

FOCUS ON

DISCLOSURE, DERECOGNITION AND CONSOLIDATION OF SECURITIZATIONS*

I INTRODUCTION



PASCAL BARNETO
Professor
IAE de Poitiers
- associé à
BEM

A securitization transaction consists of an entity (called a transferor or initiator or sponsor) transforming a pool of receivables (typically financial assets like commercial receivables, loans, mortgages, etc. but also insurance contracts, buildings, stocks, etc.) into trading securities (bonds or other) destined to be sold on to investors. By creating an ad hoc Special Purpose Entity (SPE) structure to carry out this operation, the transferor is seeking a new source of funding as well as a different way of managing financial risk. The phenomenon has reached into most if not all sectors of activities: trade, mass distribution, property development and industry, especially the automotive and aeronautics sectors. However, financial institutions (banks, insurance companies, credit establishments, etc.) constitute a special case in point. They use securitization to dynamically manage the assets and liabilities itemized on their balance sheets, and above all to manage their return on equity, after taking regulatory constraints into account. Such structured finance operations, which can be difficult to identify accurately, come in many forms. They can involve traditional securitization operations (ABS asset-backed securities, MBS mortgage-backed securities, CDO collateralized debt obligations, etc.), credit-derivative based synthetic securitizations (CDS, credit spread options, recovery swap, etc.) or hybrids like credit-linked notes, synthetic CDOs, iTraxx, CDO's of CDOs, etc. (Jobst, 2007). Positioned between transferor firms and different investors in the financial markets, securitization vehicles (SPEs) can quickly become filters that retain financial information. This means that they will often provide an incomplete image of risks, costs and modes of evaluation.

Up until now, financial research has focused on the role that securitization plays in stabilizing the economic system in general, and the effects it has on banking intermediaries in particular. Two theoretical schools have often been used to try and explain this financial technique's

usefulness. On one hand, there is asymmetrical information theory (Diamond, 1984), which provides a framework that explains securitization operations' value creation as a signal sent to the markets concerning the nature of the risk associated with a debt instrument's issuance and distribution. Secondly, there is the theory of segmentation, which demonstrates that market completeness can be reinforced by means of 'tranching' and 'pooling' techniques (Gorton and Pennacchi, 1990; Boot and Thakor, 1992). Supporters of these types of structures affirm that SPEs have been largely created for very real economic purposes: to free up capital from regulatory constraints that weigh upon banking institutions; improve market liquidity; reduce participants' informational asymmetries; create more diversified and cheaper sources of funding; enhance ratings reliability through externalized operations; expunge credit risk, etc. (DeMarzo and Duffie, 1999; DeMarzo, 2005). Critics mainly highlight the complexity and opacity of these structures, arguing that they are window dressing as well as complex and heretofore unproven evaluation techniques (Cousseran and Rahmouni, 2005); ways of hiding risk transfers between investors and creditors (Holtzman and al, 2003; McAuley, 2004); and/or artificial manipulations of banking institutions' real cost of capital (Reason, 2002).

In the wake of these kinds of securitization operations, there have been many accounting dysfunctions in recent years, particularly with the Enron affair in the United States and the unravelling of its SPEs.¹ Yet rarely has there been any detailed examination of the accounting and regulatory consequences when an entity uses an SPE for refinancing purposes, or invests in tranches that an SPE has issued. Letting corporate executives engage in lax accounting practices can have perverse and uncontrollable effects, particularly when governance systems are defective. Despite being scapegoated by some executives and bankers

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1. Over the past 30 years, there has been a proliferation of American accounting regulations dealing with financial structures of this kind. See www.fasb.org

during the subprime crisis, 'fair value' is a relatively tried and tested accounting principle for most financial instruments, (Dumontier and Raffournier, 2005). There may be criticisms of the tool's evaluation technique (mark-to-market or mark-to-model) but the concept of fair value, as opposed to historical cost, has injected a great deal of modernity into the accounting framework. It is little more than a confirmation of our economies' actual *modus operandi*, grounded in a form of financial market-based regulation. Yet accounting standardization provides only one response to current macroeconomic orientations, and to financial products' growing complexity. Despite some progress towards convergence in recent years, accounting standards remain very different on both sides of the Atlantic. On one hand, there is the FASB (Financial Accounting Standards Board), which is in charge of implementing American norms usually known as US GAAP. In reality, these involve Statements of Financial Accounting Standards – SFAS – and their interpretations. On the other hand, there is the IASB (International Accounting Standards Board), which produces IAS/IFRS standards and their interpretations. The present text focuses on accounting standardization in the field of securitization, and in particular on whether or not there is an obligation to consolidate such operations. Note that this is not a neutral question for the financial system's stability. The financial consequences can be significant, both in terms of the way that information is assessed and also in terms of the financial markets' reaction (Adhikari and Betancourt, 2008).

The first section presents securitization-related accounting rules and principles by comparing SFAS and IFRS. The second section uses a number of studies to examine the effects that these divergent accounting methods have on the financial markets.

II CONSOLIDATION AND SECURITIZATION OF SPES: A COMPLEX AND ANTINOMIC RELATIONSHIP

Two accounting approaches vie globally regarding the booking of securitization operations:

A rules-based approach that is fact-based and mainly functions via directives. This is an American regulation that stresses the search for certain 'accounting objectives';

A more principles-based approach that stresses doctrinal interpretations and case studies. This is reputed to be more adaptive but also more arbitrary, and is exemplified by IFRS standards.

1. Securitization and the standardization of American accounting

Until 2000, American companies had to consolidate any entity in which they had a controlling interest. According to Accounting Research Bulletin n°51 (ARB 51)², this applied whenever an owner had more than a 50% voting interest in the entity. Much like financial investors, however, most firms

would avoid consolidating their investments and shrug of the concept of 'controlling interest'. By neglecting a certain number of restrictions, they were able to maintain *de facto* control over SPEs without having to consolidate the financial structures. As a result, ARB 51 soon became inoperative.

In 2000, the American FASB published accounting standard SFAS 140 (Statement of Financial Accounting Standards Number 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities) accompanied by a series of texts that required – always subject to certain conditions - that SPEs be consolidated.³ Two other complementary texts – FIN 46 and FIN 46(R) – were published in January 2003⁴ and December 2003⁵ after it was observed that some provisions of the first one were not being interpreted or applied as lawmakers would have wanted (Soroosh and Ciesielski, 2004).

The revised text FIN 46(R) forced investors to examine under what conditions they might be obliged to consolidate certain so-called 'associated' entities. This involved using a risks/rewards-based reasoning to identify which entities were affected, while detecting any 'variable interest entity' (VIE) structures that might be based on 'controlling financial interests' other than voting rights.

A. Different categories of SPEs

A securitization operation involves transferring a firm's assets to an SPE. The 'True Sale', enables the SPE to require financial assets and enjoy full ownership rights. The transferor can then definitively derecognise these assets and treat the operation as being off-balance sheet. Above all, the 'True Sale' makes it possible to avoid qualifying the transferee's operation as a loan; ensures that the transaction is unaffected in case the transferor goes bankrupt, and prevents the bankruptcy from spreading to the transferee, notably when another SPE is involved. Thus, whether or not an SPE must be consolidated depends on the way it has been defined.

According to FASB, two main categories of SPEs have been identified up until now.

■ The Qualifying Special Purpose Entity (QSPE)

If an SPE's activity has been determined at the moment of its creation and if the transferor no longer controls the vehicle or its constituent assets, a QSPE is involved. This can be identified by four elements:

- The entity is legally distinct from the transferor;
- The activities in which it is authorized to engage are restricted;
- The financial assets that it can own are subject to limitations;
- There are restrictions on its disposal of assets (sales, exchanges or distributions).

Other stakeholders affected by the QSPE (investors,

2. Accounting Research Bulletin N°51; Consolidated Financial accounts, published in 1959

3. These interpretations are EITF 90-15, EITF 96-20 and EITF 96-21. EITF, Issue 90-15 - Impact of non substantive lessors, Residual value guarantees, and other provisions in leasing transactions

4. Consolidation of Variable Interest Entities – An Interpretation of Accounting Research Bulletin N°51

5. FASB Interpretation No. 46, Consolidation of Variable Interest Entities, Revised December 2003 (FIN 46R)

servicers, trustees) are under no obligation to consolidate its assets and liabilities. The role of the QSPE is to 'passively' hold the financial assets that have been transferred to it. The QSPE can only host the securities, i.e. it may not undertake any new market acquisitions. Its only involvement is servicing the assets.

Where an operation cannot be described as a 'True Sale', however, it will be qualified as a secured borrowing and the assets will remain on the balance sheet. FIN 46(R) does not apply to QSPEs, which therefore do not have to be consolidated. Current attempts to restructure this conceptual framework include plans to get rid of QSPEs.

■ The Variable Interest Entities (VIEs)

When an SPE is not defined as a QSPE during a securitization operation, it will be automatically qualified as a VIE. The expression 'variable entity' refers to the contractual, ownership or commercial interests that are held in a given entity and change in line with variations in the fair value of the entity's net assets. This is a broader construct than QSPE. Although it can assume different legal forms, an SPE will be called a VIE if it satisfies one of the following criteria:

- The entity is thinly capitalized and in the absence of additional financial aid will not have enough equity capital to fund its activities;
- Shareholders do not hold sufficient rights to make decisions ensuring that the entity's activities will be successful;
- Shareholders do not assume the entity's expected losses and receive income guarantees;
- Shareholders' voting rights are by and large insignificant;
- Investors do not receive the revenues they had expected from the entity (they are capped).

When an SPE has been qualified as a VIE, it must be consolidated as per standard FIN46(R).

B. The contents of FIN 46 and FIN 46 (R)

FIN46(R) is a standard that obliges all firms – particularly financial institutions – to consolidate entities carried off-balance sheet:

- If they hold variable interests;
- If they are the primary beneficiaries.

The notion of variable interests was defined above. A firm will be considered the primary beneficiary of a VIE if:

- It assumes most economic risks, with its variable interests in the entity forcing it to absorb most expected losses;
- It receives most economic rewards, with its variable interests enabling it to receive most expected residual returns.

The concepts of 'expected losses' and 'expected residual returns' enable a precise identification of whether the firm is the primary beneficiary and whether the entity is a VIE.⁶ It is important to note that although

there can only be a single primary beneficiary, it is also possible that a VIE may have no beneficiary at all. Indeed, it is possible that most of the risks/rewards, as defined in FIN46(R) will not be concentrated in the hands of a single party. According to the FASB, an economic relationship intimating an assumption of risks/rewards implies a certain level of control for consolidation. If no firm is going to assume more than half of the expected losses or income, there will be no primary beneficiary and therefore no consolidation. In addition, if one firm assumes more than half of the VIE's expected losses and the other receives more than half of its anticipated gains, the former will be considered the primary beneficiary.

Thus there are two securitization vehicle consolidation models in the United States:

- A voting rights model where investors who own more than half of all voting rights must consolidate their investment. This applies to entities other than VIEs;
- A variable interests entity model set up to reflect the risks/rewards that have been obtained. Any organization that participates economically in an SPE must consolidate it (Reinstein and al, 2006).

As an illustration of this concept, the subprime crisis revealed a number of difficulties that financial institutions have faced in trying to apply these texts (SFAS 140 and FIN46(R)). First and foremost, there were regulated securitization operations (mortgage loans) involving ad hoc structures called Real Estate Mortgage Investment Conduits or REMIC⁷. These SPEs were 'passive' trusts (i.e. 'pass-through' structures)⁸ that, according to the IRS (the US tax code) were not subject to taxation. This allowed financial institutions to avoid double taxation between the revenues obtained by the issuer and the dividends paid to investors. This tax advantage was a strong incentive to transfer the mortgage loans to an ad hoc entity instead of keeping them on the balance sheet and funding them via debt.

However, financial institutions also maintained control over such loans by acting as trustees or trust servicers. This meant that they could pay themselves handsomely (i.e. in the form of bonuses) for managing these assets. Furthermore, whenever there were defaults on loan repayments - as was often the case - the collection of outstanding sums was often contracted to 'Special Servicers' who would implement particular procedures to handle the loans. The conditions guiding their actions would be defined in Pooling and Servicing Agreement (PSA) contracts between the Investment Pool Trustee and the Master Servicer. They would either hold the loans themselves or else the rights to track these loans. In this case, their remuneration would be based on the services they provided, and specifically on the seizures they undertook.

6. In both cases, an average expected result is calculated beforehand. For expected losses, this will involve measuring statistically the variability of possible future results for scenarios coming in below the average result. For expected residual incomes, this will involve a symmetrical application of the measurement to possible future results for scenarios coming in above the average result.

7. For example, a REMIC's activity excludes the securitization of credit cards, automobile loans, etc. on penalty of a 100% tax on any other income received. This is called 'prohibited income' (IRC 860 Code).

8. Securities issued by the SPE are viewed as a single category, with all featuring the same characteristics. If this is not the case, the structure becomes a 'pay-through' arrangement.

In short, the overall coherency of the legal framework has been damaged in recent years by the publication of many incomplete and fragmented texts concerning the accounting systems applicable to structured products in general and securitization operations in particular.

2. Securitization within the IFRS accounting system

According to IFRS and to enable a derecognition of the assets held on a transferor's balance sheet, a securitization operation must simultaneously verify:

- The non-consolidation criteria of an SPE, as per SIC 12 (Standing Interpretations Committee);
- The derecognition criteria applied to financial assets, as per IAS 39.
- Thus, two standards must be analysed when examining a securitization operation. On one hand, there is IAS 27 relating to consolidation and the definition of control through SIC 12. On the other, there is IAS 39, relating to the evaluation and recognition (or not) of financial instruments.

A. The SPEs' situation within international standards

According to IFRS, the consolidation of SPEs largely revolves around the notion of control. It remains that this concept does not only signify 'power', 'voting' or 'participation' but is much broader, leading to a much more frequent consolidation of SPEs than is the case with American standards. In 1998, IASB began reflecting upon the effects of SPE consolidation, ultimately proposing a major interpretive text called SIC 12 (Standing Interpretations Committee). The IAS 27 standard and the SIC 12 interpretation indicate that an *ad hoc* entity like an SPE must be consolidated when it is controlled in substance by the reporting firm. To achieve this, the notion of 'control' will be defined in terms of risks and rewards. A holding company will only agree to assume such risks and rewards if it can control the SPE. This control-based consolidation model:

- Applies to all types of entities;
- Requires consolidation each and every time that an entity controls another entity via voting rights or contractual rights;
- Requires consolidation if, substantively, the nature of the relationship indicates that control exists;

Indicates that the power to make decisions alone is not sufficient to establish control but must be tied to the ability to obtain benefits from the SPE's activity.

Based on this definition, the text indicates more specifically four areas circumscribing this notion of control: activities; decision-making; benefits; and risks. Thus, an SPE must be consolidated in the accounts of the reporting entity when, in terms of:

- Activities: the SPE is structured so that its activities are conducted in the name of the company;
- Decision-making powers: the company has the power to make decisions to obtain control over the SPE or its assets via an 'automatic piloting' mechanism;
- Benefits: the company has the right to obtain most of the benefits from the SPE;

- Risks: the company assumes a significant share of the SPE-related residual risks.

For securitization vehicles, SIC 12 does not offer a precise definition of SPEs but describes them as entities created to accomplish a narrow and clearly specified objective. The common characteristics enabling its identification are as follows:

- It possesses clauses restricting the ability of the entity's executive committee (or management) to make decisions;
- The transferor transfers assets to the SPE, often within the framework of an IAS 39-dependent asset derecognition operation.

B. Conditions for (de)consolidating SPEs: The contribution of IAS 39

The SIC 12 interpretation specifies that all parties with a relationship to the SPE – the SPE trustee, creditors and derivative instrument counterparts – have an interest in it and should obtain economic rewards. However, it is the entity assuming most of the rewards or residual risks that will be considered the consolidating entity. Thus (and contrary to the prescriptions of SFAS 140), the True Sale criterion is not a crucial factor for consolidation. The logic of the approach followed when derecognising securitized assets is very different from the IAS 39 approach to financial instruments (Daske and al. 2007).

According to IAS 39, a financial instrument is derecognized totally or partially when:

- Contractual rights to associated cash flows expire or are transferred or viewed thusly insofar as they belong *de facto* to one or several beneficiaries;
- When almost all risks/rewards relating to this financial asset have been transferred;
- When control over the instrument has been transferred.

Whereas SIC 12 only refers to most of the SPE's risks and rewards with regards to the possibility of consolidation, IAS 39 refers to the transfer of almost all risks and rewards that have been transferred. Table 1 summarizes the differences between the international and American approaches.

Several cases in point can arise during the securitization operations:

- Either the derecognition is considered as total, meaning that there is a real transfer of credit and payment risk to a third party. In this case, the assets that have been transferred will no longer appear on the balance sheet and the transfer will be booked as income;
- Or else the derecognition is unfeasible. In this case, the transferor continues to assume the credit and payment risks, with the assets being maintained on its balance sheet and debt being booked on the liability side;
- Or else the derecognition is only partial. This is what happens when the credit risk is transferred but the transferor continues to assume the payment risk. An example is when a guarantee offered by the transferor means that only some of the receivables are derecognised. In this case, the transferor finds itself in a situation of 'continuing involvement', meaning that it has the right to keep only some of the receivables as assets.

Table 1. Table 1 – Comparison of the two accounting systems

| SFAS 140 & FIN 46R | IAS 39 & IAS 27 / SIC12 |
|---|---|
| Control model | Risk/rewards and control model |
| Control is surrendered if: 1. The assets are isolated from the transferor and its creditors 2. The transferee is free to pledge or exchange the assets that have been transferred 3. The transferor maintains no effective control through some repurchase agreement | Incorporation of the concept of ‘continuing involvement’ (IAS 39.30) Successive stages of analysis 1. Claims to the cash flows must have expired 2. The transfer must have taken place 3. Application of a risk/reward approach 4. Application of a control approach 5. Analysis reveals ‘continuing involvement’ |
| Consolidation becomes an issue after derecognition provisions. If QSPEs, consolidation is not required. | The principles of consolidation are applied, following which derecognition is considered Consolidation is required once a firm has substantive control over an entity. |
| Source: Adhikari and Betancourt (2008) | |

In short, analysis of the notion of control helps to decide whether or not an SPE’s consolidation can be validated (as in the case of SIC 12) – even if the transferor’s sale of receivables to the SPE must still be validated via pass-through agreement criteria⁹ for the derecognition to be accepted. This pass-through agreement forces the transferor to keep the right to receive the cash flows associated with the assets that have been transferred while also creating the obligation to repay these same flows to the transferee. Since most simple or complex securitization vehicles do not satisfy pass-through agreement’ strict qualification criteria, they are accounted for via a consolidation process.

To illustrate this, banking institutions that apply IFRS standards distinguish between securitization operations for customers and own-account operations. In the former case, their action basically consists of offering guarantees (including additional guarantees in the form of credit enhancements) plus lines of liquidity to the vehicles seeking funding through the commercial paper market. Generally, the financial establishment does not consolidate this type of vehicle since the risk of default on assets held by the SPE is assumed by the transferors of the underlying receivables or by third parties. In this case, the dedicated entities are not consolidated due to the fact that the banking institution does not have control over them (IAS 27). In the latter case, the point is for financial institutions to transfer to the market those credit risks that are associated with certain portfolios (in the shape of synthetic securitizations) as well as any securitizations of consumer loans made to certain individuals or entities (like car companies). Here, the obligation to consolidate is examined on a case-by-case basis. What is clear is that the different institutions that are subject to IFRS will usually consolidate securitization vehicles or other such conduits. This point was also strengthened by European directive n°2006-46, which forces companies to include, in an appendix to their accounts, a cer-

tain amount of information relating to their off-balance-sheet operations and any SPEs.

Thus, globally there is the coexistence of two accounting frameworks that continue to diverge despite the beginning of a convergence process.¹⁰ The question is whether the financial markets are sensitive to published accounts incorporating these standards, and whether the markets will react to any new information produced at the time that the securities’ pricing is set.

III EFFECTS OF SECURITIZATION OPERATIONS ON FINANCIAL ACCOUNTS AND MARKET REACTIONS

Until now, few academic studies have focused on the differences between booking securitization operations using American or international standards, or their impact on entities’ financial reporting, particularly where financial institutions are concerned. Whereas banking companies have often used securitization to achieve a regulatory required level of equity capital (Tier-1 or Core Tier-1) or prudential ratios through the reporting systems they establish, other motivations might induce these entities to use financial structures specifically as a way of managing their financial communications.

1. Bringing the accounting systems closer together: An impossible analysis?

The ability to apply and compare the two accounting systems in question (IFRS vs. US GAAP) is a complicated endeavour for at least two reasons.

Firstly, few firms worldwide have ever had to publish two sets of financial accounts for one and the same fiscal year. These were mainly entities listed in the United

9. Pass-through agreements are contracts where cash flows are received before being immediately repaid in their entirety.

10. The 2008 financial crisis will accelerate this convergence. The reactions and debates that took place across the world in September and October 2008 will have modified accounting systems, particularly fair value accounting standards, by the time the present text is published.

States and which since 2005 have been under the obligation to ensure that their accounts reflect American standards as well as their own national standard or the IFRS accounting system. This is the case, for instance, for some of France's leading groups, like France Telecom, Vivendi Universal, Danone etc. whose statements respect both US GAAP and IFRS standards. A number of European financial institutions are listed in the United States (Banco Santander, RBS, Barclays, etc.) but most of their European loan and structure securitizations have been issued in Europe. Examples of their booking securitization operations undertaken in the United States are few and far between. This makes it impossible to engage in any in-depth comparisons, for instance, by analysing financial statements to determine the consequences of applying one standard rather than the other. As far as we know, only one study – by Adhikari and Betancourt (2008) – has compared SFAS 140 with IAS 39 standards for securitization operations. The focus here was on different securitization operations undertaken by General Motors (GM), with a simulation of what it would mean for GM's accounts if IAS 39 and IAS 27 were applied. What the authors discovered were significant variations supporting IFRS standards to the detriment of US GAAP. They then did a second simulation on how different accounting standards affect the way that securitization operations are booked in the accounts of several leading car companies (including BMW, PSA, Toyota and Renault). Their findings were relatively disappointing insofar as they were unable to find any significant differences. The 'shortcomings' of their studies derived from the fact that they tested the consequences of these accounting standards on industrial entities as opposed to financial institutions, for whom securitization constitutes a basic line of business. It is highly probable that their findings would have been very different had the latter sector been involved.

Secondly, it is only recently that the partisans of standardization have taken any real interest in the different ways of booking and valuing derivatives and portfolios of financial instruments. This is surprising, given the reach of modern markets. The concept of fair value – which has been more or less generalised¹¹ to most if not all financial instruments – has replaced the notion of historical or amortized cost. For years, this enabled a more accurate and truthful image of company accounts, by producing a specific economic vision of financial institutions' activities. However, by first transferring debt and credit risk to the SPEs and then by segmenting this risk, securitization produced an effect that was the opposite of what people expected. Noises and rumours have been amplified in the over-the-counter markets, revealing significant psychological movements and not preventing the revelation of real information (Jobst, 2007). The notion of fair value may appear robust in periods of financial stability marked and little financial innovation, but in times of crisis all of its perverse secondary effects become evident.

2. Managing financial statements via SPEs

Setting up an SPE allows actors to refinance themselves and transfer risks to the marketplace. At the same time, this is also a way to manage the cost of capital and the value of companies' securities by hiding some of their debt and by manipulating their results.

The main issues at stake in bank reporting

The chief impact of securitization has been on credit institutions. On one hand, due to the high volumes of assets they issue, these organizations have an active market presence. On the other hand, they also operate on behalf of third parties by offering to support the SPEs' creation and operations. This means that there are a multitude of risks relating to financial institutions' securitization portfolios. These can be specific risks generated by the ratings agencies and by poor risk assessment, itself caused by a basic misunderstanding of the degree of correlation between the risk default events that are likely to occur in the underlying portfolios. Secondly, there are other risks that depend directly on the structure of the securitization operation (building of the vehicle, legal risks, contractual risks, etc.). Lastly there can also be a modeling risk caused either by the mathematical complexity of the structured product or else by the impossibility of applying a marked-to-model principle to relatively illiquid assets (Cousseran and Rahmouni, 2005). In any event and given the need for financial information, the accounting standard that is being used must be able to translate and reflect all of these exposures to market risk. Despite advances like Basel 2, this is rarely the case, largely because prudential rules are also grounded in accounting rules.

The problems faced when setting up a bank's financial reporting system are tied to efforts to value financial assets on a mark-to-market basis – particularly when they involve structured products like CDOs – but also to the question of whether the SPE structures really have to be reconsolidated. Where a lack of faith in structured products prevents the SPEs from accessing market liquidity, initiating banks and sponsors will be forced to choose between:

- Repurchasing the SPE's assets;
- Purchasing the SPE's shares;
- Extending lines of liquidity to the SPE.

In the first case, the sponsor removes the assets from the vehicle, obviating any consolidation issues. In the two other cases, however, transferring to the sponsor the risks and rewards associated with the ad hoc structure's assets does raise reconsolidation issues. This is because when a sponsor purchases shares in a SPE, the owner of the equity or first loss tranches is generally required to reconsolidate the vehicle. In case a line of liquidity has been extended, the sponsor who provides most of the structure's refinancing will be required to consolidate.

Managing the cost of capital and debt

SPE-type structures can have hidden affects on the cost of capital for firms that use securitization operations (Altamuro, 2006).

11. See IASB Discussion Paper from 19 September 2008 envisaging a complete generalization of fair value.

Leuz and Verrecchia (2000) demonstrate, based on a sample of German firms, how changing accounting standards affect cost of capital measurements. They estimate accounting standards-related risk by studying bid-ask spreads, transaction volumes and share price volatility during the times when IFRS or US-GAAP standards were being adopted. Their initial idea is that an opaque informational environment, manifested in a weak financial reporting system, reduces the demand for securities. To attract new investors, firms must issue shares at a lower price, thereby increasing the cost of capital. At the same time, the authors note that their results could vary depending on whether the transition from German GAAP standards to IFRS is a voluntary act or not. They indicate that firms who voluntarily adopted IFRS or US GAAP standards had lower bid-ask spreads and higher share turnover rates. Conversely, there was no noticeable difference when the shift was towards IFRS or US GAAP.

Lambert and al. (2006) study the relationship between reporting quality and how this affects the cost of capital, estimated on a CAPM basis. Reasoning in terms of cash flow expectations, they demonstrate that the direct effect of accounting information is to modify investors' perception of cash flow distributions. This is because when better quality information is published, estimates of the cash flow's co-variances with other firm's flows are reduced. They also demonstrate that accounting information influences the cost of capital by affecting firms' real decisions, before modifying the distribution of future cash flows compared with the flows generated by all other firms.

Callahan and al (2007) examine the consequences of applying American standard FIN46(R) to firms' cost of capital and level of debt after reconsolidating off-balance-sheet activities found in the VIE accounts. Based on a sample of firms that have reconsolidated their VIEs in response to FIN46(R), they compare the cost of capital before and after the standard's application. Their findings suggest that a weak relationship exists between the application of FIN46(R) and a fall in the cost of capital. They show that those firms that only acquired their VIEs after the publication of FIN46(R) have been subject to a marginal increase in the cost of capital compared to other firms in the sample. In conclusion, the authors affirm that firms with off-balance-sheet structures are not perceived as any riskier after the publication of FIN(46) than before. These findings would seem to indicate that the market does possess a vision that goes beyond the consolidation of securitization operations. Conversely, the authors stress that the period immediately preceding the publication of FIN(46) is exceptionally tumultuous for the market and not as good a representation of the long-term impact on the cost of capital as the off-balance-sheet structures were before the promulgation of FIN(46).

3. Managing security values via FIN46(R)

Feng and al. (2006) study the relationships between the use of SPEs, reporting and the quality of corporate governance on firms that resort to securitization intensively. As might be expected, SPEs are specifically crea-

ted to respond to funding needs but also to benefit from possible tax savings. The study demonstrates, firstly, that the number of SPEs being used is correlated to the volume of debt commitments and to executive bonuses. Secondly and above all, they reveal the manipulative role that is often attributed to SPEs as a way of managing financial statements, after detecting a positive correlation between financial reporting objectives and executives' result management, be it in terms of the handling of EBITDA with the well-known accruals¹² systems or with regards to a profitability ratio-based management of liquidity flows.

In a similar vein, Dickinson and Donohoe (2007) measure the effects of FIN46(R) on the risk that firms face, valued through share prices. For these authors, FIN46(R) produces an atypical situation with respect to the preparation of financial statements since by imposing VIE consolidation it ends up revealing, in the listed groups' financial accounts, entities that have a big potential for risk. They start with the hypothesis that regulation based on an accounting standard like FIN46(R) – which is apt to produce useful new information – generates significant market reaction, expressed as share price valuations. A number of entities may have similar economic characteristics, in which case any usage of an SPE will lead to increased risk, generating volatility and sudden reactions in the shares' market price. On the other hand, if no correlation can be proven between SPE determinants and market reactions, it can be stated that the accounting standard simply adds 'noise' to the market's informational environment (Espahbodi and Tehranian, 1989; Ziebart and Kim, 1987; Espahbodi and al, 2002). For this reason, the authors use their research to examine, in light of existing literature, four events relating to the publication of FIN46(R):

- 28 June 2002: Approval of FIN46(R) Exposure Draft;
- 17 January 2003: Publication of FIN46(R);
- 31 October 2003: Publication of FIN46(R) Exposure Draft revision;
- 19 December 2003: Publication of FIN46(R).

Dickinson and Donohoe (2007) start out with the observation that market prices do not react to the publication of standards. This suggests that market actors do not modify their perception of firms' risk in response to the promulgation of a text like FIN46(R). However, different company reactions to proposed global frameworks for SPE consolidation have been detected. Firms with the lowest debt, profitability and growth rates have experienced a positive market reaction to the announcement. Conversely, firms with the highest debt, profitability and beta ratios, and with the lowest tax rates, have experienced a negative market reaction to the announcement. The results also indicate that the securities of firms in the finance sector are likely to suffer fewer negative reactions during the promulgation of FIN46(R). According

12. Accruals represent the gap between income and treasury flows. Among such accruals, a distinction is made between charges and receipts left to the discretion of managerial decisions.

to the authors, this outcome is probably due to financial institutions' increasing use of asset securitization, given that the SPEs created towards this end have created a less dense form of financial reporting. In conclusion, Dickinson and Donohoe (2007) indicate that the standardizing events associated with FIN46(R) have modified investors' perceptions regarding the level of risk that firms face. Given the post-Enron and pre-SOX atmosphere during which FIN46(R) was enacted, the aforementioned variability in reactions mainly involves large firms and relates to questions of a regulatory nature. In other words, the promulgation process contains within itself information that, in conjunction with the demands of financial reporting, can be helpful for the evaluation of risks.

As far as we are aware, no study has ever focused on the issues raised by the derecognition of VIEs and their reconsolidation into IFRS standards. Since it is only recently that an obligation has existed to apply international accounting standards, share price reactions have also been left relatively unanalysed. What can be observed, however, is that most banking institutions in Europe do consolidate their securitization vehicles, unlike the United States. The reason why Europeans have acted thusly is not because they were forced to by some reporting standard but to protect their reputation in the financial markets. Standardization raises paramount issues today, and there is every chance that the leading securitization operation-related texts will be readjusted in the very near future (with planned announcements by both FASB and IASB). Furthermore, in light of the problems raised in Europe by the connection to other types of regulation – like Basel 2, FINREP or COREP – it is difficult to isolate which factors are affected by accounting standards alone.

IV CONCLUSION

In the current crisis situation, it is important to debate how the attribution of risks and rewards affects securitization vehicles' (de)consolidation and (de)recognition criteria. At present, fundamental differences exist between

American and international accounting standards relating to the (de)consolidation and (de)recognition of financial instruments. This explains why US financial institutions have been more seriously affected by the financial crisis than their European counterparts. The American experience shows that it is preferable to adhere to principles instead of rules, as IASB does. Yet literature in this area has also shown how difficult it can be to compare the effects of these two consolidation systems, since no entity anywhere in the world is exposed to the subprime crisis in exactly the same way. The only certainty is that security prices do not really react to a specific consolidation text, since the price is assumed to have already integrated any and all relevant accounting information beforehand. It remains that securitization operations offer a way to manage entities' financial accounts through the creation of SPEs – although window dressing alone is not the only reason for their creation, since they also help to manage the cost of capital or debt.

In addition, there is a temptation, with the generalization of the fair value principle, to hold accounting standards responsible for the fact that certain markets have assumed (and diffused) excessive banking risk. Indeed, many of the problems associated with the application of reporting standards should be attributed more to the short-term orientation of actors whose reaction to information is excessive, particularly when said information is in fact lodged in structures that can be very complex and not very transparent. In early October 2008, FASB modified the contents of its consolidation standards by proposing amendments to SFAS 140 and FIN46(R), specifically the obligation to reintegrate all QSPEs. In the same vein, IASB reacted by changing its recognition of fair value by proposing an IAS 39 amendment that would give people the possibility henceforth to book all trading securities that are classified as illiquid at their historical value on each closing date. This accounting trick will delay market reaction to the publication of banks' financial statements. The future will tell whether such amendments suffice to help markets regain confidence and resuscitate securitization operations. ■

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