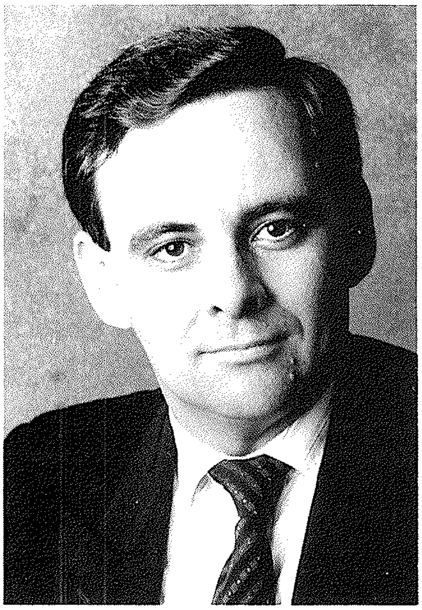
THE INSECURITIES OF SECURITISATION

NAVIGATING A ROAD WITH NO SIGNPOSTS



by BRADLEY TREADWELL

Changes in the financial markets landscape have opened up new opportunities, such as securitisation. But tread carefully: the rules are far from clear

Recent press speculation has suggested that the Australian capital markets are set in the 1990s for major growth in a range of securities backed by mortgages, finance receivables, credit card receivables and the like. Whether this "securitisation boom" will eventuate is by no means certain; indeed, many factors (both regulatory and otherwise) indicate that instead of a boom, there may be only slow growth in this market in the 1990s.

Securitisation is a process of converting receivables, or other assets that are not readily marketable, into securities that can be placed and traded in capital markets. The objective is generally to raise liquid funds at below a financial institution's or corporation's borrowing rate, or to achieve some other perceived benefit such as off-balance-sheet treatment, or to assist financial institutions to meet constraints on their capital adequacy positions.

An asset securitisation is usually effected in one of two ways:

- the title in the assets in question is transferred to a trust which issues securities representing equity interest in the trust; or
- debt instruments are issued by the entity with the payment of interest in principal on the securities being supported or secured by the securitised assets.

Equity interests in trusts are described as pass-through securities, while debt instruments are called pay-through securities.

Securitisation transactions span a wide spectrum. At one extreme are outright sales of assets or interest in assets. At the other extreme are borrowings collateralised by assets. In between are sales of assets with varying degrees of recourse to the seller and non-recourse borrowings collateralised by assets.

The transactions at each end of the spectrum are usually easy to account for because their substance follows their form. It is the transactions in the middle that create difficulties for regulators and accountants. These are transactions that have characteristics of both sales and borrowings and raise questions of whether the seller/issuer should continue to include the assets on its balance sheet, by treating the transaction as a financing, or record a sale with the appropriate gain-and-loss recognition.

Internationally, pronouncements on these issues by central banks and the accounting professions have generally lagged behind the development of securitisation transactions. Conflicting statements and standards have been issued on what distinguishes an effective sale from a collateralisation transaction.

In an environment where the aim is to encourage sale transactions of

Bradley Treadwell, a member of The Securities Institute of Australia, is a financial consulting partner in the Melbourne office of Arthur Andersen and Co. and is editor of the firm's newsletter on securitisation issues.

assets, such uncertainties make it difficult for financial and other institutions to develop the products and this will constrain the growth and development of the market.

The challenge is not to create structures and securitisation transactions which represent collateralisation of assets, but rather to create effective pass-through or sale-type securities where assets can be removed from balance sheets.

Where this has been or can be achieved, financial institutions such as banks are able to preserve precious capital for other lending activities and corporations can improve their debt-equity ratios.

Compared with the international situation, in which there is a degree of experience in determining what constitutes sale transactions and collateralisation transactions, the position in Australia today can be described as being in its infancy.

Neither the Reserve Bank or the accounting professions have decided on rules covering securitisation transactions and, in particular, what constitutes a sale of assets. This produces an added dimension of confusion which will impede the market in this country.

Australia is in an unfortunate situation, given the growing demand for such securities in this country's capital markets and the desire of financial and other institutions to adopt the concept. Much has been said about the opportunities for major Australian banks to use securitisation to enhance capital adequacy.

At present, however, those involved in promoting this market would be well advised to consider the crucial issue of sale versus collateralisation of securities in the Australian context and internationally before proceeding wholeheartedly.

International confusion

The confusion about asset sales versus collateralisation is amply illustrated in the United States, where seemingly contradictory rules apply on this important question. For example, the Financial Accounting Standards Board (FASB) has issued two accounting standards that are specifically relevant; ie, Statement No. 77 and FASB Technical Bulletin 85-2 *Accounting for Collateralised Mortgage Obligations* (CMOs).

In the United States . . . seemingly contradictory rules apply on this important question

The first standard specifically addresses the question of the transfer or sale of receivables with recourse. In such transactions, the seller is obliged under certain circumstances to make payments to the buyer to re-purchase receivables sold. Typically, the recourse is up to a specified percentage but sometimes greatly exceeds likely credit losses. Moreover, the amount and form of the recourse can vary. Additionally, the seller can often guarantee to the buyer a specified return or yield during the term of the receivables.

Briefly, Statement 77 allows receivables to be removed from a balance sheet (with gain-or-loss recognition) if they are irrevocably transferred in a transaction that "purports to be a sale or participation agreement". The seller can generally have no option or obligation to re-purchase non-delinquent receivables (calls or puts). Off-balance-sheet treatment is, however, allowed, even though it is probable that the seller/originator will make future payments to the buyer/transferee for credit losses.

Statement 77 also allows off-balance-sheet treatment of transfers of partial interest in receivables (the concept of senior and junior debts). Any interests retained are recorded (or remain) as assets on the seller's balance sheet.

In practice it has not been difficult to achieve sale accounting under Statement 77, particularly for large pools of homogeneous receivables.

FASB Technical Bulletin 85-2 was issued in relation to the collateralised mortgage obligation, which is a debt security collateralised by a pool of mortgage loan receivables. The interest in principal payments of the mortgagors are accumulated and then used to pay interest to the CMO holders. The CMOs are frequently non-recoursed to the general creditors of the borrower/issuer. The holder, however, may look only to the cashflow from the mortgage collateral for the interest in principal payments.

Although the FASB had mortgage receivables in mind when it issued the Technical Bulletin, the FASB staff indicated that it was appropriate to apply the Bulletin by analogy to other types of receivables. The purpose of the Bulletin was to give guidance as to when transactions (that are in legal form) debt instruments may be treated as sales for accounting purposes. The Bulletin allows assets and debt obligations to be removed from the balance sheet with gain-or-loss recognition. In a CMO transaction virtually all cashflows from the assets are irrevocably passed to the creditors and the borrower/issuer cannot be required to make further payments to the creditors other than from the cashflows from the collateral.

The Technical Bulletin does not allow off-balance-sheet treatment for passage of partial interests in the assets unless the interest retained by the borrower is "nominal". Further, if a CMO transaction qualifies for off-balance-sheet treatment under the Technical Bulletin then the "nominal" interest retained by the borrower (if any) may not be recorded as assets. These interests are recorded as they accrue to the benefit of the borrower.

Statement 77 and Technical Bulletin 85-2 provide conflicting guidance. Receivables transferred in a transaction that purports to be a sale or a participation may be removed from the balance sheet under Statement 77 even though there is a 100 per cent recourse to the seller/transferor for credit losses and the effects of changing interests.

Additionally the interest transferred may be removed from the balance sheet even though the seller/transferor retains a substantial interest in the transfer of receivables. In addition the seller/transferor may retain all or a portion of the benefits of favourable interest rate movements and the effects of prepayments.

If, however, the transaction is structured as a borrowing (with the receivables pledged as collateral), the Technical Bulletin provides that even lack of recourse to the borrower for credit losses and a fixed interest rate on the borrowings are not sufficient to remove the assets from the balance sheet. Stated differently, a transfer of receivables structured as a borrowing may have to be accounted for as a liability even though there is no recourse to the seller for credit losses and there is no interest-rate risk.

Statement 77 and the Technical Bulletin are also inconsistent in that the Statement permits the initial recording of a residual interest in a sale transaction (eg, due to a positive spread of receivable interest rates over investor pass-through rates), where the Bulletin does not.

In trying to reconcile these differences it should be noted that the scope of the Statement is limited to transactions that purport to be sales or participations as opposed to a collateralised borrowing.

This may be an issue of legal form. Indeed, the legal line between the sale of assets and a pledge of assets to secure a loan is not always clear. Some buyers have been unpleasantly surprised to learn that they may be classified as secured creditors in bankruptcy proceedings, in which case they could be forced to share their "collateral".

How is one to determine whether Statement 77, Technical Bulletin 85-2 or some other pronouncement applies? These issues as well as other matters make accounting for transactions in the middle of the spectrum difficult.

The criteria included in the accounting literature for removing assets and liabilities from the balance sheet produce different accounting results for transactions in which the substance is similar or identical but the form is different. If the receivables transactions purport to be a sale or participation, one standard applies; if the receivables transaction purports to be a borrowing, another and radically different standard applies, regardless of the seller/transferor/debtor's rights and obligations in the two transactions.

Central bank uncertainties

To complicate matters further, central banks in a number of countries have taken somewhat conflicting

Indeed, the legal line between the sale of assets and a pledge of assets to secure a loan is not always clear

views about what constitutes an effective sale of securities. Generally such central bank regulations are tougher than what the accounting profession has prescribed. As an example, consider the French situation. In July 1989 the French Bank Regulatory Committee issued accounting rules for securitisation transactions.

The committee indicated that a transaction will qualify for sale accounting provided:

- The seller has no further repurchase commitments or options with respect to the buyer; and
- The seller (or any of its fully consolidated subsidiaries) may not guarantee the buyer against future credit losses on the assets sold.

The accounting rules specifically indicate, however, that certain forms of guarantees are possible while still allowing the transaction to qualify as a sale. In particular:

- In a structure which calls for the issue of senior and junior debt, the seller may acquire a junior class. The seller in this case must calculate and record as an asset the estimated residual value of such junior securities. An expense must also be recorded for the amount of the amount of the estimated future credit losses (if not included in the calculation of the sale price). At each accounting date such securities must be revalued based on actual losses compared with the original estimate. Any residual value is determined and the securities are marked down as necessary with the corresponding charge to income.
- In a structure that calls for overcollateralisation and where the residual interest in the assets reverts to the seller, the transactions may also qualify for sale accounting. In this case the seller records as an asset the estimated residual value net of expected credit losses. At each balance date the estimated residual value is recalculated and the related asset is marked down as necessary with the corresponding charge to income.
- The seller may in certain cases grant a guarantee to the buyer against credit losses and still achieve a sale accounting.

The seller must be able to estimate, however, the amount of the future liability under the guarantee. In this case, the seller records the guarantee as an off-balance-sheet commitment (which would need to be taken into account in the capital adequacy rules). At each balance date, a provision for estimated losses must be calculated and recorded as a liability. Adjustments to the provision are recorded as expense or income.

The French Bank Regulatory Committee announcements are at variance with what has been considered appropriate accounting for such transactions, although some conflicting rules have also emanated recently from the Canadian Institute of Chartered Accountants.

The Australian scene

Contrast this international confusion with the current situation in Australia. The accounting profession has not specifically addressed the accounting rules that should apply to securitisation transactions, although there has been some discussion of the issue.

The Reserve Bank has not made any public announcements in relation to the securitisation transactions and sale accounting from a capital adequacy perspective. In some respects this is to be expected, given that regulatory and accounting bodies tend to react to new product initiatives by the market and design appropriate rules to overcome challenges as they arise the industry.

Clearly, however, with no accounting rules or regulatory pronouncements about sale versus collateralisation transactions, and with the international confusion about this important question, there is a degree of uncertainty in Australia about ensuring an effective sale of assets.

The overall message is that capi-

Continued Page 36

BRAND NAMES *Continued from page 21*

Australia). In its present form, ED49 has several major weaknesses.

The most serious is that it will permit the revaluation of internally generated identifiable intangibles. It will permit the manipulation of the profit-and-loss account by the deferment of expenses which, under present accounting rules, have to be written off, thus allowing the unscrupulous to inflate reported profits. ED49 is also totally out of step with overseas thinking on the subject (which includes a total prohibition on the recognition of internally generated identifiable intangibles).

Whatever final form ED49 takes, it will almost inevitably retain some unsatisfactory features.

Conclusions

There are four fundamental criteria that must be satisfied if an identifiable intangible is to be classified as an asset and be allocated a fair market value. These criteria require that the asset must be separately identifiable, protected (or capable of protection), transferable, and enduring in nature.

Valuation methods based on historic cost, historic profits and the value of the business less net tangible assets are not acceptable. Other valuation methods should be used only after taking into account their practical and theoretical deficiencies.

In the current economic environment, the pressure from some directors on valuers to obtain first, any answer, and second, the highest possible answer, will be intense. This will be particularly likely where, for example, a company is in takeover "play" or the directors wish to increase the shareholders' funds (perhaps to meet borrowing requirements or to avoid seeking shareholders' approval for certain transactions).

Further, significant unfavourable tax consequences may occur if inappropriate values are attributed to identifiable intangibles.

The valuer must ignore these pressures and ensure that detailed criteria and internal controls are established and adhered to. Any valuation — and this applies equally to shares and property — requires judgment, skill and the application of a body of general principles. However, the application of these general principles is much more critical in the valuation of identifiable intangibles.

Both the NCSC and ED49 concur that an identifiable intangible asset should only be brought to account where:

- it is probable that the future benefits or service potential embodied in the asset will eventuate; and
- the asset possesses a cost or other value that can be measured reliably.

The NCSC has quite correctly concluded that if an identifiable intangible asset fails to meet one or both of these fundamental criteria, it should not be recognised in the accounts.

The correct principles which should be applied to the valuation of identifiable intangible assets are understood by only a handful of people in the marketplace. Directors, lenders, investors and analysts should therefore treat values attributed to identifiable intangible assets with extreme caution. □

SECURITISATION *Continued from page 32*

tal market participants eager to establish securitisation structures should be cautious in the development of contracts and structures, taking a conservative approach from both the accounting and regulatory perspectives.

For example, participants would be well advised to establish purchase and sale agreements which limit the potential for put options or recourse provisions.

Where recourse provisions are considered necessary, the recourse should be quantified and limited. The following matters should also be considered:

- Any losses over and above the credit enhancement would need to be borne by the securitisation vehicle.

However, this could be hedged by mortgage insurance and the extent that mortgages or other debt instruments would be acceptable for acquisition on a loan-to-value basis.

- The sale of mortgages or other debt instruments should be effective from a legal point of view. A minimum requirement would be for the mortgage documents or other debt instruments to be transferred in a registrable form and a caveat to be lodged against the property or assets.
- Where the servicing of the debt or mortgage instruments is retained by the originator, the structure for holding the assets should be reviewed. It should ensure that the servicing rights and obligations are not caught in the overall discussion of such vehicles in the financial statements of financial or other institutions.

Given the uncertainties accompanying the development of securitisation transactions in Australia, and the absence of defined rules and regulations, care should be taken in planning for such structures and transactions.

Despite the difficulties, the opportunities for securitisation transactions continue to grow in Australia — but perhaps not at the pace at which some commentators have suggested. □

MARKET CHAOS

Continued from page 29

random fashion.

Values of d are then plotted against their corresponding values of n. If prices are chaotic the value of d reaches a limit regardless of n. The point at which this limit is reached gives the number of factors or variables in the non-linear model. For completely random prices, the value of d just increases in line with increases in n, since such prices do not tend to cluster in any identifiable pattern.

Such techniques are only now being applied to security price data. A lot of work is yet to be done. Initial results appear promising although not conclusive. □

REFERENCES

Ball, R., and Officer, R.R., "Try This on Your Chartist", *Superfunds*, June 1978.

Gleick, James, Chaos, Making a New Science 1989.

Savit, Robert, "When Random is Not Random: An Introduction to Chaos in Market Prices", *Journal of Futures Markets*, Vol 8, 271-289, 1988.

Savit, Robert, "Nonlinearities and Chaotic Effects in Options Prices", *Journal of Futures Markets*, Vol 9, 507-518, 1989.