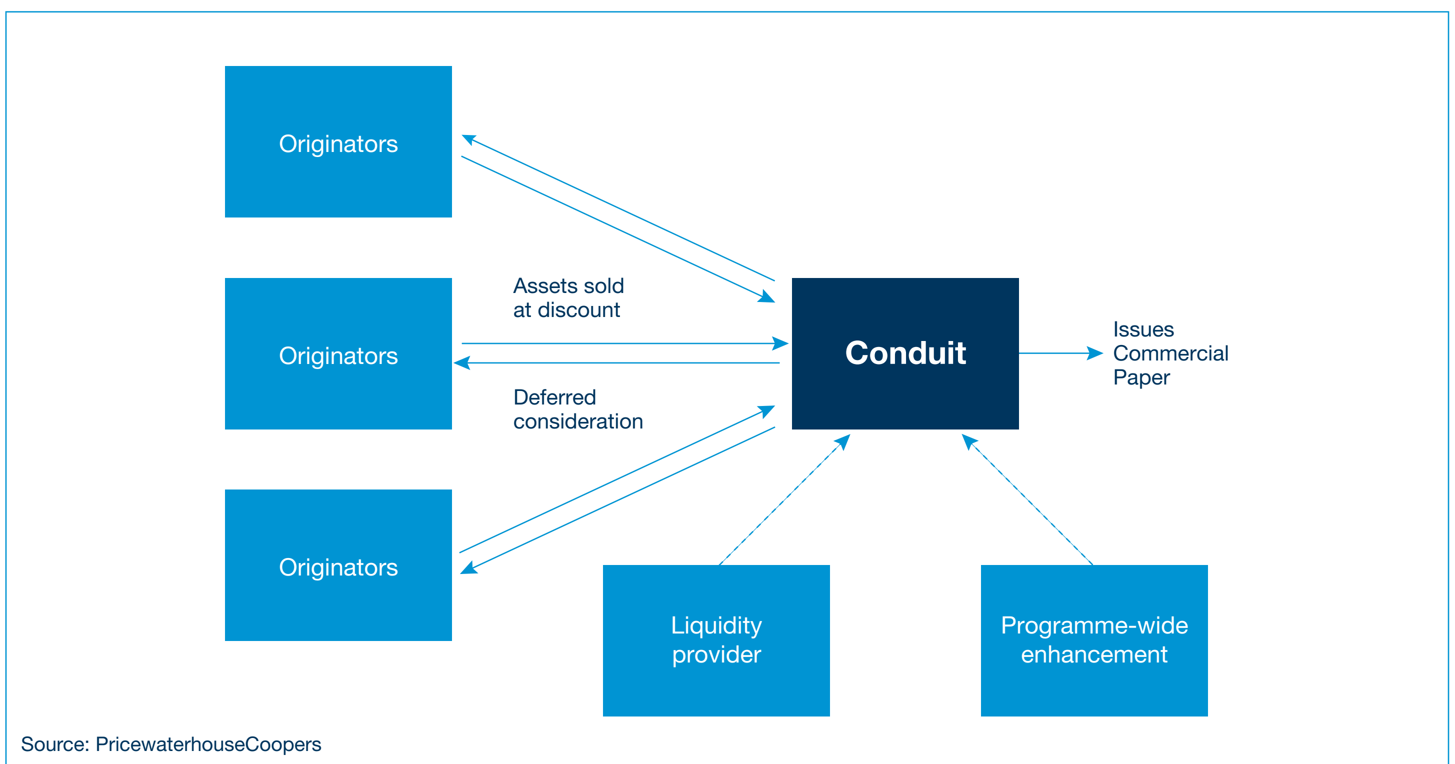
Banking & Capital Markets

Securitisation – the great accounting debate:*

Conduits – ‘on or off’ balance sheet under IFRS

Introduction

A typical multi-seller conduit has the following structure



Source: PricewaterhouseCoopers

Assets are sold by various originators at a discount to cover both primary credit enhancement and interest. The conduit, a special purpose entity ('SPE') ring fences these assets and the originator receives deferred consideration where losses do not exceed the credit enhancement.

It is assumed in this paper that no assets of the 'sponsoring' bank are included.

A liquidity provider is put in place for occasions when commercial paper issuance is not possible due, for instance, to market disruption. In some circumstances it can also cover credit losses.

A programme-wide credit enhancement ('PWE') is also put in place to ensure the conduit receives a high short-term rating. This often takes the form of a letter of credit.

In practice the liquidity provider and programme wide enhancement may be provided by the 'sponsoring bank'.

This sponsoring bank may also receive fees either from the conduit or direct from the originators. The conduit fund funds its purchases usually using Commercial Paper ('CP').

Accounting issue

The accounting issue that arises under IFRS is whether any party should consolidate the conduit? The primary accounting pronouncement that addresses this is IAS 27 and its interpretation SIC 12 but consideration of IAS 39 is also required.

SIC 12 deals specifically with when a SPE should be consolidated. It will in due course be subsumed into IAS 27(R). The fundamental concept of IAS 27 is that you consolidate those companies or vehicles that you control.

A key control test of IAS 27 is who controls the financial and operating policies of the company.

SIC 12 has four tests which indicate when a SPE may be consolidated which expand these concepts. In outline, a company should consolidate an SPE if:

(i) it is undertaking activities on its behalf and it benefits from this

(ii) it effectively controls the SPE

(iii) it has the majority of the risks of the SPE

(iv) it receives the majority of the benefits of the SPE

These tests are indicators of control and need to be considered together, for instance it might make no sense to consolidate a vehicle under tests (i) and (ii) if a company has absolutely no economic interest in the vehicle.

The risk criteria

We will first consider criterion (iii) the ‘risk test’. To understand and analyse the risk matrix of the conduit we first have to analyse the position of the originators. To do this we need to consider IAS 39.

Under this standard each originator needs to consider if they can derecognise the assets transferred to the conduit or not. To do so the originator would need to show that it has not retained ‘substantially’ all the risks and rewards of the assets. Given the high rating of the conduit and the level of credit enhancement required to support this, it will, in practice, be very rare for the originator not to have retained substantially all the risk and rewards and hence maintain the assets on its balance sheet. The corollary to this is the conduit recognising a loan to the originator rather than the assets legally acquired.

To return, therefore, to the conduit and an analysis of its risks. The conduit has a series of high quality loans to a variety of originators, funded by CP and supported by PWE and a liquidity facility. In this analysis risk will generally occur if the loans default and the key question is who bears the majority of this risk.

Clearly in the first instance it will not be the CP holders. On the face of it the PWE will bear the risk and the provider of the PWE should consolidate the conduit. In practice the liquidity provider may take some risk share and the exact terms of this facility should be considered.

Turning briefly to the other SIC 12 criteria

Criterion (iv) looks at who has the majority of the benefits of the conduit. Benefits arise in the form of interest payments to the CP holder, possibly derivative payments and various fees. How you assess and compare benefits is complex but in many cases will show a ‘sponsoring bank’ receives the majority of the variable benefit.

Criteria (i) and (ii) are more judgemental. If you ask the question why is the conduit in operation you might well conclude that it is there to enable the sponsoring bank to lend to its clients. Therefore the conduits activities are carried out on behalf of the sponsoring bank, it benefits through fees and should consolidate.

Again in practice the sponsoring bank will manage the conduit on a day-to-day basis and it will be difficult to demonstrate that de facto it does not control the conduit unless the conduit has the unlimited power to ‘kick out’ the sponsor.

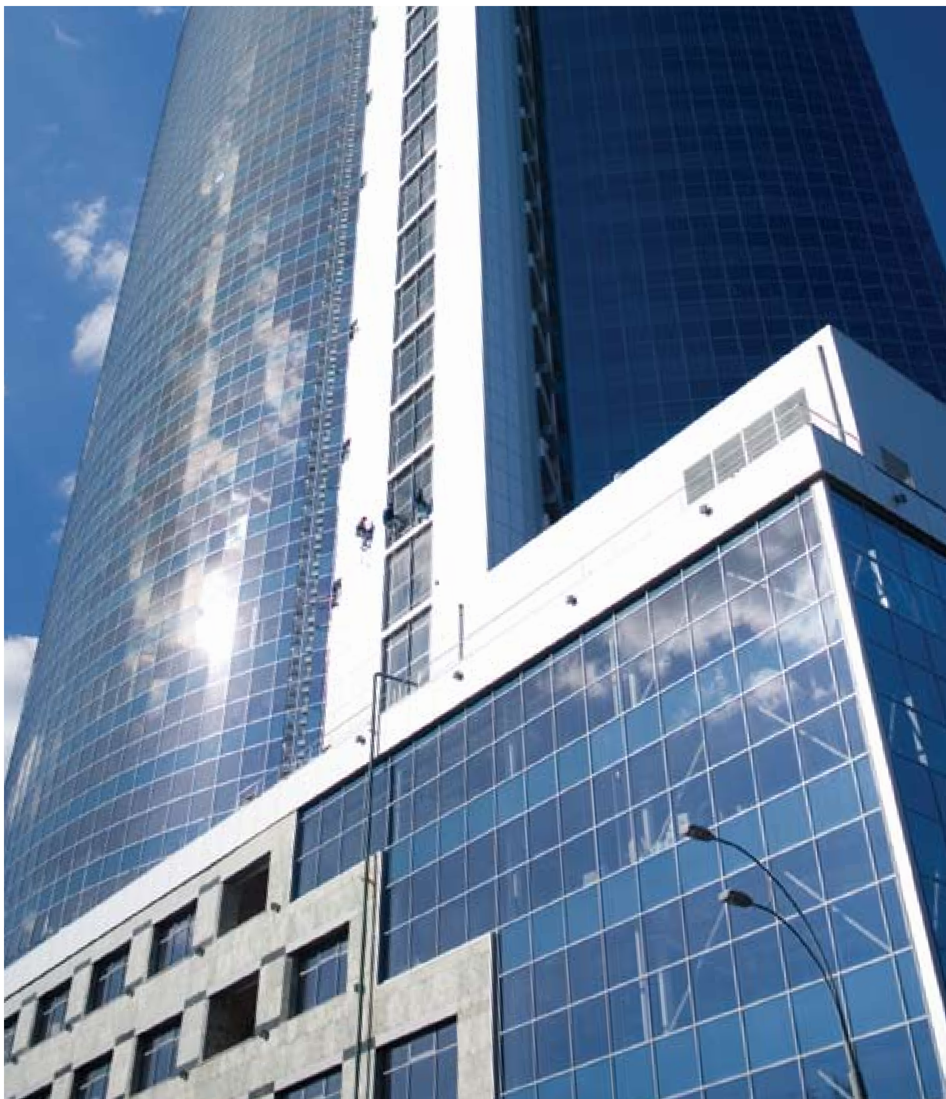
Therefore, where the sponsoring bank also provides liquidity support and PWE, it almost certainly will need to consolidate the conduit.

If, however, these roles are shared with third parties the analysis becomes more difficult and it may be possible to demonstrate nobody controls the conduit.

Does the accounting matter?

For many sponsoring banks the accounting will only matter if it affects regulatory capital. This will depend on individual country regulators. To date the French regulator seems to have decided to adopt an accounting approach and require full capital backing against the consolidated assets. On the other hand the Dutch regulator appears to be adopting a Basel II approach, ignoring the accounting and requiring capital backing against the PWE and liquidity facility.

To facilitate this the rating agencies are developing rating methodologies to rate liquidity facilities. This latter approach is the one adopted in the short term by the US authorities when FIN 46 was implemented.



Restructuring possibilities

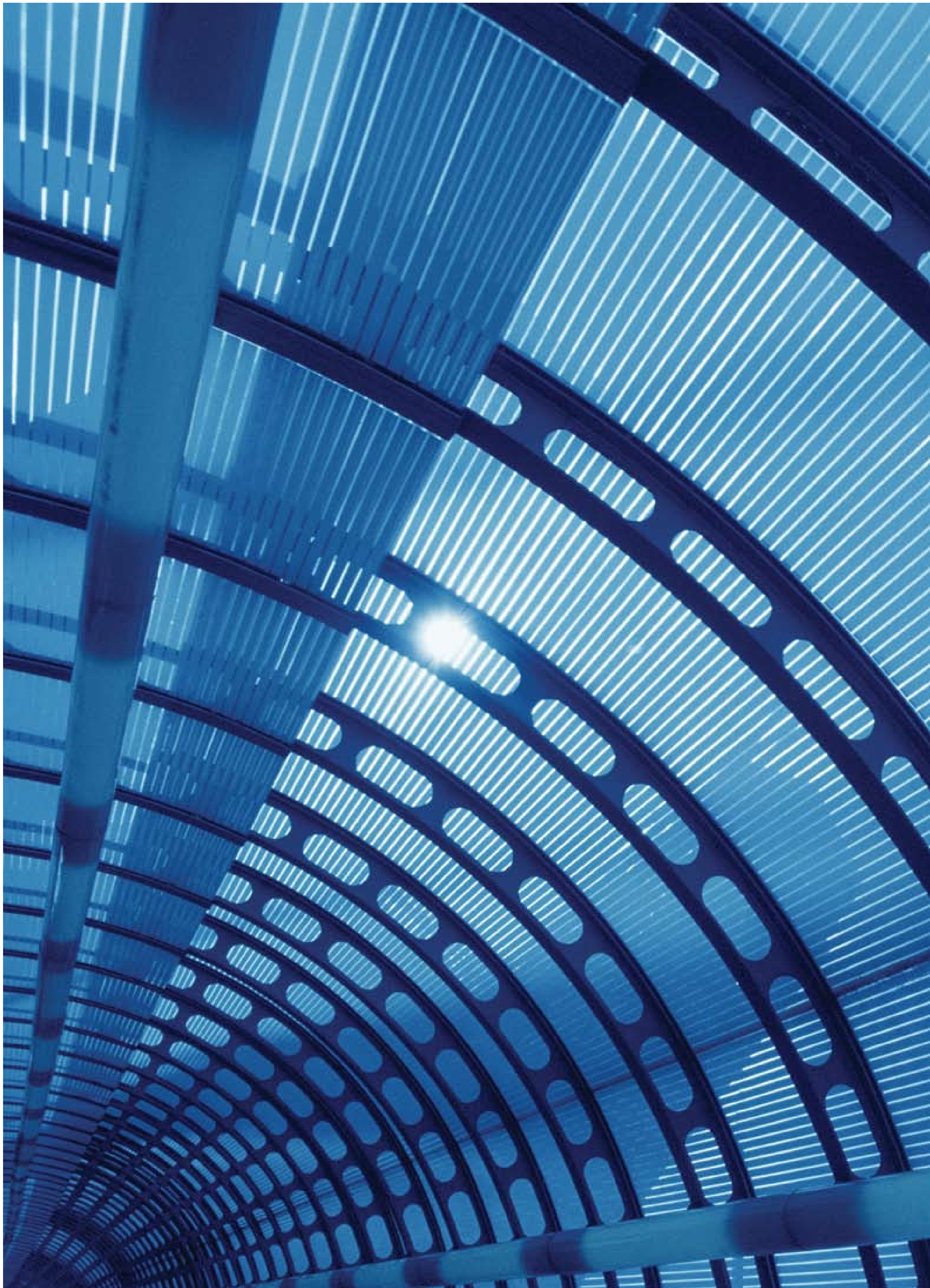
A number of European conduits sponsors who do not want to consolidate their conduits are looking to see if something akin to Expected Loss Notes (‘ELN’) helps in this regard.

ELNs were developed by US companies to avoid consolidation under FIN 46 and there are a number of potential investors in such notes active in the market.

These notes would be structured so that the PWE does not take the majority of the risks as analysed using FIN 46 type technology. Using the analysis it can usually be shown that, by issuing a relatively small level of ELNs, the majority of the risk moves away from the PWE as does enough benefit to bring the sponsor below 50 per cent.

Two important warnings should, however, be given to this approach:

- Whilst ELNs may work within the rigid rules of FIN 46, SIC 12 is a much more ‘substance’-based standard and issuing a small level of ELNs may not pass the ‘sniff test’ of SIC 12.
- ELNs will only handle the risk criteria of SIC 12 and possibly some of the benefit criteria. The activity and control criteria of IAS 27 and SIC 12 will remain a real challenge.



Contacts

Peter Jeffrey
PricewaterhouseCoopers (Europe)
44 20 7804 5214
peter.c.jeffrey@uk.pwc.com

Roland Jeanquart
PricewaterhouseCoopers (Belgium)
32 2 710 4024
roland.jeanquart@be.pwc.com

Anik Chaumartin
PricewaterhouseCoopers (France)
33 1 5657 8038
anik.chaumartin@fr.pwc.com

Dirk Stiller
PricewaterhouseCoopers (Germany)
49 40 6378 1295
dirk.stiller@de.pwc.com

Emil Yiannopoulos
PricewaterhouseCoopers (Greece)
30 210 687 4640
emil.yiannopoulos@gr.pwc.com

Padraic Joyce
PricewaterhouseCoopers (Ireland)
353 1 792 6394
padraic.joyce@ie.pwc.com

Fedele Pascuzzi
PricewaterhouseCoopers (Italy)
39 02 806 46323
fedele.pascuzzi@it.pwc.com

Peter Yates
PricewaterhouseCoopers (Jersey)
44 1534 838 233
peter.yates@je.pwc.com

Guenter Simon
PricewaterhouseCoopers (Luxembourg)
352 494 848 2375
guenter.simon@lu.pwc.com

Kenneth Macfarlane
PricewaterhouseCoopers
(Middle East – Oman)
968 2455 9113
kenneth.macfarlane@om.pwc.com

Manuel Luz
PricewaterhouseCoopers (Portugal)
351 213 599 2304
manuel.luz@pt.pwc.com

Alex Bertolotti
PricewaterhouseCoopers (Russia)
7 495 232 5635
alex.bertolotti@ru.pwc.com

Ignacio Medina
PricewaterhouseCoopers (Spain)
34 91 568 4183
ignacio.medina@es.pwc.com

Guido Andermatt
PricewaterhouseCoopers (Switzerland)
41 58 792 2540
guido.andermatt@ch.pwc.com

Jeroen De Jonge
PricewaterhouseCoopers
(The Netherlands)
31 20 568 6524
jeroen.de.jonge@nl.pwc.com

Mark Davis
PricewaterhouseCoopers (UK)
44 20 7212 4011
mark.w.davis@uk.pwc.com

The member firms of the PricewaterhouseCoopers network (www.pwc.com) provide industry-focused assurance, tax and advisory services to build public trust and enhance value for its clients and their stakeholders. More than 140,000 people in 149 countries share their thinking, experience and solutions to develop fresh perspectives and practical advice.

'PricewaterhouseCoopers' refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity. Designed by studioec4 18722 (05/07).

www.pwc.com/securitisation

PricewaterhouseCoopers