be able for the most part to figure out how much risk is on the balance sheet and how much risk is off the balance sheet. So I would make a plea that equity analysts not just look at the balance sheet but also go to the footnotes and all the other disclosure and do a thorough job analyzing what's actually going on. Because if they do, people will be punished less for the presentation of over-consolidation, because people will focus on the substance of what's happening.

Ann Kenyon: I agree that while accounting changes have removed certain reasons for securitization, they haven't removed all of them. With respect to what the future may hold, we, as accountants, are looking at rules that are based on control. But it's still rules based, not principles based, and so if structures come to us and conform to the rules, then we will follow the rules, regardless of whether the structure is on or off balance sheet.

The new rules were written, of course, to bring most structures, as we know them now, back on to the balance sheet. Nevertheless, should new structures come along with substantive changes to the old models — and there would have to be some commercial changes involved — then we would be more than happy to consider the correct accounting treatment, and that could be off balance sheet.

Kenneth Marin: To Jason's point, decoupling risk-based capital from accounting would mitigate the effects of the FASB rule changes, but that doesn't seem to be where the FDIC is heading in the NPR. If the effect of linking accounting to risk-based capital is that market participants develop creative structures to

cede control and obtain capital relief simply by meeting off-balance sheet accounting rules, that puts a spotlight on the problem with linking risk-based capital and accounting. In other words, capital relief would come without a commensurate reduction in risk.

Antony Currie: Perhaps lawmakers, regulators, or both, feel that, after WorldCom and Enron and now the mortgage-led credit crisis, there should be no place for troublesome off-balance sheet vehicles?

Gregg Silver: What Enron did and what WorldCom did is entirely different to what we do in securitization. What happened at those two firms was not securitization. That was basically an off balance sheet tool that used some of the structures that we use but was not securitization as we know it. It's wrong to tar what we do with that brush.

Debbie Toennies: What's more, the problem with assets in the current crisis wasn't that they were off balance sheet. Whether or not they're on your balance sheet doesn't impact the health of the bank after securitizations go wrong. The problem is that some of these structures, like ABS CDOs, didn't work, that the underlying assets in the securitizations were bad loans and there wasn't enough capital in the system relative to these transactions. But if we get capital aligned with risk, then we're on the right path.

Kenneth Marin: Securitization is a very efficient means of financing the consumer economy. As Debbie said, the problems stemmed from bad collateral. Certainly some securitization structures exacerbated collateral problems by providing investors with the means to double or triple down on subprime mortgages. For those issuers represented at this table



JPMorgan's Debbie Toennies and Richard Johns of Capital One

and the majority of other issuers, however, securitization was used prudently and served a very important function for the economy. It's a shame that overreaction by policy makers may result in removing the incentive to securitize high quality assets.

Antony Currie: The point is that a lot of people in Washington will not make that distinc-

tion, nor care about it. It goes down to the lowest common denominator which is that they see off balance sheet vehicles, which they don't understand, creating problems. Thus, they react against them.

Gregg Silver: I don't disagree, but it's because they don't understand fully what we do for a living — nor do they fully understand what Enron and WorldCom were doing.

Jason Kravitt: To focus on a few misuses of structured finance and produce rules that make it very difficult for that form of finance to continue is beyond shooting yourself in the foot — it's tantamount to shooting yourself in the head.



Jason Kravitt of Mayer Brown



First Financial's Gregg Silver

Antony Currie: That's a pretty bold statement. How do you quantify that to make the case to Washington?

Jason Kravitt: If you eliminate securitization, you've got to find a way to finance the equivalent of what the entire U.S. banking system finances now. ASF chairman Ralph Dalouisio wrote an article on this that I believe is appearing in this very journal (see page 3). He points out that there's about \$12 trillion of outstanding securitized product in the U.S. The banking system currently produces \$13 trillion of credit. So you've got to double the amount of credit creation if securitization ceases to exist. Just tell me how you're going to do that.

How much capital does that mean needs to go into the banking system, in addition to the capital they have now and that everybody claims they're short of? Assuming leverage of 10 to one, that's another \$1.20 trillion of capital. Where are you getting that \$1.20 trillion from? One thing you're going to do is take it away from manufacturing companies or service companies or people who Congress and the press love to call the real economy.

The reason that capitalism has been so successful for the last few centuries is credit creation. It's not just the improvement in technology, it's not just democracy and rule of law, it's also finding new ways to create credit. Securitization is part of that and people have to

think very carefully before they wound it to the point where it becomes a shadow of its former self.

Kenneth Marin: Just consider the effect the rule changes will have on multi-seller commercial paper conduits. Banks have been permitted to hold the assets in these vehicles off their balance sheets or exclude consolidated assets from risk-weighted assets. While capital was required to be held against a sponsor's liquidity commitment to its ABCP vehicle, a conversion factor of 10% was applied. Under the new rules proposed in the NPR, no such conversion factor would be applicable and the sponsoring banks will be subject to significantly higher capital charges, to the tune of 10 times what they've been in the past.

Yet that extra capital charge comes without any real change in the risk that the assets are bearing. The sponsors for these vehicles have done thorough underwriting on the assets, they have done their due diligence and monitor the assets on an ongoing basis, they carefully negotiated the transactions that are brought into the conduit, and for the most part they have a tight grasp on what the risk is. To increase the capital charges based on an accounting change doesn't seem appropriate.

Richard Johns: We'll have to hold, when you combine the addition of risk-weighted assets with the loan loss allowance that you have to add in, probably something like four to five times the contractual risk that we bear on those. Yet all that's changed as a result of consolidating assets on our balance sheet as of January 1st is the disclosure. But the transaction doesn't, so how you can then say that the risk has potentially changed and that you must thus hold more capital against it is nonsensical.

A lot of people agree more capital should be in the system, fair enough. But to misapply the accounting math, and come out with a number that represents four or five times the multiple of your true risk feels like we've swung the pendulum too far in one direction.

That said, I don't think FASB has finished what they need to do. Okay, they've gone with control as the basis upon which they're going to consolidate transactions. But they have FAS 5 on accounting for contingencies. And that's based much more around the risk-based standard rather than around control. They're mixing and matching their accounting basis. So we have to hold a loan loss allowance against assets that we might control, but because we control them, we have the right to pass con-

tractual risk losses onto investors or, alternatively, could choose to support a transaction — although we haven't seen that in the mortgage space, in auto land or in certain credit card issuances. But you have the right to control those losses.

FASB needs to take a look at the loan loss allowance provisioning, and if they're looking at control of the assets, they should look at how they can make the linkage to the substance of the transaction and then tie the risk of loss on the assets with the compensating write-down you would see on a security value if those assets ever lost money.

Antony Currie: Gregg, are you facing similar capital hikes?

Gregg Silver: We have a structure that would continue to keep us off balance sheet. However, several of our investors are going to have to consolidate our conduits onto their books, and what's interesting for them is that they have no incremental exposure. They're triple-A investors and they now have to consolidate everything on their books, even though they have no contractual risk through that piece.

If we were to consolidate them, we would probably have to more than double our capital. Or, to have the same capital ratios, we would have to cut assets in half. From a credit creation perspective, having to either double all my capital or halve my book is going to be significant for our sector of the market.

Cards are much more prone to reduced issuance because as unsecured credit they're going to need more loan loss reserves than a secured product, where the losses are typically lower. So credit card issuers will wind up needing more capital. If we're really saying the consumers will drive the economy and we're saying that a \$900 billion credit card market is now going to need to double its capital — or more in some cases — then how is the consumer going to be helped by that?

Richard Johns: It's an unintended consequence — a term I promised myself I would use at least once today. Industry losses on credit card portfolios are running to maybe 10%. You have to hold loan loss reserve against that, and that's the equivalent of well-capitalizing your whole portfolio.

Antony Currie: What are the consequences of that for borrowers?

Richard Johns: Let's posit a situation where for whatever reason you can't raise any more capital. Then to manage that additional 10% capital, you've got to shrink your portfolio down to zero, wiping out all existing credit. Alternatively, let's say you can raise the capital. Then apply the increased cost of raising that capital to new originations, and you could be looking at raising your customer APR by 300 hundred basis points or more.

Now, that's assuming it's on the new business as the card legislation out there is going to stop you increasing your prices on existing

customers, so it may very well come down to when you raise that capital, the only place you can put that increased cost is on your new customer base.

I'm not insinuating that all credit card customers are going to have 300 basis points hiked on their APRs. But if that doesn't happen, then credit card margins are reduced, which discourages lending. It's a no-win situation.

You can apply the same math to mortgage and auto loans, though you won't see the same allowance impact on these assets because they have lower losses, though clearly the mortgage product is much bigger in terms of the amount of dollars outstanding, so you're going to see that ripple through and impact on the cost of consumer credit. If the cost of mortgages is going up, then you don't need to be Einstein to work out what that does to the prospects of the housing market recovery and how that bleeds into consumer confidence.

Gregg Silver: In some cases there's even double counting going on. For example, if I were to have a card transaction that was in Debbie's conduit, not only do I have to hold the capital as the issuer, but she's going to hold it from the conduit side. How does that make sense?

Richard Johns: Does the investor in the CP have to hold capital as well?

Debbie Toennies: If they're a bank, yes.

Richard Johns: So, it might not be double, it could be triple.

Craig Shallcross: Let's not forget what all this means for investors, either. Securitization products have created a very important segment of the capital markets. These allow investors to delink their investments from the enterprise risk of the companies that are in that business.

Through securitization an investor can focus just on mortgages or just on the consumer and not be caught up with some other line of business that that bank is in that's going to bring it problems. The concept of throwing assets back on balance sheet jeopardizes, from the investor's perspective, his ability to pre-

serve access to those assets.

As we blur the accounting lines, the legal ones also get blurred and our ability to protect those assets and keep them away from some other creditor gets challenged. We're already seeing some of that in the developments that have taken place in the marketplace and obviously the FDIC safe harbor discussions go straight to that particular point. Some very important products are at risk of disappearing.

Jason Kravitt: One of my favorite quotes came from the ESF-sponsored annual conference in London last June. One of the keynote speakers, a senior officer at the FSA, made the point that because of what had happened in securitization, the regulators no longer had a consensus that securitization was the way to go and the industry had to remake its case. So we asked him: "What's the alternative to securitization?" He said, after thinking for a while: "It would be a deposit-funded system with a standard of living equal to about 1970." That was a popular statement, given the audience.

Antony Currie: Jason mentioned earlier that disclosures should now allow analysts to get a full picture of what is on or off the balance sheet. But there's still a good deal of opacity. Wells Fargo's recent announcement that it was practically halving, to around \$25 billion, the assets it would have to take onto the balance sheet left many scratching their heads, for example.

Richard Johns: The rules are not as clear-cut for mortgages as they are for credit cards and autos, where originators who service the portfolios also retain some residual or retained interest and it's black and white that those assets are coming back on. I wonder what U.S. taxpayers would say to their congressman if they realized that out of all the asset types it's mortgages that may avoid some of the consolidation issues and stay off balance sheet?

If FASB thinks they've cured the problem with the sledgehammer they've taken to the nut, they should probably think again.

Jason Kravitt: It's difficult to write a consolidation rule that will make everybody happy and be adequately transparent. That's one of the difficulties about securitization: it is such an

intricate form of finance that it's very difficult to write a set of rules. No matter how good your intentions, how skilled you are and how knowledgeable you are, it's very difficult.

But the balance sheet is merely presentation. It doesn't change people's legal rights to the assets, it doesn't change the amount of risk they have or the upside or downside. It's merely one form of presenting a snapshot of the enterprise and what's important is the substance of the enterprise's relation to its financing, not the snapshot.

People have to recognize the limitations that accounting has, and the limitations in the whole concept of consolidation, and focus on the substance of what's actually going on. That's why the disclosure that surrounds balance sheet presentation is so important, so that analysts can do their job and understand where the risks and rewards lie. That's why no other form of capital should be tied to presentation, because it's presentation and not the substance of the relationship of the enterprise to its financing.

I don't think consolidation would be as significant as it might turn out to be next year if capital were decoupled from it and analysts were to go behind presentation, just as the ratings agencies do. If that were the case, then presentation would assume a much more natural perspective and we wouldn't be having a fight to the death over whether assets are consolidated or not.

Richard Johns: Yes, accounting should be just about disclosure. We don't care whether it's disclosed on the balance sheet or not. Credit card issuers already disclose a net balance sheet and a managed balance sheet in their financial results so that everybody can see whether you securitize or didn't securitize.

Antony Currie: It's a long list of problems and unintended consequences. And these do, at least, seem to have helped get a stay of execution on capital raising from the FDIC. But the accounting rules are still in place, so what do you do next?

Debbie Toennies: We haven't given up the fight yet. The story is no stronger anywhere than it is with regard to ABCP conduits. We have shown the regulators that over the structure's 26-year



Kenneth Marin of Chapman and Cutler

history losses on the more than \$1 trillion of financing it's provided are de minimis, and that in the worst of times capital covered seven times what was needed.

If the NPR comes through as it stands, it is almost by necessity going to cause a reallocation of capital dollars within banks. Banks today, more than ever, have limited risk-weighted assets, limited regulatory capital, and they have to put that to work in the highest return businesses. If you multiply by 10 the capital that you require them to hold on this kind of business, it's a natural progression that they're going to take that capital and put it somewhere else where it can earn a more attractive return.

Interestingly, that's into more risky forms of lending, so I'm not sure that the economy has been helped by that decision. And it's also probably true that in reallocating capital the banks are going to lend less because it is more risky — and they're not going to have the comfort of doing the size financing that they've done on a secured basis in bankruptcy-remote ABCP conduits, if they're doing it unsecured, let's say, on their balance sheet to a non-investment grade company.

So either credit shrinks in that world or we'll see an increase in pricing to our customers. Many of them go out and lend to consumers or small businesses. They can't absorb that increase in pricing, so it ends up going back through the chain to the consumers or the small businesses that will end up having to pay for any credit they can get from this market.

Kenneth Marin: Debbie, I'm curious as to what you've been telling your customers who use the CP conduit. What's going to happen with respect to increased costs for things like accounting consolidation events? For a borrower with an outstanding draw out of your conduit, the deal documents likely contain standard market provisions that permit the conduit to assess these increased costs. For deals that are currently being negotiated, I would guess that its an understatement to say that there is an element of uncertainty about where pricing will go if the conduit has a ten-fold increase in capital charges for CP-funded assets and invokes increased cost provisions. Also, Gregg,

what have you heard and what are your concerns as to the game changing in terms of your pricing?

Debbie Toennies: Given that the NPR could come out in any different direction, we start by saying we're not sure where this is going to come out. This fight is not over yet and we are still making our case. Customers in ABCP conduits wrote to Congress and the regulators expressing concern at what they had been told by people such as ourselves, that: "I'm going to lose availability or have a sizeable increase in my pricing — or both. I'm concerned. This is not good for our economy, and, from what I understand, not warranted given the experience."

Kenneth Marin: Is it possible to give your customers any level of certainty on increased costs? Is it feasible to set a maximum pricing increase that borrowers may be exposed to as a result of an accounting consolidation event?

Debbie Toennies: It depends on the sponsor and what they've been willing to do. My understanding is that has not been consistent from one sponsor to the next.

Gregg Silver: There's a lot of potential for increases in costs, because those provisions are open-ended. It's not like it says they're capped out, although there are also counter-provisions that require that if there are alternative jurisdictions where you could put it, where you would have a smaller impact on those capital charges, that could happen.

I don't know how an American bank gets around that, but foreign institutions aren't subject to the same restrictions. So what is likely to happen is that some of this financing which had previously been done by U.S. institutions may be done by foreign institutions that aren't subject to the same type of accounting. That could be a competitive disadvantage for a lot of U.S. institutions.

Debbie Toennies: It absolutely could be, given that non-U.S. firms are on Basel II. It probably creates an interesting dynamic for a treasurer of a company who's looking at foreign competitors some of whom, over the last three years, have had more difficulty getting themselves funded, versus going with a U.S. institution that might have had an easier time with that but their pricing has gone up significantly.

Kenneth Marin: Another unintended consequence.

Gregg Silver: A lot of issuers have been finding alternative sources. For example, we use the 144a market far more than we used to do, partly because we are concerned about what happens to our conduit sponsors. We're not the only issuer in that boat.

Craig Shallcross: These new rules, 166 and 167, are very similar to the rules that exist in Europe with respect to consolidation activities. Those sets of rules provide for some mechanisms for deconsolidation, and some banks in Europe are using these as a way to do this. Why are these techniques not being adopted here in the U.S.?

Ann Kenyon: I'm not an international accounting standards maven. But it's true: the foreign banks that sponsored commercial paper conduit under SIC 12 had consolidated most of them. The new U.S. GAAP rules will impact any U.S. bank or any branch that was using U.S. GAAP, and those conduits will have to be primarily consolidated.

Craig Shallcross: Actually, I'm asking the opposite question. There are banks in Europe which avail themselves of SIC 12 and IS 37 to keep their conduits off balance sheet using a combination of third-party capital and control. Why aren't the U.S. banks doing that?

Jason Kravitt: As we discussed earlier one way to mitigate the effects is to come up with structures that allow you not to consolidate

and are consistent with the rationale behind the rule. Well, a rule based on control means you have to give up some real control, and some banks are willing to do that, and some banks are not.

I'm familiar with foreign banks that have put their conduits on balance sheet and have put their conduits off balance sheet. In just about every case the sticking point wasn't economics, it was whether they were willing to surrender control or not.

It's that simple. I don't think the biggest issue is

going to be economics, because you can always work out how to share the economics. But a lot of banks are very leery about giving up control because they believe in their business, their customers, their staff. They tend to see the warts on other people's businesses, staff and structures, etc.

We've just gone through a period where people have suffered a lot of losses, and so people are skittish about giving up control. If the market does begin to return to normal, people will be much more willing to enter into



Ann Kenyon of Deloitte

joint ventures and we will see some conduits come off balance sheet down the line, in 2010 or 2011 perhaps. I don't think there will be a lot of joint ventures, for example, between JPMorgan and BofA, but there may be joint ventures between JPMorgan and somebody like Lord.

Debbie Toennies: There is this looming comment in the NPR about reservation of authority, and while regulators had the right to evaluate any structure from the beginning, the fact that they chose to put that language in the NPR caused us to take a step back. It made us think about whether we want to go to all this trouble and consider whether we would be willing to give up any level of control to make this happen, which is, as Jason said, a very tough decision, when it could potentially be all for nothing if a regulator is allowed to come in and say: "I don't really think you did enough. I think you're going to hold full capital."

Richard Johns: Beyond the fact that it could be taken away from you at any point in time, how on earth is giving up your control reducing your risk? Let's take a conceptual step back here. We have this disclosure change, and the solution to looking as if you have transferred more risk is to give up control to conform with the accounting standard.

I just don't see how that can work. If it's your business and you believe in it, then giving up control increases the risk, because you're passing the reins into somebody else's hands. If you believe in your ability to manage your business, you want all the control you can get.

Craig Shallcross: I understand the issues relating to control that have been raised, but there are significant financial institutions that have found a commercially viable way to interact with third parties to avoid these adverse consequences from a capital standpoint.

Richard Johns: I don't know whether it's FASB or the SEC, but at some point this week we've also seen them advise all the auditors that while they're saying 166 and 167 appears to be working, the auditing firms need to watch out for structures that try to find the loophole and remain off balance sheet.

So, Craig, I take your point, but I don't know how long that is going to last if there is a risk that folks take an action only for them to have their hand slapped a day later and told that it still goes back on the books.

Antony Currie: Shouldn't you all be camped out down in DC?

Jason Kravitt: We have been. The ASF has repeatedly sent delegations to Washington. Not everybody is willing to talk with us, if you can believe that. So the question becomes: why aren't they listening? And I don't know why. The case seems compelling and we need to keep trying to find different ways to get our message across.

Antony Currie: Have you hit them with numbers that hurt most, the ones that hit their own pocketbooks? Surely the message needs to be blunt: "If you allow these changes to go through, the cost of your home loan is going to shoot up and you'll be forking over between X and Y extra a year."

Debbie Toennies: We have told them the effect on APR. And as Richard said, that math works for everything — a 300 basis point jump is a significant number.

Gregg Silver: It's very difficult, politically speaking, or from a regulator's standpoint, to take the side of the banks. The media has made us the pariah of society, which makes it's difficult to be the one guy standing up saying: "Hey, you know what? We need to help these people out." Because they already think we've taken their money, despite the fact that many of the institutions that got the TARP money didn't want it in the first place, and then when they realized what it had morphed into, decided to pay it back with interest, which actually reduced the taxpayers' burden. But that seems to have been lost completely in all of these discussions.

Ann Kenyon: We have to be careful, because members of the administration have been very open in saying they support securitization, and they have put programs into place that support securitization, such as TALF. It's the accumulation of the accounting changes and the regulatory impact and how it bleeds through the system that needs to be articulated, not just countering the notion that securitization is bad. Because their obvious push-back is that they've openly supported securitization as a facility.

Jason Kravitt: The Fed clearly recognizes that securitization, overall, is a good thing, and TALF is one of the best government programs of the entire credit crisis. But to say, abstractly or theoretically, that you want securitization to work and then every single regulation and law that is proposed is going to make it harder to work doesn't produce the outcome that, abstractly, you say you're in favor of. Risk retention makes it much harder. Accounting makes it much harder. Risk-based capital makes it much harder. Attaching conditions to the FDIC rule makes it much harder.

I believe them when they say that they're in favor of it. But everything they're proposing is going to make it harder. They have to focus on the long-term effects of the short-term actions that they're taking.

Gregg Silver: Their actions and the unintended consequences of their actions are defeating the goals at hand.

Let's take TALF. Yes, it is a fabulous program, but there were a lot of unintended consequences there, too. While it helped open up the triple-A market, it gave a disincentive for any investor to take a subordinated position

because the returns offered to those triple-A investors was so significant that it made the cost for the sub notes substantively higher than it needed to be.

And the government has made a lot of money on the TALF program. To my knowledge, there has not been a single default on any of those transactions, and the government is getting 100 basis points for it. That's a large amount of money made off the back of the securitization industry. While they've supported us, I want to make it clear that the taxpayer absolutely benefited from that process.

Richard Johns: I would say the government's probably making about 140 basis points considering they raise money at a Treasury rate rather than swaps.

Antony Currie: In sum, what's the message you as a bank treasury executive and as a representative of the ASF, want to make sure gets across to Washington?

Richard Johns: What we've always been pushing for at ASF is for the regulators to recognize the linkage between the asset and the security and how the risk effectively manifests itself as a consequence of that linkage. I don't know if that's necessarily a question for accounting, although it might be as far as the accounting for contingencies and FAS 5 goes. But it is certainly an aspect that needs to be taken care of through the reg cap provisions.

This is a "speak now or forever hold your peace" moment for the administration and the agencies, because it will be too late to come back to this six months after everybody has pulled in balance sheets and increased their capital.

We need to turn this economy into a virtuous cycle, and what's about to happen accentuates the vicious cycle we're still in. ▼

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