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FAS 166 and 167: Forcing Banks to Bring Assets Back on the Balance Sheet

Bill Emmons, assistant vice president and economist at the Federal Reserve Bank of St. Louis, speaks on the implications for banks of changes to Financial Accounting Standards 166 and 167.

Two important accounting standards come into effect this year: FAS 166 and 167. They are designed, together with slight changes in bank capital regulations, to increase the capital in major financial institutions and also increase the transparency of risks faced by those institutions. These are unlikely to have very significant affects on the majority of banks, and certainly, most small banks will not be affected. It mostly affects those banks and other financial institutions that were involved in securitization, creating new assets and liabilities off their balance sheets that then could be bought by investors.

The reason for these accounting changes is that we found during the financial crisis that many of the off-balance-sheet exposures actually did come back and cause major problems—billions of dollars of losses—for the originating institutions. Some of those were because of the legal agreements that were set out in advance; some of those were just business decisions made by firms that they didn't want to see those disruptive collapses of the entities that they had created.

It's too soon to know how significant these changes will be, but it's likely they will have very major impacts on a few—monoline credit card banks, the government-sponsored enterprises Fannie Mae and Freddie Mac, for example, and perhaps a few others—but most banks will not see a lot of immediate impact.

The Schizophrenic Banking System before the Crisis

The first point is that we had what I would call a bifurcated, or even a schizophrenic, banking system before the financial crisis began. Many large banks in particular had obviously on-balance-sheet assets—those that show up in their financial statements very plainly—but also off-

balance-sheet assets and liabilities. This was a business strategy that went back a number of years and was perfectly acceptable under GAAP accounting standards as long as the institution that originated the assets—for example, mortgages or credit card receivables—engaged in what was called a “true sale”—a transaction between itself, the originator, and some other entity, a new entity, that allowed them to de-recognize those assets and liabilities from their balance sheet.

Those other parties typically were custom-made new institutions, not other banks, but special-purpose entities that received the assets and liabilities and then issued new securities for investors. This was a process called “securitization.” In fact, it was so common and so accepted that this part of the financial system grew much more rapidly than the on-balance-sheet part of the financial system. So, this securitization with so-called qualified special purpose entities (QSPEs) accepting these new assets and liabilities exceeded \$4 trillion at the peak. It is now in the process of shrinking very rapidly, and that’s been a big part of the problem during the crisis.

So the pre-crisis accounting and bank capital rules allowed banks to effectively wash their hands of these assets that they had originated and the associated liabilities. And as long as the underlying cash flows generated from credit cards, auto loans, or in the case of mortgages, the mortgage payments made by borrowers, as long as those cash flows continued, there was no problem. But of course, these were always risky vehicles in the sense that there was essentially no capital held by those new entities. That was of course known, but what was not as fully appreciated was their vulnerability to disruptions in liquidity—that is, the ability of these new special purpose entities to continually roll over their liabilities during all market conditions. That turned out not to be the case, and so that was one of the real flashpoints in the financial crisis was these new vehicles, the special purpose entities, that hit with inadequate capital and no access to liquidity; so, the vehicles started to collapse, essentially.

So even going into the crisis, we knew that this was a somewhat risky accounting treatment, a business strategy, and the question was always whether the originating institutions would in fact be able to maintain the separation between their own financial situation and the performance of those off-balance-sheet entities.

The Big Bank Off-Balance-Sheet Problems Come Home to Roost

The second topic I want to discuss, then, is what happened during the crisis? Well, I’ve already alluded to some of the problems that emerged, and I guess I would summarize it by saying that a big part of the financial crisis really was these off-balance-sheet positions, problems in those off-balance-sheet entities coming home to roost. And that was something that we, frankly, in the regulatory community didn’t quite anticipate, we didn’t fully understand. And I think it’s safe to

say the institutions themselves did not fully understand how likely and the scale on which some of those off-balance-sheet problems would come back to haunt the originating institutions.

So what actually happened? As I said, it was as much a liquidity problem as a capital problem, as it turned out. Investors in the securities issued by those special purpose entities essentially panicked—we had the equivalent of a bank run in the wholesale capital markets. And so as the credit quality deteriorated—as the losses, for example, in the mortgages, subprime mortgages and other types of mortgages, as those losses mounted and the expectation of further losses as house prices continued to decline, and the economy went into recession, the investors of course wanted to bail out. And partly that was done by existing holders selling those securities to others, but because so many of these entities essentially contained longer-term assets funded with shorter-term liabilities, the business strategy itself depended on the ability of those entities to be able to continue to roll over to issue new liabilities, and that turned out not to be a safe assumption at all. So, many of these vehicles essentially were stranded without the access to funding that they needed, and then the question was: How would these entities unravel, or would they unravel?

As it turns out, some of the sponsoring banks, the originators, or the parents, if you will, had made actual promises in the agreement setting up these entities to support these entities if problems arose. Sometimes that took the form of a line of credit, [therefore] liquidity support; sometimes it was actually some sort of loss sharing, so some sort of capital support. But I think it's safe to say most of the banks that originated those agreements never really expected this to happen; they didn't really expect to have these contingencies occur, and when they did, it hit some of the banks pretty hard—given that they hadn't expected it, they hadn't provided reserves for it; they really were not in a strong position. Given the fact that they were suffering lots of problems on their on-balance-sheet business, these off-balance-sheet problems that came rushing back to hit them was a double whammy.

Of course, there were other cases of sponsoring banks or financial institutions that were not legally required to provide any support, whether capital or liquidity, for those off-balance-sheet entities. Some of them did so anyway, and that's of course a very interesting question why they did. I think the best explanation is that many of the sponsoring entities felt that their own reputations would suffer if they didn't provide the support. Given the fact that it was of course well known, publicly known that they had created these entities, if they in fact had used their legal ability to remain separate and allowed losses, disruptions to occur in these off-balance-sheet entities, it may well have caused their counterparties—their potential future investors—to be very wary of doing business with them. So, as a business decision, some of the sponsoring entities decided to provide support for some of the special purpose entities even when they didn't have to, and that of course was very costly also, in many cases.

In the end, the combination of the legal recourse that some of the entities had, plus this informal—the support of their own reputation, that motivation—together did cause very large losses, in the billions and billions of dollars, on these off-balance-sheet exposures which, according to the accounting treatment going into the crisis, didn't even exist. So this, as I said at the beginning, was one of the real surprises in the financial crisis was how large the exposures were for many of these major originating and securitizing institutions, when it didn't appear on their balance sheet as an exposure at all.

New Accounting Standards are Tougher but More Realistic

As one of the lessons of the crisis, accounting standard setters and the bank regulatory agencies determined that the idea of a true sale with balance sheet de-recognition was, in many cases, a sham. It was not a true transaction; it did not actually reduce or eliminate the exposure that those sponsoring entities undertook with those assets and liabilities. So, that was really the motivation for the new accounting standards—FAS 166 and 167. FAS 166 is officially “Accounting for Transfers of Financial Assets,” and it's an amendment of FAS Statement No. 140; that was the previous securitization standard. FAS 167 is “Amendments to FASB Interpretation No. 46-R.” So, of course, there's lots of documentation available if you would like to look into those statutes or those standards in more detail. These are effective January 1st of 2010, but there is some phase-in; so, that will not be an immediate impact.

Coming out of the crisis, I think we can say—at least we anticipate—that the new accounting standards—FAS 166 and 167—together with new bank capital rules, that I'll talk briefly about, really constitute a more realistic—and yes, a tougher—approach to the relationship between the traditional banking system and the off-balance-sheet, or what's sometimes called the shadow banking system. So, that's really what this is all about is making more transparent or more clear or more legally binding the connections that we discovered during the crisis really were there, but they were not adequately reflected in the accounting statements and in the bank capital regulations.

FAS 166 and 167 essentially require all firms—not just banks, but it's in the banking system that the effects are going to be most quickly felt, I think—it simply requires all firms to list all of their assets and all of their liabilities on their balance sheets, if they have originated them and if they have any connection whatsoever to them. In other words, it raises the hurdle—it's a much tougher standard now to demonstrate that the sale is an actual extinguishment of all potential losses or liabilities associated with that.

For example, the notion of the qualified special purpose entity—these essentially passive vehicles that were created especially to receive these assets and liabilities—these are no longer going to exist. So, to sell these assets and liabilities, a bank needs another legitimate bank to buy

them; it can't be parked in an off-balance-sheet special purpose entity, the way they were before. So it's become much more difficult to disown the assets and liabilities that were created by any financial institution.

This was mid-2009 when the standards were put out for comment and then finalized, and so the question, then, quickly arose: What would the bank capital regulations be? Given that for a number of years there's been the working assumption, which of course now is being called into question, that in some cases moving the assets and liabilities off-balance-sheet indeed did reduce the risks to the sponsoring institution, or the originator. So, there was a proposal made by many bankers and others that even after bringing the assets and liabilities back onto the balance sheet, there ought to be some sort of capital relief, or some sort of recognition that the exposures might not be as great as they would have been if they had been originated and maintained on the balance sheet from the very beginning.

As it turned out, the federal banking agencies took a fairly tough line on this. Despite fairly loud protests by bankers and others, the banking regulations are going to be essentially unchanged. As I said, there will be a transition period, so it doesn't need to be done immediately, but those assets and liabilities that are brought back onto the balance sheet will be treated very much the same as if they had never been off-balance-sheet at all.

The combination of FAS 166 and 167, together with the essentially unchanged bank capital standards, mean that there will be particular financial institutions, although only a few, that are likely to be very significantly impacted by these changes. As I mentioned, Fannie Mae and Freddie Mac, the government-sponsored enterprises that have created somewhere in the neighborhood of \$4 trillion of mortgage-backed securities that they had previously accounted for off their balance sheets, all of that will come back; there will be capital requirements against that. Of course, the special situation with Fannie Mae and Freddie Mac is that they're in government conservatorship, and they're not actually satisfying any capital requirements right now anyway, so it's a bit of a moot point. But in principle, if Fannie and Freddie were to be removed from government conservatorship, in principle, they would be subject to FAS 166 and 167—full capital requirements against all of those assets. As for the banks, those most affected are going to be those that were primarily in the business, or at least a very, very large part of their business was in creating assets and then securitizing them. And that's most extreme in the case of the so-called monoline credit card banks. One estimate from the industry is that there could be as many as \$1 trillion of assets that will come onto banks' balance sheets, largely in the form of credit card receivables, but other types of loans that were securitized, including mortgages, auto loans, and all those sorts of things. And so this will in fact require those affected banks to raise fairly substantial additional amounts of capital.

Conclusion: Regulators Keeping Capital Rules Unchanged

So I think, in sum, this is in principle an appropriate response to the financial crisis—it certainly closes what we now, I think, can fairly say was a loophole, or at least a poorly understood area of accounting: the relationship between banks and the off-balance-sheet securitized assets and liabilities that they created. There will be some who judge this to be overreaction, overkill by requiring these institutions to take all of these assets and liabilities back onto the balance sheets, holding full capital against them. And in fact, there are some who have suggested that this will kill securitization and a large part of the shadow banking system. To that, I think one response is that we certainly were not very well served by the system during the financial crisis, and so I don't think that that alone is probably an adequate argument. It certainly didn't dissuade the banking regulators and the accounting standard setters from significantly changing the way we treat the off-balance-sheet assets and liabilities of the shadow banking system.