Spring 2006

Banking/ Capital Markets Issues

Insights into the Trends Shaping our Industry*

SEC Update
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PwC Resources

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Welcome to the Spring 2006 edition of PwC's Banking/Capital Markets Issues, formerly Banking Issues, where we bring you insights into the trends shaping our industry. Our publication's new name, we feel, reflects the diverse backgrounds of our readers and caters to a wider scope of industry interests. We hope you agree!

You'll also notice that we added a new section, "Market Noise", where you'll hear the latest "top of mind" industry buzz. Of course, our magazine still offers you the key areas of interest: SEC Update, Technical Accounting Issues and Regulatory Developments, each of which have articles specifically written to keep you abreast of our industry's critical challenges. Our objective is to provide you with fresh perspectives and analysis of recent industry and regulatory developments.

As always, all articles are written by subject matter specialists from PricewaterhouseCoopers' Banking & Capital Markets Industry Practice. And because each author is a subject matter professional in his or her respective discipline, I encourage you to contact them with questions you may have about a particular or related topic.

We are committed to keeping you informed of industry trends, public reporting requirements, and regulatory changes. We extend our commitment through meaningful forums, such as conferences, roundtables, conference calls, white papers and publications, such as this magazine, which are designed to be value-added learning experiences for our clients and colleagues. On behalf of our practice, we hope that you find Banking/Capital Markets Issues to be insightful and we welcome your feedback.

Best regards,

William J. Lewis
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U.S. Banking & Capital Markets Practice Leader

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SEC Update

Regulation AB: A New Era for Asset-backed Securities—Are You Prepared?

by Mike Seelig/
LaWanda Morris/
Richard Gill

January 1, 2006 marked the beginning of a new era in the disclosure and periodic reporting requirements related to publicly-issued asset-backed securities (ABS) under the Securities and Exchange Commission's Regulation AB (Reg AB) guidance.

Reg AB does not supplant the Securities and Exchange Acts of 1933 and 1934, but rather enhances them to reflect the development, growth and maturation of the traditional mortgage backed security (MBS) and ABS markets, now collectively referred to as ABS markets. As a result of Reg AB, there are numerous changes to what now can be defined as an ABS, as well as new and enhanced requirements surrounding the composition, registration, disclosure and reporting responsibilities of issuers associated with a public transaction.

Reg AB also addresses one of the most critical components in the success of any issuance—that is, the servicing of the supporting assets and bonds on behalf of investors. Changes to the disclosures surrounding the servicing function, as well as the new servicing criteria to be applied to servicing activities, are stipulated in sections 1108 and 1122 of Reg AB, respectively.

Why Is Servicing So Important?

Following the issuance of an asset-backed security, the servicing of assets is a critical component in maintaining the viability of the issuance. Generally, market and credit risk are clearly explained in the prospectus and are highlighted at issuance. Many transactions have multiple servicers (that is, master, primary, and sub-servicing relationships) and special servicers (for example: foreclosure, workout or repossession experts). Some of these servicers are private companies or are less experienced in making assessments as to their compliance with the nuances of servicing individual asset classes that are within the ever-expanding ABS market. The SEC intends for the adoption of Reg AB's uniform criteria for servicing and the related cyclical disclosures to provide investors with greater transparency as to the performance of the servicers who are supporting the value of the underlying assets and ensuring the proper application of cash flows to the bond holders.

Prior to the issuance of this regulation, the servicing of the underlying assets was generally reported upon under a framework known as the Mortgage Banker's Association (MBA) Uniform Single Attestation Program (USAP).

Reg AB provides for broader and more formal servicing performance reporting and also expands upon the definition of a servicer. A servicer is now defined as "...any person responsible for the management or collection of the pool assets or making allocations or distributions to holders of the asset-backed security(ies)." The criteria to be applied and disclosures required for all those entities deemed servicers are extensive and extend beyond the historic perception of servicing activities.

A year after the release of the new rules, the industry continues to debate this definition and question who might qualify as a servicer under the expanded rules. As Reg AB is a principles-based standard, the broad-based application of the definition should be applied. However, diligence should be taken in any application of the term. The MBA, the American Securitization Forum (ASF) and other industry groups have been instrumental in advancing common industry views on some of these matters and in seeking further guidance where warranted.

Servicer Disclosures: Section 1108

The disclosures that are a part of Section 1108 are designed to provide insight into what a

"…reasonable investor would find material in considering an investment in the asset-backed securities and the servicing and administration of the pool assets and the ABS."

The three broad areas that need to be addressed are as follows:

1. Identifying information and experience: A narrative on the qualifications and expertise of the servicer in performing their functions as they relate to the pool of assets as well as any material financial information or changes to servicing policies and procedures that may affect the pool being serviced.

2. Servicing agreements and servicing practices: A description of the terms of the servicing agreement, general and unique elements to servicing a particular asset class, and any limitations on servicer liability.

3. Back-up servicing: The naming of an identified back-up servicer as well as a description of the material terms necessary and process in place to bring in a back-up servicer, if needed.

The clear identification of all roles and responsibilities of all material servicers (as defined above) will provide further disclosure to investors as to the level of competence of the parties involved in daily maintenance and monitoring of pool assets, as well as their expertise in the administration of cash allocations and distributions. These disclosures now allow investors to evaluate the manner in which the underlying assets and cash administrative processes are being governed and to make an informed investment decision about a significant component of the process that was formally never disclosed.

Servicing Criteria: Section 1122

There are more than 30 specific servicing criteria mentioned in section 1122 of Reg AB, which will become the de facto minimum servicing criteria for all ABS. These criteria will likely usurp the MBA's USAP servicing criteria that have been the residential mortgage industry standard, but were often applied by analogy to other asset types within the greater ABS market. As no official minimum servicing standard existed for other asset classes, Reg AB marries the newly defined role of servicer (above) with servicing criteria that can be applied across a broader class of assets in the marketplace.

Following are the four general categories of servicing criteria with brief summaries of content:

1. General servicing considerations: Review of the monitoring of trigger events, a third party's performance and compliance of servicing, preparedness for backup servicing, and assurance that the fidelity bond and errors and omissions policies are in effect.

2. Cash collection and administration: A focus on establishing and maintaining proper controls around all forms of cash that may relate to a transaction - inflows, disbursements, and reserve amounts - are all covered as well as the application of cash to obligor's accounts and the subsequent timely reconcilement of the cash accounts.

3. Investor remittance and reporting: Assurance that all requisite investor

filings with the SEC have been verified, are accurate, and are in accordance with the underlying transaction agreements.

4. Pool asset administration: Detailed descriptions of daily servicing activities (for example: substitutions of assets, loan modifications, interest rate adjustments, etc.) that are conducted in accordance with the transaction documents and that credit enhancement is properly maintained.

Each of the parties that are defined as servicers must now formally assess and make an assertion regarding their compliance with the criteria in 1-4 above. On an annual basis, public accountants will be required to perform an attestation of the servicing party's assertion on compliance with the criteria and note any areas of material non-compliance that have occurred throughout the year, regardless of whether the issue has been remediated by year-end. The ramifications of any material instance of noncompliance include clearly disclosing these elements in the 10-K and while there is no defined penalty for a material instance of non-compliance, the existence of them could affect an issuer's ability to issue securities via their shelf registration. What reaction will the market have? Market participants must be diligent in their preparation for the implementation of these new rules that took effect on January 1, 2006.

Clearly, Reg AB expands upon the existing servicer assertion criteria pursuant to USAP guidance. The new criteria will likely require participants to enhance existing processes and related documentation in order to demonstrate compliance with new servicer criteria. Furthermore, new and expanded disclosure criteria for both initial registration and ongoing monthly reporting under Form 10-D will require automated collection of tremendous amounts of data which will place significant demands on data management, technology, and reporting resources.

There are many questions related to the interpretation of the new rule which continue to be vetted and clarified by industry participants, attorneys and the accounting firms.

Industry Insights

The ASF, MBA and others have been actively involved in leading industry discussions among market participants and the major accounting firms to discuss disclosure and servicing criteria-related issues with respect to Reg AB.

During meetings attended by various industry constituent groups and the major public accounting firms over the past six months, a number of questions have been raised surrounding implementation and application of the new Reg AB requirements, particularly as it pertains to some of the new servicing criteria.

Some of the questions currently being vetted by market participants, industry groups and the accounting firms include the following:

- Definition of Platform: How should servicers define their servicing platforms? Can a platform be defined to include collateral only for post 1/1/06 deals? Should collateral for registered and non-registered ABS (public and private deals) be included in the platform for similar asset type? Should a platform break out collateral by servicing location, legal entity, collateral type? May servicers exclude deals from compliance testing after a transaction is delisted?

- Identification of "servicer": What parties participating in the servicing function should be required to issue separate 1122 Servicer Attestation reports? How should companies differentiate between "vendor" versus "servicer"?

- Management documentation of its internal assessment process and testing performed to support its compliance assertion: As the auditor is required under generally accepted auditing standards to ensure that management has a basis for their assessment of compliance, what level of documentation should management maintain to evidence their internal assessment for making their compliance assertions?

- Compliance criteria interpretations: How does the SEC define "all reports to investors" pursuant to section 1122.d.3 (i)? What degree of transaction remodeling by management or the auditors will be required to assert to the accuracy surrounding the calculation of payments remitted to investors?

- Material instances of non-compliance: How will "material instances" of non-compliance be defined for purposes of identifying reportable findings? Should a framework be developed for evaluating "material" exceptions similar to Sarbanes-Oxley assessments conducted under Section 404?

These issues and others continue to be discussed among industry participants as implementation of the new requirements begins to take hold.

Recently, the Securities and Exchange Commission (SEC) issued an online list of frequently asked questions and answers (Q&A) regarding the Securities Offering Reform (SOR) (as of November 30, 2005).

The SEC Division of Corporate Finance has also posted telephone interpretations on the SEC's web site related to the Regulation. We expect further guidance to be issued, where warranted.

The questions and answers represent the views of the staff of the Division of Corporation Finance with respect to questions they have received regarding the new rules and forms adopted by the SEC in the SOR rulemaking. The questions and answers are not rules, regulations, or statements of the Commission. Further, the Commission has neither approved nor disapproved the questions and answers.

Compliance Considerations

While the first reporting date under the new servicing criteria is a year away for most companies, compliance must be demonstrated for all of 2006. This is an important distinction as the assessment under Reg AB is a "during the year" assessment, not a "point in time" or "end of year" assessment as many are accustomed to under Sarbanes- Oxley requirements. Management should now be evaluating the suitability of their current processes to meet the new compliance criteria pursuant to Section 1122 of the Regulation.

If not already initiated, management should reach out to legal counsel and their external auditors as quickly as possible to begin discussions surrounding their:

- servicing compliance assertion: how management will define servicing platform and demonstrate compliance with servicing criteria; and

- compliance assessment with Reg AB: documentation of management's assessment, identification of exceptions at transaction level, testing to be performed by management, and the auditors, etc.

Reflections, Thoughts & Comments:

Many investors have indicated they welcome these changes brought about by Reg AB as an attempt to create transparency in the market and to have a uniform measure in the evaluation of servicing attributes. The road ahead for servicers will require greater levels of internal scrutiny and evaluation, and compliance in the initial year may be challenging for some companies as improvements to processes and systems may be necessary to ensure and demonstrate compliance.

In some cases, diversity remains in the definition of critical terms; however, their interpretation should be broad-based to ensure compliance. It is essential that all servicers clearly understand and define their role in the transaction and what is required of them as a result. Companies are encouraged to think about their platform definition—not too broad, not too narrow—and to ensure that all parties impacted by the servicing criteria are notified and expectations managed.

An emerging best practice is to create a matrix of the criteria, denoting each party required to assert compliance. Perform an internal assessment of your company's ability to adopt these principles and evaluate the controls that are in place to ensure that the assessment and assertion covers the role your company plays in the servicing of assets under the transaction agreements.

While there remain several key questions and issues that may require further clarification around Reg AB and its implementation, the various industry, accounting firm, and legal constituents will continue to resolve these items in the coming months. From now through the first quarter of 2007, when the first annual reports will be due, the business of servicing will once again be front and center. The process of how information will be reported, by whom and when it will be reported, will be challenging as the industry makes its first attempts at asserting compliance with the new criteria, and the accounting firms prepare their initial year attestation reports.

For more information on Reg AB, please contact Mike Seelig at 612.596.6401 (mike.seelig@us.pwc.com)/Lawanda Morris at 646.471.5653 (lawanda.morris@us.pwc.com)/Richard Gill at 773.710.0702 (richard.gill@us.pwc.com).

We encourage you to read the related article, "Securitization: An Everchanging Landscape," which may be found on page 26 in this publication.

Important dates:

- August 31, 2005—Shelf Registration (S-3) requirements change
- January 1, 2006—All new Registrations (S-1 and S-3) must be Regulation AB compliant
- February 2006—First Form 10-D's filed with SEC
- March 31, 2006—Prospectus Supplement changes
- March 2007—New Form 10-K accompanied with Servicer Assertion and Accountant's Attestation report required for full fiscal year period (1/1/2006—12/31/2006)

Sarbanes-Oxley Section 404: From Project to Process—5 Lessons Learned for Improved Year-3 Efficiency

By Darin Wettengel

Compliance with Section 404 of the Sarbanes-Oxley Act of 2002, which requires public companies to assess their internal controls over financial reporting, has proven to be among the most challenging of the many new statutory and regulatory requirements imposed on business during the past several years.

During 2004, the first full year of Sarbanes-Oxley compliance, companies and their auditors were concerned with understanding the law's requirements, identifying issues within their own operations and charting a compliance path. Given the evolving guidance from the SEC and PCAOB, the path to compliance proved a challenge.

2005 Year Two progress towards a more sustainable process was slowed somewhat as companies tried to digest the first year's results and adapt to the more detailed guidance issued by the SEC and PCAOB in May 2005. Now in Year 3, companies are striving to improve Sarbanes-Oxley compliance efficiency—especially for Section 404—by changing their approach from a project-based effort to a more sustainable process strategy. To achieve such efficiency, companies are moving towards embedding compliance fulfillment in the day-to-day operations rather than executing the process as a compliance exercise.

Following are five key lessons from Years One and Two that banks and other financial institutions have learned related to Sarbanes-Oxley compliance efficiency in moving from project to process in Year 3.

Lesson 1: Identify Control Deficiencies

The news from Year One was both good and not so good. Good, in that the revelations of widespread fraud predicted by some did not materialize. U.S. businesses, on the whole, are doing the right thing.

However, a significant number of internal control deficiencies were identified, and their importance should not be minimized. For example, a review of Edgar filings with the SEC through September 30, 2005 indicates that 14.5 % of Section 404

reports submitted by accelerated filers in Year One had an adverse opinion, or 472 adverse reports among the 3,263 submitted.

The Banking and Capital Markets sector, with a 10 percent adverse report ratio, had a lower rate of adverse reports than U.S. industry as a whole (although still higher than the Investment Management and Insurance sectors, at 7 percent and 8 percent, respectively).

The most frequently-cited material weaknesses at financial services companies included:

- accounting for deferred loan fees and costs;
- accounting for transfers of financial assets;
- accounting for derivative financial instruments; and
- allowance for loan and lease losses.

Given the varied nature of such weaknesses, it is crucial for companies to quickly identify control deficiencies, the controls affected, and the level of risk associated with a deficiency. Not all control deficiencies are created equal, and resources need to be dedicated appropriately.

Lesson 2: Remediate Control Deficiencies

Investor responses appear to differ depending on the type of weakness identified. For example, investors seem to be more concerned about pervasive weaknesses rather than those that are more isolated, and are especially concerned about the impact of weaknesses on possible financial statement restatements. This understanding can help focus a company's remediation efforts.

A key operating principle learned from Year One is remediation almost always takes longer than anticipated, and is affected by the total number of weaknesses as well as their severity. Notably, information technology weaknesses were especially time-consuming to remediate. Also, the use of a point-in-time evaluation standard allows companies to remediate existing control deficiencies throughout the period, but for purposes of Section 404 the remediated controls must be in place and operating effectively by the end of the current reporting year.

In some instances, remediation in Year One seems to have taken the form of short-term fixes that are neither cost-efficient nor effective in the long run. Addressing the root cause of problems requires not only resources but often a commitment to structural or process changes over time. Once control exceptions or deficiencies have been identified, management needs to quickly focus on evaluating their cause and impact, and putting in place well-documented remediation initiatives that address the root causes of weaknesses.

Lesson 3: Focus Early on Company Level Controls and Information Technology General Controls

Company level controls ("CLC's") are controls that are operational throughout the entire organization and often have a pervasive effect on controls at the process, transaction, or application level.

Information Technology General Controls ("ITGC's") generally operate to ensure the proper operation of electronic data processing and include controls related to: access to programs and data; computer operations; program changes; and program development. Effective ITGCs promote the continued effective operation of application controls and automated accounting procedures that depend on computer processes and are also significant for manual controls that are dependent on application generated information.

Both of these areas are considered to be pervasive in nature and generally should be evaluated early in the Section 404 process to achieve the greatest benefit from both an efficiency and effectiveness perspective.

Early testing of pervasive controls offer companies the following advantages:

- Early testing of CLC's and ITGCs allow companies to avoid being constrained by the resource demands that they typically encounter during the third and fourth quarters.
- An early determination of the effectiveness of CLC's and ITGC's should

provide timely insight as to the internal control work that will be required at the business process level and may result in efficiencies when testing these controls.

- Knowing the results of CLC and ITGC testing earlier in the year allows companies to identify issues sooner, allowing problems to be remedied prior to the "as of" date for compliance.

As companies continue to refine their 404 process, early focus on CLC's and ITGCs will help to improve resource and testing efficiency and to maximize the leverage that can be placed on effective controls.

Lesson 4: Attribute 404 Ownership

Many companies met Section 404's requirements in 2004 through an extraordinary and costly effort that demanded countless hours from staff and consultants. Such efforts draw resources from core business operations and are not sustainable, especially for many smaller public companies. To help manage the effort and maximize efficiency, companies should determine 404 ownership early on in the process.

To a large extent, the decision on how to attribute 404 ownership will be the result of each company's culture, organizational structure and operating needs. However, as time progresses, companies are likely to gravitate towards a model that more directly embeds 404 compliance into each business line's operations, which ultimately tends to make the process more efficient and more likely to generate synergistic benefits. The assignment of responsibility for compliance will guide how easily Section 404 activities can be embedded into operations, and needs to be made early in the process.

Lesson 5: Adopt Across-the-Board Training

For Section 404 compliance to be embedded in operations, all impacted employees—and especially those at a managerial level—need to understand how Section 404 activities affect their day to day work and how they can leverage these activities to improve their own operations.

Such understanding is not likely to be obtained through an annual memorandum or mention at a staff meeting. Instead, companies need to relate Section 404 compliance activities to their operations, analyzing possible benefits of mainstreaming these activities. These benefits, and the steps needed to realize them through Section 404, must be communicated to employees through periodic training that makes it directly relevant to their work. By mainstreaming these activities, management can better realize spin-off benefits from Section 404 while reducing compliance costs (in some examples, companies have integrated their 404 compliance with other self-assessment programs or process improvement initiatives).

Conclusion:

Achieving sustainability in Section 404 compliance is clearly a multi-year process. In addition to patience and endurance, it requires the aptitude to effectively evaluate the 404 process and the discipline to commit to a pace for the long term.

When implementing Section 404 compliance programs, companies need to ensure that they clearly define roles and expectations early, promptly incorporate lessons learned from the previous period, and dedicate resources appropriately. Sustainable, "project to process", compliance can be embedded in company operations from the ground up, and generate benefits that will begin to offset the cost of compliance.

For more information on Sarbanes-Oxley compliance, please contact Darin Wettengel at 704.350.7923 (darin.wettengel@us.pwc.com).

Regulatory & Tax Developments

Top 5 Anti-Money Laundering Challenges Facing Banks

By Monique Maranto

Passage of the USA PATRIOT Act in October 2001 dramatically changed anti-money laundering (AML) compliance for banks and other financial institutions, strengthening requirements and increasing penalties and fines for noncompliance. In the four years since then, financial institutions have made great efforts to enhance their systems and procedures to comply with AML requirements. Yet, continued increasing scrutiny by regulators has many banks searching for the light at the end of the tunnel. While we can't currently forecast such an occurrence, we do suggest that banks and financial institutions focus on the following five critical areas to navigate an effective strategy for money laundering compliance:

- Identifying compliance issues
- Implementing enterprise-wide AML programs—risk-based approach
- Managing the risks of certain businesses
- Knowing your employees
- Applying technology to AML initiatives

Identifying Compliance Issues

The fines and penalties assessed against banks for failure to comply with AML-related requirements have increased significantly in the last two years. For example, U.S. Department of the Treasury civil penalties imposed for bank secrecy violations grew from $200,000 in 2001 to $35 million in 2004. These fines, and the extensive remedial agreements that typically also are required, represent significant costs for noncompliant institutions. Equally important is the reputational damage suffered by institutions once their noncompliance is spotlighted in the media.

It is critical that preventative measures be taken to identify compliance issues before they result in damaging penalties or media exposure. In today's environment, banks can no longer rely solely on an independent review or internal audit, but rather must proactively develop effective controls to deal with high-risk processes or businesses. The challenge is having the resources to develop the proper controls and methods to identify issues/concerns. This can be more easily managed if it is done on a risk-based approach.

Implementing Enterprise-Wide AML Programs—Risk-Based Approach

Experience, industry best practices and recommendations from regulatory bodies, such as the U.S. Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) suggest that the only manageable way for banks to meet the regulatory requirements and expectations for AML is to assume a risk-based approach. This means implementing an enterprise wide AML compliance program consolidated across activities, business lines and entities. Such a program should include:

- Enterprise-wide identification of the sources, ranking, limits and typologies of risk;
- Appropriate limits on the enterprise-wide AML compliance program and central management of specific functions of the program;
- Customer due diligence, initiated at account opening and maintained throughout the relationship;
- The role and scope of an internal audit in evaluating the enterprise wide AML compliance program and the extent of transaction testing;
- Comprehensive training tailored to individual employee responsibilities; and
- Effective internal reporting.

While each of these initiatives will take time, critical areas can be identified and resources deployed accordingly by applying an enterprise-wide risk-based approach. This not only helps from a regulatory perspective, but also demonstrates to the institution's board of directors and senior management the risks associated with compliance failures and substantiates requests for additional resources.

Managing the Risk of Certain Businesses

FinCEN and other U.S. government entities have identified certain types of businesses as being at a higher risk for money-laundering, such as money services businesses, jewelers and charities. In order for these businesses to function properly, they need bank services to facilitate their transactions. However, in some cases, particularly with money services businesses, banks have decided to discontinue such relationships due to high risk or the lack of return given the additional work required.

For banks that do maintain relationships with such types of businesses, FinCEN has strongly advised that proper controls be put in place to manage the associated risks. These controls serve as best practices for complying with AML requirements—in some cases it is not a regulatory requirement but necessary for the business so banks will work with them. These controls include, but are not limited to, the following:

- Ability of the bank to identify and track high-risk customers;
- The bank to review the customer's AML policy and AML training programs;
- Required independent AML program review by a qualified third party;
- Understanding of the customer's business transactions, including locations, clientele, types of products or services provided;
- Site visits;
- Transaction expectations, including type, frequency and dollar amount;
- Licensing requirements; and
- Independent oversight or approval of the business relationship.

Banks will need to apply the risk process to adequately determine which steps need to be applied to which customers and when.

Knowing Your Employees

In the past, businesses developing antifraud measures have always been told: "Know your customer." That advice is still sound, but needs to be extended to: "Know your employees."

A review of major money laundering cases reveals an increase in employee involvement, whether for personal enrichment or through misguided attempts to meet customer demands. Therefore, it is important for financial institutions to better know their employees and to monitor job performance—not just its quality but whether it meets certain other criteria.

Some examples of employee-level controls that may be considered include making sure employees take the proper time off, performing Office of Foreign

Assets Control (OFAC) checks on employees, involving additional employees in client management and ensuring that certain types of transactions are under dual control.

Applying Technology to AML Initiatives

Banks depend on technology not only for business efficiency but also to meet regulatory requirements. In the past, some banks, depending upon their size, were able to manually comply with currency transaction reporting or monitoring requirements. However, in today's environment—with improved technology capabilities and greater data availability—systematic solutions are less expensive and can more accurately meet regulatory standards.

In order to monitor transactions for potentially suspicious activity, banks should be implementing systems similar to those used by the U.S. government to review currency transactions and assess Suspicious Activity Reports. Although such a system would allow for more accurate and timely data, it does pose the following challenges:

Data Integrity

The "garbage in, garbage out" mantra of information technology officers is as valid here as it is anywhere. If a bank does not have complete information in key fields (e.g., legal name, permanent address, local address, Social Security number or tax identification number, industry code, country of origin, foreign status and other detailed information depending upon the client type), the results of the software solution will not be accurate or effective.

Multiple Sources of Data

Banks will often have several systems or databases that contain customer information. However, these systems do not always correlate nor do they share common fields that can easily link similar customers or relationships.

Selecting the Appropriate Software Solution

With many vendors providing solutions for compliance needs, the challenge for banks is selecting the system most appropriate for their particular needs, especially given regulatory deadlines that do not permit the usual vendor selection processes. The following are some criteria that may be considered before choosing a vendor:

- Does this product meet the compliance needs for which it is intended?
- Can the vendor be relied upon for technology support and system upgrades?
- What are the experiences of other companies who have used this system?
- Is this system compatible with the institution's existing internal systems?
- Is the system suitable for the institution's size and is it scalable to accommodate growth?

Establishing the Proper Infrastructure to Support the Solution

During the implementation phase of a technology-based solution, consideration must be given to the resources and processes needed to support the effective use of the output. The resources and processes may be revised as the system is refined, but if the basic infrastructure is not established, then the institution can find itself in the situation of having a solution but no means to populate, manage or use the information.

Conclusion

There seems to be little appetite in Congress or the Administration for significantly lightening the USA PATRIOT Act's AML requirements, so banks and other financial institutions must maintain a laser-like focus on compliance.

Institutions seeking to reduce the risks of noncompliance should focus on implementing effective, risk-based management programs. They must be cognizant of the risks that can lead to AML penalties, including failure to monitor employee-level compliance and doing business with high-risk sectors. Most importantly, banks and financial institutions should invest in the technology that will best serve their particular AML compliance needs.

In combination, these strategies will enable banks to fulfill the applicable AML requirements, avoiding the cost and reputational damage associated with noncompliance.

For more information on AML challenges, please contact Monique Maranto at 202.414.4334 (monique.maranto@us.pwc.com).

Balancing Tax and Regulatory Requirements: an Investment Banking Institution's Dilemma

by Adam M. Katz/
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In 2004, the Organization for Economic Co-operation and Development (OECD), through Working Party 6 of the Committee of Fiscal Affairs, issued Part III of its draft paper on the Attribution of Profits to Permanent Establishments, which addresses global trading.[1] As the OECD works toward finalizing Part III of the Discussion Draft, multinational taxpayers conducting global trading operations may find themselves in a quandary from a tax and banking regulatory perspective.

The issue under debate relates to the appropriate sharing of profits, under the arm's length principle, between capital-related and trading activities. The OECD position is that the provider of capital is entitled to a routine return commensurate with the risks inherent in the trading book in question and, in effect, the residual profits are attributable to the people functions or key entrepreneurial risk taking activities ("KERT's"), which in most scenarios are undertaken by the traders (this is also known as the "OECD Approach"). When taxpayers house capital and people functions in separate legal entities, the OECD's model raises two banking and securities regulation issues:

1. The consistency between the arm's length return on capital defined by the OECD and that required by regulatory bodies (e.g., the Federal Reserve, the Bank of England); and

2. The potential increase in the level of capital reserves held by the broker/dealer required by securities regulatory bodies (i.e., the SEC, the FSA, etc.), due to its role as the entrepreneurial risk taker under the OECD model.

As illustrated below, the OECD approach is in many instances in direct conflict with banking and securities regulatory requirements; Working Party 6 should consider this issue when finalizing its paper, which is expected in early 2007. Additionally, it is critical that taxpayers be careful to consider both tax and regulatory implications when determining a compensation policy for booking and trading activities, when such activities are housed in separate legal entities, and that such policy be

[1] OECD Discussion Draft of the Attribution of Profits to Permanent Establishment—Part I (General Considerations), 2 August 2004, Discussion Draft on the Attribution of Profits to Permanent Establishments (PEs): Part II (Banks), 4 March 2003 and Part III: Special Considerations for Applying the Authorized OECD Approach to Permanent Establishments of Enterprises Carrying on Global Trading of Financial Instruments, 4 March 2003. Parts II and Part III were subsequently revised based on responses from the banking, business and advisory firms, as well as a March 2004 consultation in Geneva Switzerland, and re-issued in draft during August, 2004, solely to the group of commentators.

appropriately documented in an intercompany agreement.

Case Study: Bank ABC

To illustrate the conflict between the OECD and Regulatory bodies, consider the case study below:

1. Bank ABC is a U.S.-based multinational commercial and investment bank, which, among many other business lines, is a market maker in equity derivatives;

2. The bank has two legal entities, ABC-Capital, Inc., a U.S. subsidiary, and ABC-Broker/Dealer Ltd., a UK subsidiary;

3. ABC-Capital, Inc. holds all capital relating to the equity derivatives book;

4. ABC-Broker/Dealer Ltd. employs all sales people, risk managers, and traders that manage the equity derivatives book;

5. All equity derivative trades are booked by ABC-Capital, Inc. and executed by ABC-Broker/Dealer Ltd.

A. OECD Approach Applied to Bank ABC

The implications of the OECD approach to Bank ABC are clear: ABC-Capital, Inc. is entitled to a routine return on its capital contribution to the equities derivatives book and ABC-Broker/Dealer Ltd., which houses substantially all the KERTS, is entitled to substantially all of the residual profit. At first glance, this approach may appear relatively straight forward in terms of implementation. It would entail implementing a profit split model in which Bank ABC would need to determine the arm's length return on capital for investors in comparable investments in equities derivatives, compensate routine functions, such as back office activities and sales functions undertaken by ABC-Broker/Dealer Ltd., and attribute the residual to the trading function undertaken by ABC-Broker/Dealer Ltd. This approach fails to address several critical issues from a regulatory perspective, particularly in the case of trading losses.

B. Regulatory Implications

In terms of Section 23B of the Federal Reserve Act, ABC-Capital, Inc. should earn an arm's-length or better return for its capital contribution. This fact appears to be consistent with the OECD model, except in one respect, which is the "or better" clause. The OECD Approach would suggest that ABC-Capital, Inc.'s upside be capped at the routine return for capital, and does not provide for a share of the book's residual profits. The Federal Reserve may be concerned that ABC-Capital, Inc. is theoretically placing its capital at risk, but has its upside profit potential limited.

The second issue relates to the amount of regulatory capital that must be held by ABC-broker/dealer Ltd. Under the OECD Approach, ABC-Broker/dealer Ltd. is the entrepreneurial risk taker and thus is entitled to substantially all non-routine profits. The other implication, however, is that in a loss-making scenario, ABC-Broker/Dealer Ltd. bears the downside risk and would be the party to bear any losses, giving ABC-Capital, Inc. a fixed return. Given this fact, securities regulatory bodies, such as the SEC in the U.S., and in this example the FSA in the UK, would require ABC-Broker/Dealer Ltd. to hold sufficient regulatory capital to be able to withstand reasonably anticipated losses that the equity derivatives book may suffer. Such a requirement would be extremely costly to Bank ABC as one of the benefits of housing the capital and market makers in separate legal entities is eliminated. Thus, the OECD Approach, in a loss making scenario, may be in direct conflict with the regulatory requirements.[2]

Conclusion

As financial institutions continue to expand their reach in international capital markets, taxpayers engaged in global trading need to carefully consider both the tax and regulatory ramifications of profit attribution among capital providers and market makers. As the OECD finalizes Part III of the Discussion Draft, which is

[2] In loss years, it is sometimes suggested that the booking vehicle absorb most of the losses, thus paying costs over to the trading vehicle, and that such losses would be recouped from future years' profits due to the trading vehicle. This transfer pricing solution however causes concern under the bank regulatory rules (e.g., Federal Reserve Rule 23A) as the booking vehicle may be deemed to have made a "loan" to the trading vehicle for the forgone (albeit temporary) loss amounts.

expected in early 2007, its members should consider and address the ability of taxpayers to satisfy banking and securities regulatory requirements, while fully complying with the OECD Approach.

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The Voluntary Compliance Program is Ending—Now What?

by Jayne Alfano/
Denise Hintzke

In September of 2004, the Internal Revenue Service ("IRS") instituted a voluntary compliance program ("VCP") that allowed qualified withholding agents, not currently under audit, to voluntarily report operational and/or withholding/reporting failures. The VCP covers all payments made under Sections 1441 to 1443 of the Internal Revenue Code during 2002 through 2004. In return for this voluntary disclosure, withholding agents are entitled to a more lenient review standard and penalties would be alleviated. The program was originally slated to end on December 31, 2005, but was subsequently extended until March 31, 2006.

With the VCP now coming to an end, the focus has shifted to how institutions prepare for the impending IRS audits. The IRS has stated that it plans to audit all taxpayers who are (or should) be filing a Form 1042. This list of taxpayers includes a broad array of institution types, such as banks, broker-dealers, insurance companies, hedge funds, venture capital firms, law firms, multi-national corporations and entertainment companies.

The IRS has already begun sending out audit letters to taxpayers who have not made a VCP submission and are adamant that regular audits will be forthcoming. The IRS has stated that a Form 1042 review will be part of the ordinary income tax audit and local audit teams are undergoing training on identifying key issues.

The IRS has gained a vast amount of knowledge through the VCP and will continue to expand this knowledge base at the local and national levels through a widespread audit program. More specifically, the IRS has become aware of common short-comings, industry issues and various technical problems; it understands what questions to ask, what some of the IT shortcomings are for specific industries and how to tailor the information document requests ("IDRs").

As part of the audit process, expect to receive IDRs targeting your systems and processes, in an effort to gain an understanding of your products and the income payments that you make as well as your current procedures. The IRS will review Forms 1042, the corresponding Forms 1042-S along with the underlying documentation for each non-U.S. person to

whom a payment was made. The documentation will be validated pursuant to the stringent document due diligence standards established in the 1441 Regulations. This is significant since the IRS has said that it will not be as lenient as it was under the VCP with respect to documentation, withholding and/or reporting errors. This means that even minor errors on a Form W-8, such as an entity type missing on Line 3, may result in the form being treated as invalid. To the extent that a withholding liability is identified on audit, interest and penalties will be assessed.

For those institutions that did not participate in the VCP, it is not too late to take action. PwC strongly recommends that you begin preparing for the inevitable audit by reviewing your documentation and procedures in order to identify any failures before the IRS does. Pay particular attention to items such as entity type, incomplete addresses and/or U.S. addresses, place of incorporation and capacity, as the IRS will fail forms if this information is inconsistent or missing. You should also ensure that you have obtained appropriate additional documentation when required. To the extent that you do identify documentation problems, you can take steps to remediate them by obtaining the additional documentation (e.g., passports, letters of explanation, organizational documents) and/or re-soliciting forms which include an affidavit of unchanged status.

As institutions review their 1441 compliance, they should review payments related to independent personal services for non-U.S. contractors and/or Directors. These payments are subject to withholding and reporting if the services were performed within the United States and the documentation required may include a Form 8233, which is much more onerous to complete compared to the other Forms W-8. Please remember that institutions can continue to cure forms, even while under audit.

It is important to note that IRS Sections 1445 (Disposition of Real Property) and 1446 (Effectively Connected Income paid to partners) were not included in the VCP program. However, there is talk that a similar program might be put in place to deal with these issues.

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Technical Accounting Issues

Fair Value Measurement: A Closer Look

By Matthew Singer

Fair Value Measurement….How does one define fair value? What accounting and reporting standards are appropriate in determining fair value?

The Financial Accounting Standards Board ("FASB") is anticipated to issue in the first quarter of 2006: Statement of Financial Accounting Standards No. 15X "Fair Value Measurements". A working draft of the final Fair Value Measurement Statement is now available on the FASB website. This project was added to the FASB's agenda in June 2003. The new standard defines fair value, establishes a framework for measuring fair value, and requires expanded disclosures about estimates of fair value.

This new statement will make significant changes to current practice and is expected to improve financial reporting in a number of ways. There now will be a single definition of fair value under Generally Accepted Accounting Principles ("GAAP") and provide a framework for how to measure and determine fair value. The goal is to increase consistency and comparability in estimates of fair value.

The incremental information provided to users of financial statements through enhanced and expanded disclosures about the use of fair value should increase transparency of the fair value process. The guidance in the new statement builds on current practice and requirements; however, it will require some entities to make changes to comply with the requirements.

Definition of Fair Value:

"Fair value is the price that would be received for an asset or paid to transfer a liability in a current transaction between marketplace participants in the reference market for the asset or liability."[1]

The Statement clarifies common terms used in the fair value process such as market place participants, reference markets, the application of fair value to assets and liabilities, and transaction costs.

Fair Value Estimates at Initial Recognition and in Subsequent Periods:

The standard describes three different valuation techniques including:

1) Market approach;

2) Income approach; and

3) Cost approach.

The objective is to use a valuation technique or combination of valuation techniques that are appropriate for the

[1] *Statement of Financial Accounting Standards* No. 15X, Fair Value Measurements—October 21, 2005 Working Draft

circumstances. An important consideration is the sufficiency of data available to estimate fair value. In addition, it sets an expectation that a consistent valuation technique be applied, unless however a change in valuation technique or its application would result in an estimate that is more reflective of fair value.

Market Inputs:

"Valuation techniques used to estimate fair value shall maximize the use of market inputs and minimize the use of entity inputs, whether using the market approach, income approach, or cost approach."[1]

There are a variety of markets that can provide information for inputs, including:

- Exchange markets (ie. Securities traded on the New York Stock Exchange);
- Dealer market (ie. Over-the-counter (OTC) markets;
- Brokered market (ie. Brokers attempt to match buyers with sellers but do not stand ready to trade for their own account); and
- Principal-to-principal market (ie. trades negotiated independently with no intermediary).

Fair Value Hierarchy

The hierarchy has five levels. Ranging from Level 1 - items with quoted prices for identical assets or liabilities in active markets, to Level 5 items valued using models with significant entity derived inputs (examples include inputs that are derived through extrapolation or interpolation but that are not corroborated by other market data).

In October 2005 the FASB issued Proposed FSP no. FAS 133-a "Accounting for Unrealized Gains (Losses) Relating to Derivative Instruments Measured at Fair Value under Statement 133) - comment period ended on November 21, 2005. The proposed FSP addresses fair value estimate at initial recognition specifically for derivative instruments. Simply stated, if the entity is not trading in its reference market and falls within Levels 1-4, the unrealized gain (loss) resulting from day one profit shall be recognized in income.

If Level 5 is the hierarchy level used at initial recognition of the derivative instrument, an unrealized gain (loss) shall be recognized as a deferred credit or debit, separate from the derivative instrument. The unrealized gain (loss) shall be recognized only when the instrument moves into Levels 1-4 (when the minimum threshold for the estimate is met) or when the contract expires due to maturity or exercise. Any unrealized gain (loss) that is deferred shall not be amortized into income or equity.

This discussed exposure draft is a complicated standard, so if you think it may affect your business, we suggest that you carefully read through the working draft for more details.

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Market Noise

The Richest Corporate Jewel: Strategically Managing Reputation Risk & Shareholder Value

By Carlo di Florio/
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Never underestimate the power of reputation. Good or bad, a reputation can significantly affect a bank's market value. A strong reputation can reduce the cost of raising capital—both equity and debt—and increase investors' confidence in a bank's ability to meet future earnings expectations. In fact, Roman maxims counseled that "a good reputation is more valuable than money," and Socrates defined reputation as "the richest jewel." Major changes in reputation have a very large effect on market capitalization—as a bank's reputation improves, so should its price-to-book ratio.

It also works the other way. A damaged reputation can lead to a significant loss in market capitalization that often exceeds any related financial losses. In some cases, reputation-damaging problems, such as deceptive sales practices or compliance failures, can reduce total return to shareholders by 5.5% or up to 12 times the actual loss.[1] Shareholders and markets are particularly unforgiving when an event appears preventable and the bank acted irresponsibly.

This evidence is not lost on leaders of global financial institutions, who increasingly view reputation risk as the greatest potential threat to market value, according to research conducted by PricewaterhouseCoopers and the Economist Intelligence Unit.[2] As a result, many banking executives want to develop an effective reputation risk management approach that leverages strong governance, risk management, and compliance practices to safeguard the franchise and turn reputation into a source of sustainable value creation.

A Framework for Reputation Risk Management

In general, banks need a reputation risk management approach that works with existing credit, market, operational, and business risk management frameworks. The goal, of course, is to identify and assess risk events that could significantly affect a bank's reputation before they occur, identify ways to prevent their occurrence, and to manage the fallout if these events do occur. There are five steps involved in developing this type of reputation value and risk management approach.

[1] Dunnett, Robert S., Levy, Cindy B., Simoes, Anthony P., The Hidden Costs of Operational Risk, McKinsey Study on Finance, Winter 2005.

[2] PwC/EIU study, "Uncertainty Tamed? The Evolution of Risk Management in the Financial Services Industry" Survey Results 2004.

Major changes in reputation have a very large effect on market capitalization—as a bank's reputation improves, so should its price-to-book ratio.

1. Define reputation and stakeholder expectations. To manage reputation risk more effectively, banks can segment and map stakeholder expectations in detail to gauge the bank's ability to meet those expectations. But first, a bank must clearly define what reputation value and risk mean within the context of those stakeholder relationships. From there, the bank can develop a common language for discussing, managing, and building a consensus around reputation value and risk.

Reputation value can be measured as the sum of intangible assets—both internally generated (brand, customer base and loyalty, intellectual property) and externally generated (good will acquired through mergers or acquisitions)—and is reflected in shareholder expectations of future returns and the bank's market premium (market capitalization minus book equity).

Reputation risk occurs when a bank's business conduct does not meet the expectations of stakeholders that include employees, investors, and customers. When a reputation risk event does occur, the fallout can affect future earnings flows and the market premium investors are willing to pay for the bank's equity. This reputation risk is often a secondary effect of underlying credit, market, operational, regulatory or business risk events that can occur anywhere in the organization.

2. Assess risks to reputation value and identify the underlying drivers. Using retrospective and prospective analyses, a bank can isolate key enterprise-wide events that could damage its reputation by preventing it from meeting stakeholder expectations and its own reputation objectives. This approach serves two purposes.

- First, it allows the bank to aggregate reputation risks into an enterprise-wide risk portfolio that can be viewed and managed as a whole.
- Second, it can identify the six to eight key drivers that have the greatest effect on a bank's ability to meet stakeholder expectations. This way, the bank can manage the resulting reputation risk using value-at-risk measures based on the estimated volatility of the underlying factors. This provides the raw material that banks need to begin exploring the complex interactions and compounding effects that various risk events can have on their reputation.

The retrospective analysis focuses on the historical impact of risk events on reputation value and measures how long specific events affected market premiums once they became public knowledge. It also gauges how the response to a negative event affected the speed at which a bank recovered its lost value. The prospective analysis uses the identified risk drivers to identify future reputation issues based on the bank's corporate objectives, corporate social responsibility agenda, and relevant external factors. For example, a risk and control self-assessment process can identify weaknesses in the IT infrastructure as a key risk to achieving retail customer service objectives then assess that risk based on the direct financial impact of a customer information security breach.

3. Develop proactive and reactive reputation risk response strategies. With information on reputation risks, banks can take steps to control reputation exposures before and after they occur. These proactive and reactive response strategies should:

- leverage existing risk management information and infrastructures
- be linked to strategic planning activities
- be enterprise-wide in nature

After all, events in one business unit can tarnish the reputation of the whole organization. The enterprise risk management framework proposed by COSO[3] defines a set of principles that banks can use in these efforts.

Proactive steps are often directly connected to existing risk identification and assessment processes and are designed to manage the likelihood of certain events and the reputation impact of those events before they occur. Reactive steps focus on limiting the downside and accelerating recovery once a reputation event has affected stakeholders and become public knowledge. These reactive steps include crisis management and public relations components, which are most effective when executed

[3] Enterprise Risk Management—Integrated Framework and Application Guidance authored by PwC under sponsorship of the Committee of Sponsoring Organizations (COSO), Sept 2004. See web page: http://www.pwc.com/extweb/manissue.nsf/docid/11FE433C2B151E5285256D580059C547

Reputation risk management metrics should be an explicit part of performance management processes and drive evaluation, capital allocation, compensation, promotion, and success.

using an existing crisis-response plan. Strong reactive reputation management steps can actually enhance a bank's reputation significantly.

4. Clearly define roles and responsibilities for reputation risk management by leveraging existing governance and organization structures. Banks can manage reputation risk by using an organizational structure that extends existing governance practices and clearly defines roles and responsibilities. An executive-level owner of the reputation risk management framework who has decision-making authority and the ability to direct resources can ensure senior management attention and consensus. This, in turn, can ensure the independence, authority and standing of the reputation risk management process through board and executive management oversight.

Effective policy setting can ensure that reputation risk management principles are embedded into key business processes, including:

- strategic planning (for example: new products, services, M&A)
- performance management
- training
- reporting
- systems architecture

Banks can leverage Sarbanes-Oxley and other regulatory compliance efforts to enhance effectiveness and streamline processes and technology, while the bank's control functions facilitate design, measurement and monitoring of reputation risk.

The ownership of the reputation risks themselves must be managed by those parts of the organization that incur the risk with accountability incorporated into day-to-day responsibilities. To reinforce this, reputation risk management metrics should be an explicit part of performance management processes and drive evaluation, capital allocation, compensation, promotion, and success.

5. Take a risk-based approach to reputation risk monitoring. The greatest risks to a bank's reputation should be monitored carefully and continually at the business unit level by individuals in key control functions using supporting technology and risk self assessments (for example: RCSA). Banks can use tailored reputation risk escalation protocols to identify, assess, and mitigate visible, high-impact, and unique transactions or issues. Once reputation risk management functions, policies, and procedures are in place, it is up to the internal audit function to independently validate their design and operating effectiveness.

At the executive level, senior management and other decision makers must receive formal reporting flows from the reputation management framework so that they can take appropriate action. One way to communicate this information is by using dashboards with key reputation risk indicators. Formal measures and reports are essential to developing senior management awareness and consensus around reputation risks and to ensuring that the framework enables effective decision making and follow through.

Conclusion

By building its reputation risk management capability, a bank can take a portfolio view of how actual and potential events can affect its reputation. This, in turn, can improve a bank's ability to identify, proactively address, and effectively respond to issues that could damage its reputation. In doing so, banks can focus on areas of greatest importance to stakeholders to increase trust in and the value of their reputation and, ultimately, shareholder value.

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Securitization: An Everchanging Landscape

by John Gibson

What is Securitization, and Why Does it Exist?

"Securitization activity in the capital markets sector continues to lead the marketplace in innovation and new product development by customizing yield and risk profiles for an increasingly diversified investor base. The attention placed on these transactions, in addition to increased transparency forced by regulators, should provide consistency and quality in product information," according to Frank Serravalli, Co-Leader of PwC's US Securitization group.

Transactions continue to grow in both volume and complexity. Increased regulation may lead to more private, synthetic and partially funded transactions. The US regulatory environment has led to increased emphasis on disclosure of and transparency in transaction attributes - both current and historical.

Securitization has continued to gain popularity for many reasons, including improved liquidity for originators, access to new capital, product generation and yield enhancement.

"The market has changed dramatically from the first securitization transactions in the 1970s. The initial transactions were simple pass-through mortgage structures. Today, the marketplace is responding to increased investor demand for investment opportunities with various asset types and structures. The market is driven by the ability to segment various credit risks and distribute those risks to targeted investors," comments David Lukach, Co-Leader of PwC's US Securitization group.

Securitized products often combine various types of credit enhancement to meet increased investor demands for certain repayment attributes and more importantly to modify the risk profile of the assets. Forms of credit enhancement include:

- third party guarantees,
- derivatives,
- reserve funds,
- over collateralization and
- credit insurance.

Thus, the demand for information and transparency by investors grows. An outgrowth of the customization is an increase in mezzanine and residual interests. These leveraged interests also have increased in complexity, which has caused regulators and investors to demand more detailed and thorough economic and financial reporting.

While the mainstream continues to focus on residential and commercial mortgages, credit card and auto loans, a wide variety of asset classes continues to grow. Some examples include: stranded costs, negative amortization loans, life-settlements, timeshares and synthetics. The risks in each of these assets are very different and structural complexity requires detailed information to properly analyze the risk and return profile of the investment products.

The State of the Securitization Market

The Financial Accounting Standards Board (FASB) issued three Exposure Drafts (EDs) related to separate projects to amend FAS 140, which include accounting for:

- transfers of financial assets,
- certain hybrid financial instruments and
- servicing of financial assets.

The EDs propose to amend and clarify FAS 140 as follows:

- Prohibit financial assets transferred to any entity (including a QSPE) from being de-recognized by the transferor unless the financial assets are isolated from the transferor and its consolidated affiliates, except for certain bankruptcy–remote affiliates. The legal analysis requires any arrangements in connection with a transfer to be considered even if the arrangement is not entered into at the time of the transfer.
  - If the transferee is a QSPE, no arrangement or agreement is made between any Beneficial Interest Holder ("BIH") and the transferor that would have caused the assets not to be isolated if the same arrangement or agreement had involved the qualifying SPE instead of its BIHs.

  A participating interest (new term) ("PI")—defined as a portion of a financial asset that:

  - represents an ownership in an individual financial asset other than an equity instrument, derivative, or a hybrid instrument with an embedded derivative that is not clearly and closely related as described in FASB Statement 133;
  - conveys proportionate ownership rights that are equal to the priority of each other PI;
  - involves no recourse to or subordination by any participating interest holder (PIH);
  - does not entitle any PIH to receive cash before any other PIH; and
  - neither the transferor nor any PIH has the right to pledge or exchange the entire financial asset in which they own a PI.
  - Establishes the following conditions for reporting a transfer of a portion (or portions) of a financial asset as a sale:
    - the transferred portion(s) and any portion retained by the transferor must be PI, and
    - the transferred portion(s) must meet the conditions for surrender of control.
  - If the transfer does not meet those conditions, sale accounting can be achieved only if:
    - Entire financial asset (or group of financial assets) is transferred to a qualifying SPE (special purpose entity) or other entity that is not consolidated with the transferor;
    - Entire transferred financial asset(s) must meet the conditions for surrender of control.
  - The term *retained interest* is replaced by other, more specific terms. The two most prevalent types of interests described in the ED are:
    - *Transferor's beneficial interest*—a beneficial interest received by a transferor as part of the proceeds from a sale of financial assets to a qualifying SPE;
    - *Participating interests retained by the transferor*—the transferor's ownership interest (or share of ownership) in a financial asset that has been divided according to the requirements for PIs.
  - Other types of interests referred to as retained interests held by or retained by the transferor in FAS 140 include:
    - Servicing rights;

  - Rights to a portion of the interest from a transferred financial asset or transferred PI; and
  - Cash collateral accounts.
- A servicing right and cash or other collateral posted by the transferor are considered retained interests. For purposes for applying FAS 140 de-recognition model, these interests will be considered *new assets* by the transferor under the ED.
- A transferor's beneficial interest shall be initially measured at *fair value*. This approach supersedes the current model (relative fair value allocation of carrying value of transferred assets between the portion sold and retained).
- If the SPE can roll over (retire and reissue) BIs, it must have certain conditions to be a QSPE:
  - No party may have more than one responsibility with the QSPE that provides that party with the opportunity to obtain a "more-than-trivial incremental benefit" relative to the benefit that would be obtained if separate parties had performed those activities.
  - For example, if one party holds a residual interest in the SPE and manages the BI rollover process, that party presumably derives a "more-than trivial incremental benefit" from the arrangement (ability to manage the entity's spread, which would insure to the party).
  - A QSPE may not hold equity instruments unless those instruments result from efforts to collect the transferred financial assets in which case they may be held only temporarily.

ED would amend FAS 133 and FAS 140 to:

- Permit fair value re-measurement for any hybrid financial instrument that contains an embedded derivative;
- Clarify which interest-only strips and principal-only strips are not subject to FAS 133;
- Establish a requirement to evaluate BIs in securitized financial assets to identify interests that are freestanding derivatives or hybrid financial instruments with derivative requiring bifurcation;
- Eliminate restrictions on a QSPE's ability to hold passive derivatives that pertain to BIS;
- Must initially measure all separately recognized servicing rights at fair value, if practicable;
- For each class of separately recognized servicing assets and liabilities, an entity may choose either of the following subsequent measurement methods:
  - amortize servicing assets or liabilities over the period of estimated net servicing income or net servicing losses based on fair value at each reporting date (no change from FAS 140), or
  - report servicing assets or liabilities at fair value at each reporting date and report changes in fair value earnings; or
  - Additional disclosures for all separately recognized servicing rights.

Regulation AB (Reg AB) and the Impact on the Securitization Market

Reg AB rules impact four areas of ABS securities regulation:

- registration requirements under the Securities Act of 1933, as amended;
- disclosure requirements under Reg AB;
- communications during the offering process; and
- ongoing reporting requirements under the Exchange Act.

An important feature of Reg AB is a new definition of an asset-backed security, which encompasses a wide variety of asset types. The definition specifically excludes synthetic securitizations.

The Securities Exchange Commission's (SEC) objectives for Reg AB was to enhance the conformity and transparency of the public ABS markets. The new rules attempt to codify various staff positions and no-action letters adopted by the SEC over the last 20 years.

The ABS rules modify the traditional securities registration process to address the unique requirements of

asset securitization. Reg AB also imposes substantial new disclosure requirements on ABS transactions with additional disclosures in the prospectus, including expanded descriptions and financial disclosure regarding transaction parties.

For more information on securitization, please contact John Gibson at 202.414.4691 (john.l.gibson@us.pwc.com).

We encourage you to read "Regulation AB: A New Era for Asset-Based Securities—Are You Prepared?," which is located in this publication on page 1.

PwC Resources

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