

FASB's Failure to Regulate Off-Balance Sheet Special Purpose Entities and the Downfall of Securitization

C H A R L E S A B R A M S *

I. INTRODUCTION

CORPORATE SCANDALS AND FINANCIAL TURMOIL USHERED IN major overhauls of financial regulations and reporting requirements in the United States during the past decade. While many of these regulations aimed to increase transparency, corporate off-balance sheet transactions that used special-purpose entities¹ (“SPEs”) remained a mysterious and powerful force in both creating liquidity and increasing leverage. SPEs are legal entities created to carry out a specific purpose, activity, or series of transactions.² The quantity of SPEs increased significantly with the growth of structured finance and, specifically, the use of securitization during the years leading up to the Great Recession.³

* J.D. (Florida State University College of Law); Business Law Certificate (Florida State University College of Law); B.Sc. (Business) (Miami University). Thank you to Megan O’Connor for her continuous support and encouragement. Also, many thanks to Professor Jay Kesten for his guidance and to my brothers, Ben and Sam Abrams, for their helpful input.

¹ Special-purpose entities and special-purpose vehicles are interchangeable terms. This article uses only special purpose entity, or “SPE”, for consistency and to avoid confusion. Economic Commission for Europe, *The Treatment of Special Purpose Entities*, UNESC, UN Doc ECE/CES/GE.20/2010/13 (15 February 2010) [UN Report] (also described as “shell companies, special financial institutions, brass plate companies, mailbox companies or international business companies” at para 4).

² Gary B. Gorton & Nicholas S. Souleles, “Special Purpose Vehicles and Securitization” in Mark Carey & René Stulz, eds., *The Risks of Financial Institutions* (Chicago: University of Chicago Press, 2006) 549 at 550 [Gorton & Souleles]

³ Basel Committee on Banking Supervision, *The Joint Forum: Report on Special Purpose Entities*, September 2009, (Basel: Bank for International Settlements, 2009), online: Bank for International Settlements <<http://www.bis.org/publ/joint23.pdf>> at 1 [Basel Report]; see also, Janet M. Tavakoli, *Structured Finance and Collateralized Debt Obligations: New Developments in Cash and Synthetic Securitization*, 2nd ed, (Hoboken: John Wiley & Sons, 2008) [Tavakoli, *Structured Finance and CDOs*] (“[s]tructured finance is a generic term referring to financings more complicated than traditional loans, generic bonds, and common equity. . . . [f]inancial

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Indeed, some experts estimate that SPE off-balance sheet transactions were in excess of four trillion dollars at the peak of their use.⁴

SPEs in securitization contributed to the financial crisis that began in 2008. To obtain the benefits of securitization, sponsor firms⁵ needed to avoid recognition of SPEs' assets and liabilities on their balance sheets.⁶ This avoidance depended on whether the accounting rules treated the transfer of assets between a sponsor and its SPE as a true sale or a loan.⁷ The classification of a transaction as a true sale allowed for non-consolidation treatment.⁸ Non-consolidation through a true sale meant off-balance sheet treatment for the sponsor.⁹

This paper identifies serious deficiencies in the understanding and risk management of SPEs and their connection to the information asymmetries, over-leveraging and risk-retention problems that flowed through the securitization pipeline and shadow banking system.¹⁰ A significant part of the failure to appropriately regulate off-balance sheet entities stemmed from the Financial Accounting Standards Board's ("FASB") deficient accounting rules that governed the consolidation of related entities. FASB's rules allowed the avoidance of capital requirements in securitization transactions and the asset-backed commercial paper ("ABCP") markets without appropriately measuring risk

engineering involving special purpose entities (SPEs) is also considered a part of structured finance" at 1).

⁴ See Bill Emmons, "FAS 166 and 167: Forcing Banks to Bring Assets Back on the Balance Sheet", Remarks on the implications for banks of changes to Financial Accounting Standards 166 and 167, (25 March 2010), online: Federal Reserve Bank of St. Louis <<http://www.stlouisfed.org/media/video/transcripts/20100325-emmons.pdf>> [Emmons].

⁵ A sponsor is a firm that creates an SPE.

⁶ Gorton & Souleles, *supra* note 2 at 550.

⁷ *Ibid* at 555.

⁸ Financial Accounting Standards Board, *Statements of Financial Accounting Standards No. 140* (Norwalk: FASB, 2000), online: FASB <www.fasb.org/pdf/fas140.pdf> at 4-5 [FASB, *Statement of FAS No 140*]; see also Financial Accounting Standards Board, *FASB Interpretation No. 46(R)* (Norwalk: FASB, 2003), online: FASB <http://www.fasb.org/> [FASB, *Interpretation No 46(R)*]; Counterparty Risk Management Policy Group (CRMPG III), *Containing Systemic Risk: The Road to Reform* (6 August 2008), online: CRMPG <http://www.crmppolicygroup.org/docs/CRMPG-III.pdf> [CRMPG III] ("[c]onsolidation is the process by which the financial statements of a parent are combined with those of its subsidiaries, as if they were a single economic entity" at 40).

⁹ Tyson Taylor, "Detrimental Legal Implications of Off-Balance Sheet Special Purpose Vehicles in Light of Implicit Guarantees" (2009) 11 U Pa J Bus L 1007 at 1008 [Taylor].

¹⁰ Financial Stability Board, *Shadow Banking: Scoping the Issues – A Background Note of the Financial Stability Board* (12 April 2011), online: FSB <http://www.financialstabilityboard.org/publications/r_110412a.pdf> (the Financial Stability Board broadly defines the shadow banking system as "credit intermediation involving entities and activities outside the regular banking system" at 2).

by permitting true sale treatment between firms and their SPEs without a complete divestiture of assets and without the consolidation of rights and obligations in an arm's length transaction. These problems were foreseeable to the regulatory bodies and should have been addressed by them.

This paper shows that FASB's rules failed in two ways: first, FASB created a concept known as qualified special purpose entities ("QSPEs"). By meeting a few requirements, discussed later, sponsors could set-up QSPEs, which automatically received true sale treatment.¹¹ The leniency in creating QSPEs and receiving automatic non-consolidation treatment provided the mechanism for the growth of securitization. The accounting rules allowed sponsors to retain residual interests in their QSPEs without simultaneously measuring the risks on their financial statements. However, many QSPEs were vulnerable to disruptions in liquidity.¹² Consequently, the liquidity crunch of the Great Recession caused many QSPEs to fail and led to massive investment losses. Second, when the recession started and numerous SPEs began collapsing, many financial institutions honored implicit recourse agreements to bailout their failing SPEs.¹³ This resulted in significant unaccounted for losses for sponsor firms.¹⁴ Although these implicit guarantees violated the true sale rules and sponsors should have consolidated the assets and liabilities of their guaranteed SPEs, sponsors and investors colluded to avoid reporting these risks.¹⁵ However, these implicit risks and guarantees were well known.¹⁶

¹¹ See Parts IV-B-ii and V-A, below.

¹² See Part V-A, below.

¹³ Taylor, *supra* note 9 at 1007; see also Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve System & Office of Thrift Supervision, *Interagency Guidance on Implicit Recourse in Asset Securitizations* (OCC 2002-20) (May 2002) online: OCC <<http://www.occ.gov/news-issuances/bulletins/2002/bulletin-2002-20a.pdf>> [OCC, *Interagency Guidance*] ("[i]mplicit recourse arises from an institution providing post-sale support to a securitization in excess of any contractual obligation" at 3).

¹⁴ *Ibid.*

¹⁵ Gorton & Souleles, *supra* note 2 at 551.

¹⁶ *Ibid.* at 551-52; see also OCC, *Interagency Guidance*, *supra* note 13 at 3-5 (noting that the determination of implicit recourse agreements in securitization transactions requires a case-specific factual inquiry and discussing the potential repercussions of non-contractual support of asset-securitization on a sponsor's "earnings capacity, liquidity, asset quality, and capital adequacy over the life of its securitization" at 2); Dan Amiram et al., "Market Reaction to Securitization Retained Interest Impairments during the Financial Crisis of 2007-2008: Are Implicit Guarantees Worth the Paper They're Not Written On?" (2011), online: Social Science Research Network <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1508664> at 8-11 [Amiram et al] (examining various studies indicating that investors included the implicit guarantees when valuing securities issued by SPEs prior to the Great Recession); Office of the Comptroller of the

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FASB should have addressed this collusion by forcing firms to disclose their off-balance sheet SPE assets and liabilities. This disclosure did not exist prior to the Great Recession.

To address these two problems, FASB issued two statements that became effective in late 2009. Both of these statements aim to increase corporate transparency. First, FASB statement 166 (“FAS 166”) eliminated QSPEs.¹⁷ The second, FASB statement 167 (“FAS 167”), alters the approach to account for implicit guarantees by requiring disclosures of all off-balance sheet entities.¹⁸ Although these changes arrived several years too late, they effectively address the type of off-balance sheet abuse of SPEs that occurred before the crisis.

Before discussing how FASB’s rules failed to appropriately account for the problems with corporate SPEs in the securitization pipeline, it is necessary to understand SPEs and their off-balance sheet treatment. Thus, this paper proceeds as follows. Parts II and III provide an overview of SPEs and the benefits SPEs confer upon their sponsors and investors in the securitization process. Part IV briefly describes major regulatory changes in the consolidation treatment of SPEs that occurred in the aftermath of the Enron scandal. Parts V and VI explain how FASB’s rules and securitization went wrong during the Great Recession. Part VII discusses FASB’s recent remedial action. Part XIII provides a conclusion.

II. SPECIAL PURPOSE ENTITIES

Sponsor firms set up SPEs in various forms, including as limited partnerships, limited liability companies, trusts or corporations.¹⁹ Often,

Currency, *Asset Securitization: Comptroller’s Handbook* (November 1997) online: OCC <<http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/assetsec.pdf>> at 59 (acknowledging that banks provide implicit recourse in securitization by selling assets to SPEs at a discount value, exchanging performing for nonperforming assets, providing cash infusions, and in other ways that impair banks’ capital).

¹⁷ Financial Accounting Standards Board, *Statements of Financial Accounting Standards No. 166: Accounting for Transfers of Financial Assets, an Amendment of FASB Statement No. 140* (June 2009), online: FASB <<http://www.fasb.org>> [FASB, *Statement of FAS No 166*].

¹⁸ Financial Accounting Standards Board, *Statement of Financial Accounting Standards No. 167: Amendments to FASB Interpretation No. 46(R)* (June 2009), online: FASB <<http://www.fasb.org>> [FASB, *Statement of FAS No 167*].

¹⁹ Gorton & Souleles, *supra* note 2 at 551; Janet M. Tavakoli, “Structured Finance: Uses (And Abuses) of Special Purpose Entities” (Address delivered at International Monetary Fund, 19 April 2005) (transcript available at <http://www.tavakolistructuredfinance.com>) [Tavakoli, Address] (this includes “Special Purpose Corporations (SPCs) which may or may not be Special

multiple transferors contribute to the creation of a single SPE.²⁰ They are typically thinly capitalized, have no employees, no independent management, no physical location, and are often serviced by a trustee based on pre-specified rules under a servicing agreement.²¹ This means that SPEs do not make substantive economic decisions, but instead are governed by explicit financing arrangements. For these reasons SPEs are often classified as “passthrough” or “paythrough” structures.²²

Firms have used SPEs for many years²³ because they provide several advantages in both non-securitization transactions and in the securitization process. Outside securitization, SPEs serve as a mechanism for transferring assets or contract rights,²⁴ isolating high-risk projects from sponsors,²⁵ facilitating permit transfers,²⁶ creating financial engineering schemes designed to avoid taxes,²⁷ circumventing regulatory restrictions,²⁸

Purpose Subsidiaries or captives; Master Trusts; Owners Trusts; Grantor Trusts; Real Estate Mortgage Investment Conduits (REMICs); Financial Asset Securitization Investment Trust (FASIT); Multiseller Conduits; Single Seller Conduits; and certain Domestically Domiciled Corporations” at 2).

²⁰ See generally John E. Stewart et al., *CCH Accounting for Financial Assets and Liabilities: Sales, Transfers, and Extinguishments*, 2007 (Chicago: CCH, 2007) at 696-97.

²¹ Gorton & Souleles, *supra* note 2 at 550; see also U.N. Report, *supra* note 1 (explaining that SPEs “may have little physical presence beyond a ‘brass plate’ confirming their place of registration” and are always related to other entities, often as subsidiaries, at para 8).

²² See Tavakoli, Address, *supra* note 19 at 2.

Special purpose entities used for structured finance are often classified as either passthrough or paythrough structures. Passthrough structures pass through all of the principal and interest payments of assets to the investors. . . . Paythrough structures allow for reinvestment of cash flows, restructuring of cash flows, and purchase of additional assets. For example, credit card receivable transactions use paythrough structures to allow reinvestment in new receivables so bonds of a longer average life can be issued.

²³ See Jalal Soroosh & Jack T. Ciesielski, “Accounting for Special Purpose Entities Revised: FASB Interpretation 46(R)” (July 2004) 74:7 CPA Journal 30 at 30 [Soroosh & Ciesielski] (explaining that SPEs were used for securitization in the 1970’s); see also Tavakoli, *Structured Finance and CDOs*, *supra* note 3 at 11-14 (providing an account of the Catholic Church and the Vatican Bank’s abuses of SPEs in the 1970’s through 1980’s).

²⁴ UN Report, *supra* note 1 (“they are commonly used to own a single asset and associated permits and contract rights (such as an apartment building or a power plant), to allow for easier transfer of that asset” at para 5).

²⁵ *Ibid* (“[c]ompanies may use SPEs to legally isolate a high risk project/asset from the parent company and to allow other investors to take a share of the risk” at para 7).

²⁶ *Ibid* (“[m]any permits required to operate certain assets (such as power plants) are either non-transferable or difficult to transfer. By having an SPE own the asset and all the permits, the SPE can be sold as a self-contained package, rather than attempting to assign over numerous permits” at para 7).

²⁷ *Ibid* (“SPEs are often used in complex financial engineering schemes which have, as their main goal, the avoidance of tax or the manipulation of financial statements” at para 7).

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and obtaining preferential tax treatment for investments.²⁹ Because they contribute to such a broad range of activities, some experts attempt to categorize SPEs based on their functions. For example, a United Nations report on SPEs classifies these entities as financing and holding companies,³⁰ royalty and licensing companies,³¹ factoring companies,³² and lease companies.³³ To maximize SPEs' benefits, sponsors commonly

²⁸ *Ibid* (“[a] special purpose entity can sometimes be set up within an orphan structure to circumvent regulatory restrictions, such as regulations relating to nationality of ownership of specific assets” at para 7).

²⁹ *Ibid.*

Some countries have different tax rates for capital gains and gains from property sales. For tax reasons, letting each property be owned by a separate company can be a good thing. These companies can then be sold and bought instead of the actual properties, effectively converting property sale gains into capital gains for tax purposes” at para 7); see also Tavakoli, *Structured Finance and CDOs*, *supra* note 3 (“If we choose a venue such as the Cayman Islands that does not have tax treaties in place with most jurisdictions, there is no mechanism for reclaiming tax withheld (if any) on the underlying asset income from the country of origination. The SPE will purchase assets that are not subject to withholding at the country of the assets’ origination so that investors will not suffer a reduced return.

³⁰ *Ibid* at para 15.

The first category consists of financing and holding companies. Financing and holding companies channel funds in a world wide group on behalf of a non-resident mother company. Large cross-border financial transactions are typical for this type of SPE. The asset side of the balance sheet almost completely consists of financial assets and accounts receivable relating to foreign entities. Holding companies are also known to own claims on notional units abroad (e.g. buildings, natural resources). In the Netherlands the financing and holding companies form, by far, the largest group of SPEs.

³¹ *Ibid.*

Royalty and licence companies make up the second category of SPEs. These businesses have been assigned ownership of intellectual property rights by their parent companies and collect income in the form of royalties as fees on licenses or act as a cashier of their parent company in the invoicing of royalty and license fees (in which case the SPE usually only owns sublicenses). The flows of the royalty and licence companies are recorded as exports of services. The revenues are passed on to the parent company.

³² *Ibid.*

The third group of SPEs are factoring companies, conducting the invoice of sales of the world wide company on behalf of the (non-resident) parent company. Although the sales are not related to the domestic company, the payments are accounted as revenue for the SPE.

³³ *Ibid.*

A fourth type is the lease company, where a distinction between operational lease companies and captive financial lease companies can be made. Operational lease companies are companies with foreign parent companies that lease out fixed assets to foreign customers through operational lease contracts. In the case of captive financial lease companies the SPE legally “owns” the

choose tax-friendly states and countries to set up these entities.³⁴ Further, the structure and organization of an SPE usually depends on the transaction type.³⁵

In the context of securitization, SPEs grant beneficial bankruptcy-remote, liquidity, leverage, and interest rate risk treatment.³⁶ These benefits allow sponsors to create more attractive investments, change the risk profiles of securities they issue, and avoid capital requirements.³⁷ In turn, the securitization process provided an avenue for the abuse of SPEs. While SPEs serve a multitude of functions, it was predominantly their role in securitization that deepened the financial recession that began in 2008.

III. SPEs IN SECURITIZATION

Securitization is the process of transforming receivable assets into sellable securities.³⁸ In a typical asset securitization, a sponsor firm pools together mortgages, car loans, student loans, credit card receivables, or other debt obligations, then transfers these pooled loans to an SPE.³⁹ The SPE that holds these loans issues securities to investors.⁴⁰ This means investors pay money to the SPE to receive a portion of the loan repayments made by the mortgage, student loan, and credit card borrowers. The SPE issues multiple securities from the repayment streams, with each security having a different risk profile.⁴¹ The lowest risk security

assets and leases them back to the parent or other foreign affiliates of the group (who are in fact the “economic” owners of the assets).

³⁴ Tavakoli, *Structured Finance and CDOs*, *supra* note 3 at 16-17 (listing Delaware, New York, Luxembourg, the Netherlands, the Cayman Islands, the Bahamas, Ireland, Jersey, Guernsey, and Gibraltar as common tax-friendly places where sponsors set up SPEs.). This is because SPEs are created and governed under state law; see David B. Stratton, “News at 11: Special-Purpose Entities and Authority to File Bankruptcy” (2004) 23:2 *Am Bankr Inst J* 36 at 36. [Stratton] (explaining that state law determines the recognition and enforcement of SPEs’ charter documents and bankruptcy filings).

³⁵ Soroosh & Ciesielski, *supra* note 23 at 31.

³⁶ See Part III-A-D, below.

³⁷ See Part III B-C, below.

³⁸ Barry J. Epstein, Ralph Nach & Steven M. Bragg, *Wiley GAAP Codification Enhanced* (Hoboken: John Wiley & Sons, 2009) at 230-1 [Epstein, Nach & Bragg].

³⁹ See The Financial Crisis Inquiry Committee, *The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* (January 2011) (Chair: Phil Angelides) [FCIC, *Crisis Inquiry Report*]

⁴⁰ Kurt Eggert, “The Great Collapse: How Securitization Caused the Subprime Meltdown” (2009) 41 *Conn L Rev* 1257 at 1266 [Eggert].

⁴¹ *Ibid.*

will receive the earliest and most secure income stream, but this security will pay a lower return to its investors.⁴² Conversely, the higher risk securities will pay greater returns to investors, but there is a greater chance that the SPE cannot collect enough income from the receivables to pay the higher risk securities. Put differently, the higher risk securities receive a lower payment priority. Multiple securities allow investors to invest based on their desired risk level. This process of risk profiling and granting priorities to the payment streams from different securities is referred to as “tranching.”⁴³ The securities issued by the SPEs are called asset-backed securities (“ABS”) because the payment stream that flows to investors comes from borrowers’ repayments of loans from underlying receivable assets (or from the sale or foreclosure of the asset if the borrower is in default).⁴⁴ Thus, the securities are “backed” by these assets.⁴⁵

Through the securitization process a sponsor can transform illiquid loans into rated securities.⁴⁶ If the receivables in a securitization transaction consist solely of mortgage loans, the securities are labeled “mortgage-backed securities” (“MBS”).⁴⁷ Collateralized debt obligations (“CDOs”) contain a combination of receivables from both mortgage loans and other assets, making these instruments a hybrid or combination of MBSs and ABSs.⁴⁸ In mortgage-backed securities, asset-backed securities and collateralized debt obligations, the highest payment priority of tranches are deemed senior securities, followed by subordinated, junior or

⁴² *Ibid.*

⁴³ See *ibid.*

⁴⁴ *Ibid.*

⁴⁵ This outline provides a simple overview of securitization and shows the role of SPEs in this process. Actual securitization transactions often have greater complexity, and involve investment houses helping to pool loans and sell securities, servicers to collect and disperse the borrowers’ payments and foreclose or collect when necessary, and credit rating agencies to rate the various securities. For more information on the securitization process; see generally Eggert, *supra* note 40.

⁴⁶ Basel Report, *supra* note 3 at 12.

⁴⁷ See Steven L. Schwarcz, “The 2011 Diane Sanger Memorial Lecture—Protecting Investors in Securitization Transactions: Does Dodd-Frank Help, or Hurt?” (2012) 72 La L Rev 591 at 592 [Schwarcz, “Protecting Investors”].

⁴⁸ See Steven L. Schwarcz, “Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown” (2008) 93 Minn L Rev 373 at 376. Many other types of complex financial instruments such as Synthetic CDOs and CDOs Squared are created through the securitization process. However, these instruments are beyond the scope of this article. For a good overview of various structured finance products see Tavakoli, *Structured Finance and CDOs*, *supra* note 3.

mezzanine securities, and the lowest priority class that retains a residual claim once the other securities are paid in full is called equity.⁴⁹

SPEs are an essential ingredient in creating each of these structured finance products. Along with the creation of debt instruments offering different sets of risk and rewards, using SPEs in securitization provides several advantages for sponsors and creditors. The following paragraphs describe the bankruptcy-remote treatment for sponsors, investors and creditors as well as liquidity, leverage and interest-rate risk benefits SPEs create for their sponsors. However, these benefits depend upon the classification of a sponsor's transfer of the receivable assets to its SPEs as a true sale.

A. Bankruptcy-Remote Treatment

One primary advantage of using SPEs is their bankruptcy-remote status which refers to restrictions that reduce the risk that the SPE will voluntarily file for bankruptcy or will be involuntarily forced into a bankruptcy as a result of a substantive consolidation⁵⁰ with an affiliate or sponsor.⁵¹ Firms employ various methods in setting up SPEs to achieve this goal.

First, specific provisions in SPEs' organizational and loan documents, which create impediments to filing for bankruptcy, help in obtaining bankruptcy-remote status.⁵² Although the force of many of these provisions has recently been called into question,⁵³ the pre-recession

⁴⁹ Steven L. Schwarcz, "Disintermediating Avarice: A Legal Framework for Commercially Sustainable Microfinance" (2011) U Ill L Rev 1165 at 1176; see Gorton & Souleles, *supra* note 2 at 565 (these are sometimes labeled "A," "B" and "C" tranches, with the A tranche being the senior note).

⁵⁰ Substantive consolidation refers to a situation where multiple related debtors are combined in bankruptcy proceedings for the purpose of paying creditor and debtor claims. This equitable doctrine allows courts to disregard the separate legal status of two entities in the spirit of justice. See Practical Law Company, *Resources: Glossary*, online: Practical Law Company <<http://uslf.practicallaw.com/9-382-3854>> *sub verbo* "Substantive Consolidation".

⁵¹ Practical Law Company, *Resources: Glossary*, online: Practical Law Company <<http://uslf.practicallaw.com/7-382-3826>> *sub verbo* "Special Purpose Entity (SPE)"; see also Gorton & Souleles, *supra* note 2 at 549.

⁵² Brian M. Resnick & Steven C. Krause, "Not So Bankruptcy-Remote SPEs and In re General Growth Properties Inc." (2009) 28:8 Am Bankr Inst J at 60 [Resnick & Krause]. For example, Resnick and Krause provide that one common mechanism to accomplish bankruptcy-remote status is by stating in the SPE's organizational documents the requirement of a unanimous vote of the directors to file for bankruptcy.

⁵³ See e.g. *In re General Growth Properties Inc.*, No. 09-11977 (Bankr SDNY 2009) (holding that the SPEs of General Growth Properties Inc. could be included in the firm's chapter 11 bankruptcy);

market operated under the assumption that these mechanisms protect lenders from the frustrations and delays associated with bankruptcies and other problematic financial conditions of an SPE's sponsor and affiliates.⁵⁴ Put differently, because an SPE is a separate legal entity from its sponsoring firm, the SPE assets do not become subject to the sponsor's creditors' claims.⁵⁵ Likewise, the investors and creditors of the sponsor do not become subject to any claims on the SPE's assets or securities. Second, an SPE is typically restricted from all activities, except those considered necessary or incidental to the SPE's ownership or operation of property.⁵⁶ These restrictions often prevent the SPE from incurring debt or engaging in risky activity that could eventually result in the SPE's bankruptcy. Additional measures that increase the likelihood of bankruptcy-remote treatment depend on the legal form of the SPE and may include: restricting the SPE's purpose, limiting its ability to incur indebtedness, "prohibitions on merger, consolidation, dissolution, liquidation, winding up, asset sales, transfers of equity interests, and amendments to the organizational documents relating to 'separateness,'" requiring an independent director "whose consent is required for the filing of a voluntary bankruptcy petition," and obtaining inter-creditors agreements to not file involuntary petitions for bankruptcy.⁵⁷

see also *In re JER/Jameson Mezz Borrower II, LLC*, 461 BR 293 (Bankr D Del 2011) (Finding that special purpose entities may be considered in a sponsor's bankruptcy filing. However, the court blocked the reorganization because the single creditor (the only impaired class) would not reasonably consent to any plan submitted by the debtor. Thus, under the bankruptcy code, the petition for bankruptcy could be dismissed for a lack of reasonable likelihood of rehabilitation under 11 USC § 1112(b)(4)(A).); *In re Zais Inv. Grade Ltd. VII*, 455 BR 839 (Bankr DNJ 2011) (ignoring the supermajority requirement to force the SPE into bankruptcy). For an analysis of SPE bankruptcy-remote treatment, see generally *L Distressed Real Est*, vol 4 at § 56:52 (September 2011).

⁵⁴ See Resnick & Krause, *supra* note 52 at 60.

⁵⁵ See Basel Report, *supra* note 3 at 2.

⁵⁶ Richard F. Hahn, Nicole L. Mesard, & Maureen A. Cronin, *D & P Client Update: Bankruptcies of General Growth Properties' "Bankruptcy-Remote" Affiliates Test CMBS Structure* (June 1, 2009), online: Debevoise & <http://www.debevoise.com/files/Publication/de8fd29f-895d45bf-a47d-28aaacdf0d58/Presentation/PublicationAttachment/ceb3a513-e588-44f9-b7df-37de8534e6e1/BankruptciesOfGeneralGrowthPropertiesBankruptcyRemoteAffiliatesTestCMBSStru.pdf> [Hahn, Mesard & Cronin].

⁵⁷ Gorton & Souleles, *supra* note 2 at 550; see also Stratton, *supra* note 34 at 36 (noting that sponsors and SPEs can have the same managers and directors, which may cause a conflict of interest in a situation where it would be beneficial for the sponsor to cause a financially viable SPE to voluntarily file for bankruptcy and consolidate its assets—This concern has prompted rating agencies and lenders to require an independent director for SPEs).

These restrictions and measures reduce the risk of an involuntary bankruptcy filing because they limit the transactions the SPE may execute as well as the number and type of SPE creditors.⁵⁸ This means payment streams from the receivable assets that the bankruptcy-remote SPE collects and distributes are not subject to any claims from the sponsor or the sponsor's creditors. Consequently, investors stand a greater chance of receiving their payments. Additionally, because the limited financial assets held by bankruptcy-remote SPEs are easier to value and understand than those held by sponsor firms that engage in a far greater array of activities and risks, SPEs can pay lower interest rates to their investors than if the sponsors directly issued the securities.⁵⁹

Sponsors can also benefit by ridding themselves of risky receivable assets. In ABS transactions, most of the value received by a sponsor comes from the elimination of potential bankruptcy costs associated with risky receivables.⁶⁰ Thus, securitization through SPEs allows sponsors to avoid recognizing risky receivables and creates interest-rate savings by not subjecting the SPE assets to sponsor's creditors' claims.⁶¹

Further, credit rating agencies use bankruptcy-remoteness as a criterion in rating securities.⁶² For example, Standard and Poor's 2004 ratings guide for evaluating structured finance transactions considers whether the structure of the transaction provides for the availability of assets in the event of the sponsor's insolvency, receivership, or bankruptcy.⁶³ The inclusion of this bankruptcy-remote criterion helps

⁵⁸ Hahn, Mesard & Cronin, *supra* note 56; see also Lee Gilliam, "Accounting Consolidation Versus Capital Calculation: The Conflict over Asset-Backed Commercial Paper Programs" (2005) 9 NC Banking Inst. 291 at 296 [Gilliam] (explaining that bankruptcy-remote SPE investors avoid the time and administrative costs as well as the need to deal with the sponsor's creditors in the event of the sponsor's bankruptcy; instead, investors only need to fight with other lenders of the SPE . . . in the event default).

⁵⁹ Schwarcz, "Protecting Investors", *supra* note 47 at 591-592.

⁶⁰ Taylor, *supra* note 9 at 1012.

⁶¹ See Stratton, *supra* note 34 at 36.

⁶² See e.g. Standard & Poor's, Structured Finance: *Legal Criteria for U.S. Structured Finance Transactions* (April 2004) at 71, online: Mortgage Bankers Association <<http://www.mortgagebankers.org/files/ResourceCenter/RegAB/RegAB-LegalCriteriaforStructuredFinance%28S&P%29.pdf>> [Standard & Poor's] (explaining that Standard & Poor's can base its credit rating of ABS solely on the credit-worthiness of the assets delinked from the creditworthiness of the sponsor if the SPE is bankruptcy-remote).

⁶³ *Ibid* ("[t]he structure of the transaction should provide the means by which the assets would be available to make interest payments on the rated securities in a timely manner and to ensure ultimate recovery of principal upon maturity, notwithstanding the insolvency, receivership, or bankruptcy of the transferor" at 13.)

account for the SPE's ability to make timely payments to the holders of its rated securities.⁶⁴ A better credit rating also creates better financing terms for bankruptcy-remote SPEs.⁶⁵ Thus, SPEs' freedom from bankruptcy is an essential ingredient in gaining the benefits associated with SPEs.

B. Liquidity

SPEs in securitization also provide liquidity benefits for their sponsors. Many consumer loans, such as mortgages, are paid off over multiple years or decades. When a bank extends loans to borrowers, the bank must account for the funds that are no longer in its hands⁶⁶ because capital requirements and certain loan covenants oblige lenders to hold specified minimum ratios of capital to assets.⁶⁷ This restricts the number of loans a lender can provide, thereby limiting the lender's exposure to risk. Additionally, requiring the lender to maintain a certain amount of money on hand ensures it can pay its obligations such as bond payments and depositor withdrawals. By selling loans to an SPE, which issues and sells securities to investors to pay the sponsor back, the funds are replenished and the sponsor or lender has these funds to make additional loans.⁶⁸ The sponsor's balance sheet no longer needs to reflect the illiquid assets connected to the long-term loan receivables, allowing the sponsor to

⁶⁴ *Ibid* at 14.

⁶⁵ See Schwarcz, "Protecting Investors", *supra* 47 at 591-92 (explaining that the interest-rate payable on securities issued by SPEs is often lower because the assets are associated with less risks, are easier to value, and are more creditworthy).

⁶⁶ The Bond Market Association, International Swaps & Derivatives Association, & Securities Industry Association, *Special Purpose Entities (SPEs) and the Securitization Markets* (1 February 2002), online: ISDA <<http://www.isda.org/speeches/pdf/SPV-Discussion-Piece-Final-Feb01.pdf>> at 2 [Bond Market].

⁶⁷ Squam Lake Working Group on Financial Regulations, *Working Paper: Reforming Capital Requirements for Financial Institutions* (April 2009), (New York: Council on Foreign Relations Press, Center for Geoeconomic Studies, 2009), online: Council on Foreign Relations <<http://www.cfr.org/economics/reforming-capital-requirements-financial-institutions/p19001>> at 2.

Banks in the United States and many other countries must satisfy regulatory capital requirements that are intended to ensure they can sustain reasonable losses. These requirements are generally specified as a ratio of some measure of capital to some measure of assets, such as total assets or risk-adjusted assets. Capital requirements are typically designed as if each bank is an isolated entity, with little concern for the effect losses or default at one bank can have on other financial institution.

⁶⁸ See Bond Market, *supra* note 66 at 2-3.

hold less capital.⁶⁹ Thus, using SPEs creates an expanded funding base for sponsors.⁷⁰

C. Leverage

The ability for a sponsor to additionally leverage its assets follows the creation of liquidity. Firms engage in leverage by borrowing money to acquire additional assets in an effort to increase their return on equity.⁷¹ When a firm becomes exposed to a change in the value of the asset it purchased that is greater than the amount the firm paid for the asset, it faces economic leverage.⁷² For example, if a firm enters into an implicit agreement to guarantee a loan, this may not show up on the firm's balance sheet.⁷³ However, if the guarantee materializes, the firm will need to pay the cost of honoring the guarantee. Only after the firm pays this guarantee will the balance sheet reflect the risk.⁷⁴ Thus, the firm increases its leverage.

In the United States, "capital adequacy requirements are based on the amount of reported balance sheet assets."⁷⁵ To combat excessive leverage, U.S. agencies began developing risk-based capital frameworks for banking institutions that followed the standards set by the Basel Committee in the late 1980s.⁷⁶ The Basel Committee altered its approach in 2004 in what is known as "Basel II."⁷⁷ Namely, Basel II attempted to create a framework that measures banks' credit risks, market risks and operational risks across

⁶⁹ However, this treatment often proved incorrect. Many banks had emergency financing commitments that forced them to fund the SPE, requiring the banks to reflect the assets back on their balance sheets. Sponsors also financed the SPEs directly to protect their reputations. See Parts V-B. & VI, below.

⁷⁰ Basel Report, *supra* note 3 at 12.

⁷¹ Katia D'Hulster, "The Leverage Ratio: A New Binding Limit on Banks", Note Number 11, *Crisis Response: Public Policy for the Private Sector* (2009 December) at 1, online: World Bank <<http://www.worldbank.org/financialcrisis/pdf/leverage-ratio-web.pdf>> [D'Hulster].

⁷² *Ibid.*

⁷³ See *ibid.*

⁷⁴ See Parts V-B and VI, below.

⁷⁵ Basel Report, *supra* note 3 at 13.

⁷⁶ Federal Reserve, *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action*, online: OCC <<http://www.occ.gov/news-issuances/news-releases/2012/nr-ia-2012-88a.pdf>> at 21 [Federal Reserve, "Regulatory Capital Rules"]; see also BCBS, *International Convergence of Capital Measurement and Capital Standards* (July 1988), online: Bank for International Settlements <<http://www.bis.org/publ/bcbs04a.htm>>.

⁷⁷ *Ibid.*; see Federal Reserve, "Regulatory Capital Rules", *supra* note 76 at 22 (commonly known as "Basel II").

jurisdictions.⁷⁸ Following the Basel II guidelines, the U.S. created a tier 1 capital ratio requirement of 3 percent for banks that were rated “strong” and 4 percent for all other banks.⁷⁹ However, the accounting rules for measuring balance-sheet leverage varied widely amongst different countries, with the U.S. having very lenient rules.⁸⁰ Specifically, through holding assets in off-balance sheet SPEs, U.S. firms can show better financial ratios.⁸¹ This means by removing the loan receivables from the sponsor’s balance sheet, and replacing them with funds that an SPE transfers upstream to the sponsor, the sponsor can engage in more transactions and sell new loans.⁸² However, firms also create greater risks by leveraging their assets.⁸³

⁷⁸ *Ibid* at 22.

⁷⁹ D’Hulster, *supra* note 71 (“[t]ier 1 capital is broadly defined as the sum of capital and reserves minus some intangible assets such as goodwill software expenses, and deferred tax assets” at 2; The largest U.S. investment banks followed a different measure of leverage based on the “amount of customer receivables the investment bank could hold as a multiple of capital (net capital rule)” *ibid* at 2-3).

⁸⁰ *Ibid* at 2.

As a result of differences in accounting regimes, balance sheet presentation, and domestic regulatory adjustments, however, the measurement of leverage ratios varies across jurisdictions and banks. Accounting regimes lead to the largest variations. In particular, the use of International Financial Reporting Standards results in significantly higher total asset amounts, and therefore lower leverage ratios for similar exposures, than does the use of U.S. generally accepted accounting principles. The reason is that under International Financial Reporting Standards netting conditions are much stricter and the gross replacement value of derivatives is therefore generally shown on the balance sheet, even when positions are held under master netting agreements with the same counterparty.

⁸¹ *Ibid*.

By holding assets off-balance sheet, the sponsoring institution might benefit from the ability to show better financial ratios, such as a higher return on assets. In addition, the sponsoring institution might be able to show higher tangible capital ratios (depending on the extent to which off-balance sheet items are added back to on-balance sheet items), and will not have to reserve against the assets in the SPEs. The ability to move assets off balance sheet could also affect regulatory capital ratios in certain jurisdictions in which capital adequacy requirements are based on the amount of reported balance sheet assets. The leverage ratio in the US is one such example.

⁸² See Robert B. Dickie, *Financial Statement Analysis and Business Valuation for the Practical Lawyer*, 2d ed, (Chicago: American Bar Association, 2006) at 83 (explaining that sponsors enhanced their earnings without needing to increase their assets or equity and without incurring debt on their balance sheets by using the proceeds from the sales to their SPEs to generate new assets to sell to other SPEs).

⁸³ Manual Utset, “Complex Financial Institutions and Systemic Risk” (2011) 45 Ga L Rev 779 at 790 (explaining that leverage magnifies potential profits and losses because it allows firms to engage in more transactions).

D. Interest Rate Risk

Along with liquidity and leverage benefits, securitizing loans through SPEs prevents interest rate risk. Interest rate risk may arise either in a mismatch situation where assets pay fixed-rate coupons and liabilities pay floating-rate interest or when assets and liabilities do not have equivalent maturities.⁸⁴ Banks make money by obtaining deposits or borrowing short-term loans at low interest rates, then issuing long-term debt at higher interest rates. They require a higher rate of interest on these longer loans for the risk that interest rates will fluctuate during the term of the loan. If interest rates rise after a financial institution provides a loan, it loses the opportunity to loan money at the higher rate. By selling the loans to an SPE, a firm avoids interest rate risk because it no longer carries the long-term loan and has replenished funds to make new loans.

E. “True-Sale” Treatment and SPE Independence

Firms may generate each of these benefits through using SPEs. However, effective securitization transactions require a true sale of the assets between the sponsor and SPE.⁸⁵ A true sale makes the SPE an independent entity from its sponsor. Conversely, when the accounting rules treat a transaction as a loan instead of a true sale, the sponsor needs to consolidate the SPE’s assets and liabilities on its balance sheet.⁸⁶ If a true sale does not occur, the SPE remains subject to its sponsor’s bankruptcy (is not bankruptcy-remote) and will not provide the liquidity, leverage or interest-rate benefits associated with securitization because the SPE’s assets and liabilities will remain on the sponsor’s consolidated financial statements.

In the years leading up to the Great Recession, U.S. firms often employed a two-tiered structure that used two SPEs in securitization to achieve true sale treatment.⁸⁷ In a simple version of this structure, the sponsor sells the originated or purchased assets to an intermediate SPE.⁸⁸ The intermediate SPE is typically a subsidiary of the sponsor that acts as a firewall between the sponsor and issuing QSPE.⁸⁹ The intermediate SPE

⁸⁴ See Christopher L. Culp, *Structured Finance and Insurance: The Art of Managing Capital and Risk* (Hoboken: John Wiley & Sons, Inc. 2011).

⁸⁵ Gorton & Souleles, *supra* note 2 at 560.

⁸⁶ *Ibid* at 555.

⁸⁷ See Tavakoli, Address, *supra* note 19.

⁸⁸ Standard & Poor’s, *supra* note 62 at 14.

⁸⁹ *Ibid*.

then sells the assets to the issuing QSPE.⁹⁰ The issuing QSPE issues rated securities and receives proceeds from investors.⁹¹ With the proceeds, the issuing QSPE purchases assets from the intermediate SPE.⁹² The intermediate SPE, not the sponsor, holds the residual interest and retains the proceeds.⁹³ The true sale takes place between the two SPEs and not the sponsor.⁹⁴ These multi-tiered transactions help eliminate the risk of a bankruptcy judge re-characterizing a true sale as a secured loan in the event of a sponsor's bankruptcy.⁹⁵

FASB failed to correctly address this true sale treatment before the Great Recession. Sponsors were able to set up their SPEs in a manner that allowed them to retain significant interests and risks in these off-balance sheet entities.⁹⁶ A look into the consolidation rules before and after Enron sets the stage for why and how FASB failed to address the risk of SPEs.

IV. ENRON AND THE CONSOLIDATION RULES BEFORE THE GREAT RECESSION

FASB first addressed off-balance sheet entities in 1996.⁹⁷ However, in 2000, FASB issued FAS 140, which provided greater detail on how to treat SPEs.⁹⁸ FAS 140 applied a “financial components” approach that focused on control of assets and distinguishing sales from secured borrowing.⁹⁹ It stated the following three criteria for whether a sponsor

⁹⁰ *Ibid.*

⁹¹ *Ibid.*

⁹² *Ibid.*

⁹³ Gorton & Souleles, *supra* note 2 at 558.

⁹⁴ *Ibid.*

⁹⁵ *Ibid.*

⁹⁶ See Parts IV-B-ii & V-A, below.

⁹⁷ See Financial Accounting Standards Board, *Statement of Financial Accounting Standards No. 125: Accounting for Transfer and Servicing of Financial Assets and Extinguishment of Liabilities* (Norwalk: FASB, 1996), online: FASB <<http://www.fasb.org/pdf/fas125.pdf>>. In 1959, SPE accounting was indirectly established in *Accounting Research Bulletin 51, Consolidated Financial Statements* under the basis that ownership of a majority voting interest was the measure of whether a firm had the controlling financial interest. See also Soroosh & Ciesielski, *supra* note 23 at 31.

⁹⁸ See FASB, *Statement of FAS No 140*, *supra* note 8 at 141-49.

⁹⁹ See *ibid* at 4 (explaining that under the financial components approach, “sponsors derecognize financial assets when control has been surrendered, and derecognize liabilities when extinguished,” at 4. Further, when a transferor surrenders control and receives consideration in exchange, a true sale occurs for the transferred assets. FAS 140 also introduced the concept of a “qualifying special purpose entity” that does not require consolidation onto its sponsor’s balance sheet). See Parts IV-B-ii, below.

surrendered control over the transferred assets and, therefore, did not need to consolidate the SPE on its balance sheet:

The transferred assets have been isolated from the transferor-put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.

Each transferee (or, if the transferee is a qualifying special-purpose entity (SPE), each holder of its beneficial interests) has the right to pledge or exchange the assets (or beneficial interests) it received, and no condition both constrains the transferee (or holder) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor.

The transferor does not maintain effective control over the transferred assets through either

- (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity or
- (2) the ability to unilaterally cause the holder to return specific assets, other than through a cleanup call.¹⁰⁰

These rules governing consolidation were lenient for sponsors receiving off-balance sheet treatment. By making SPEs bankruptcy-remote, not retaining decision-making power over the SPEs' assets, and avoiding repurchase agreements between the sponsor and transferee, sponsors could become independent of their SPEs. However, the Enron scandal drew a great deal of attention to SPEs and ushered in changes to these rules. Thus, a brief description of Enron's abuse of SPEs helps explain FASB's reformation of the consolidation rules prior to the Great Recession.

¹⁰⁰ *Ibid*; See also William C. Powers, Jr., Raymond S. Troubh, Herbert S. Winokur Jr., *Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp.* (2002), online: CNN <<http://i.cnn.net/cnn/2002/LAW/02/02/enron.report/powers.report.pdf>> at 38-39 (explaining that without independent equity, there was a rebuttable presumption that the sponsor should consolidate. This presumption could be overcome if independent owners made a substantive capital investment of at least 3% in the SPE and an independent owner exercised control over the SPE).

A. The SPEs of Enron

Enron, a global energy company, restructured its operations in the mid-1990's to attain its goals of rapid growth and immediate profits.¹⁰¹ To retain its credit rating and ability to attract investment during this explosive growth, Enron and its subsidiaries developed financing, operational and accounting strategies to manipulate its financial statements through using SPEs.¹⁰²

In many of its transactions, Enron excluded its SPEs' debts from its consolidated financial statements while including SPEs' revenue, "thereby enhancing its return on investment and certain other financial performance measures."¹⁰³ Thus, Enron hid its true financial condition by overstating its net income, assets, and shareholder equity and concealing large amounts of debt through its SPEs.¹⁰⁴ The auditors, who were supposed to act as Enron's watchdogs, turned a blind eye instead of providing an independent examination of these off-balance sheet transactions because they were "compromised by lucrative non-audit contracts with Enron."¹⁰⁵ By October of 2000, almost half of Enron's approximately \$60 billion in assets were in SPEs.¹⁰⁶

Enron's SPEs violated FAS 140. In addition to various conflicts of interest involving Enron's executives¹⁰⁷ and misstatements of financial performance, its SPEs violated both the asset-isolation requirement and the necessity for an independent entity to exercise sufficient control.¹⁰⁸

¹⁰¹ See US, Joint Committee on Taxation, 108th Cong, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations, Volume I: Report* (JCS-3-03) (Washington, DC: US Government Printing Office, 2003) at 64-74, online: Joint Committee on Taxation <<http://www.jct.gov/s-3-03-vol1.pdf>> [Joint Committee, on Taxation].

¹⁰² *Ibid* at 70; see also Steven L. Schwarcz, "Enron and the Use and Abuse of Special Purpose Entities in Corporate Structures" (2002) 70 U. Cin L Rev 1309 [Schwarcz, "Enron"] ("[Enron's] primary motivation was to minimize financial-statement losses and volatility, accelerate profits, and avoid adding debt to its balance sheet, which could have hurt Enron's credit rating and thereby damaged its credibility in the energy trading business" at 1309-10).

¹⁰³ Joint Committee, on Taxation, *supra* note 101 at 70-71.

¹⁰⁴ Powers, *supra* note 100 at 3; see Epstein, Nach & Bragg, *supra* note 38 at 683-84.

¹⁰⁵ Gilliam, *supra* note 58 at 299.

¹⁰⁶ Joint Committee, on Taxation, *supra* note 101 at 70.

¹⁰⁷ See Schwarcz, "Enron", *supra* note 102 (explaining that Enron's executives receiving massive amounts of compensation by manipulating Enron's SPEs, thereby creating a "tangled web of conflicts of interest" at 1312).

¹⁰⁸ For consolidation requirements, see text accompanying notes 99 & 100.

Thus, Enron did not follow the consolidation rules, but instead fraudulently abused SPEs.¹⁰⁹

After the discovery of Enron's fraud, it needed to restate its financial statements from the last several years. In doing so, Enron had to recognize certain SPEs' debts on its previous and current financial statements.¹¹⁰ Although the consolidation rules did not permit the Enron scandal, Enron's abuse of SPEs created a demand for greater transparency of off-balance sheet activities.

B. The Response to Enron

A multitude of hearings and investigations following Enron's demise sought to root out causes and initiate prevention measures to combat Enron-type fraud.¹¹¹ In response, FASB designed new rules to reinforce accounting disclosures and created more stringent requirements for sponsors to receive non-consolidate treatment. Under these post-Enron regulations, SPEs either met the requirements set out in FAS 140, in which an SPE became a QSPE, or an SPE was treated as variable interest entity ("VIE").¹¹²

i. Variable Interest Entities

FASB Interpretation 46(R) ("FIN 46R") became the authoritative source in explaining how to identify when an SPE should be considered a variable interest entity ("VIE") and when a sponsor "should include the assets, liabilities, non-controlling interests, and results of activities of a VIE in its consolidated financial statement."¹¹³ FIN 46R defined variable

¹⁰⁹ See generally Schwarcz, "Enron", *supra* note 102.

¹¹⁰ See *ibid* at 1311-12.

¹¹¹ See e.g. Powers, *supra* note 100; US, *Report on Fishtail, Bacchus, Sundance, and Slapshot: Four Enron Transactions Funded and Facilitated by U.S. Financial Institutions: Hearing Before the Senate Permanent Subcommittee on Investigations*, 107th Cong (S. Rep. No. 107-82) (Washington, DC: US Government Printing Office, 2003); US, *The Role Enron Energy Service, Inc., (EESI) Played in the Manipulation of Western State Electricity Markets: Hearing Before the Senate Committee on Commerce, Science, and Transportation*, 107th Cong (S. Hrg. 107-1139) (Washington, DC: United States Government Printing, 2005), online: GPO <<http://www.gpo.gov/fdsys/pkg/CHRG-107shrg83978/pdf/CHRG-107shrg83978.pdf>>; US, *Examining Enron: Developments Regarding Electricity Price Manipulation in California: Hearing Before the Subcommittee on Consumer Affairs, Foreign Commerce and Tourism of the Senate Committee on Commerce, Science, and Transportation*, 107th Cong (Washington, DC: United States Government Printing, 2005), online: GPO <<http://www.gpo.gov/fdsys/pkg/CHRG-107shrg84039/pdf/CHRG-107shrg84039.pdf>>.

¹¹² Gorton & Souleles, *supra* note 2 at 556.

¹¹³ Soroosh & Ciesielski, *supra* note 23 at 37; FASB, *Interpretation No 46(R)*, *supra* note 8.

interests as “contractual, ownership, or other pecuniary interests in an entity that change with changes in the fair value of the entity's net assets exclusive of variable interests.”¹¹⁴ Instead of only concentrating on financial control, FIN 46R focused on the actor that holds the residual risk and majority of the benefits.¹¹⁵

While the consolidation rules of VIEs received a lot of attention after Enron, QSPEs served as the mechanism that enabled securitization transactions.¹¹⁶ For an SPE to achieve its desired bankruptcy-remote status and other securitization benefits,¹¹⁷ sponsors needed to exclude SPEs from their balance sheets. QSPEs automatically accomplished this task and did not require consolidation.¹¹⁸ On the other hand, the consolidation treatment of SPEs classified as VIEs required an examination of several complicated factors.¹¹⁹ Thus, to avoid potential consolidations, financial institutions generally used QSPEs in securitization transactions and circumvented the complicated VIE consolidation analysis.¹²⁰

ii. *Qualifying Special Purpose Entities*

SPEs that met four requirements set out in FAS 140 were considered QSPEs and the stricter regulations for VIEs did not apply. First, to qualify under FAS 140, an SPE needed to be “demonstrably distinct” from its sponsor.¹²¹ To meet this requirement, the sponsor of the SPE could not

¹¹⁴ FASB, *Interpretation No 46(R)*, *supra* note 8 (“[t]he identification of variable interests involves determining which assets, liabilities, or contracts create the entity's variability and which assets, liabilities, equity, and other contracts absorb or receive that variability. The latter are the entity's variable interests. The labeling of an item as an asset, liability, equity, or as a contractual arrangement does not determine whether that item is a variable interest. It is the role of the item—to absorb or receive the entity's variability—that distinguishes a variable interest. The role, in turn, often depends on the design of the entity” at para B4).

¹¹⁵ Gorton & Souleles, *supra* note 2 at 556; see also Soroosh & Ciesielski, *supra* note 23 (“[a]ccording to Interpretation 46(R), expected losses and expected residual returns refer to amounts derived from expected cash flows as described in FASB Concept Statement 7, *Using Cash Flow Information and Present Value in Accounting Measurements*” at 37).

¹¹⁶ Epstein, Nach & Bragg, *supra* note 38 at 229-30.

¹¹⁷ See Parts III-A-E, above.

¹¹⁸ See FASB, *Statement of FAS No 140*, *supra* note 8.

¹¹⁹ The determinations of whether an interest is a variable interest and whether an SPE is a variable interest entity often involves a complex range of decision-making steps. See generally Deloitte, *Consolidation of Variable Interest Entities: A Roadmap to Applying Interpretation 46(R)'s Consolidation Guidance*, 3d ed (Deloitte Development L.L.C., 2007) online: Deloitte <<http://www.iasplus.com/usa/0709roadmapfin46r.pdf>>.

¹²⁰ See Gorton and Souleles, *supra* note 2 at 560.

¹²¹ *Ibid* at 556.

have the ability to unilaterally dissolve the SPE.¹²² Additionally, independent third parties needed to hold at least ten percent of the SPE's beneficial interests.¹²³ Second, a QSPE's organizing legal documents needed to ensure that the SPE was "significantly limited in its permitted activities."¹²⁴ Third, the SPE could hold only "passive" receivables.¹²⁵ Financial assets were considered passive if the holding of the assets did not involve any decision-making other than those necessary for servicing the assets.¹²⁶ Passive receivables included cash collected from held assets, purchased investments that were pending distribution to beneficiaries, and certain derivative instruments that were sold to parties other than the sponsor and its affiliates, such as interest rate swaps.¹²⁷ Fourth, an SPE's sale or disposition of noncash receivables could only occur in automatic response situations that were triggered upon the occurrence of certain events.¹²⁸ A few situations that would allow a QSPE to dispose of noncash financial assets included: the fair value of financial assets declining to a specified degree (as indicated in the SPE's legal documents), an independent beneficial interest holder exercising its right to give a beneficial interest back to the QSPE, or termination of the QSPE.¹²⁹

V. FASB'S FAILURE

A. The Leniency of Receiving Off-Balance Sheet Treatment Through QSPEs

The requirements of creating QSPEs and receiving off-balance sheet treatment opened an avenue for sponsors to move assets off their balance sheets while still retaining the residual benefits and risks of their QSPEs.¹³⁰

¹²² *Ibid.*

¹²³ *Ibid.*

¹²⁴ *Ibid.*

¹²⁵ *Ibid.*

¹²⁶ Epstein, Nach & Bragg, *supra* note 38 at 230-31.

¹²⁷ *Ibid.* at 231.

¹²⁸ Gorton & Souleles, *supra* note 2 at 556.

¹²⁹ Epstein, Nach & Bragg, *supra* note 38 at 231.

¹³⁰ See CRMPG III, *supra* note 8 at 39.

Securitization vehicles considered to be 'Qualifying Special Purpose Entities' (QSPEs) receive off-balance sheet treatment even if the sponsoring entity provides credit enhancements by retaining a significant residual interest in the securitization trust (i.e., the sponsor is expected to absorb the majority of the risks and rewards). The rationale for off-balance sheet treatment is that the vehicle is passive and therefore the sponsor does not control it.

Because the determination of whether an SPE *qualified* turned mainly on whether the SPE held passive receivables and reacted according to pre-specified rules, firms could organize their off-balance sheet entities in a manner accommodating the QSPE requirements. Thus, firms automatically avoided the possibility of consolidation. For example, if a sponsor set up a QSPE trust and retained the residual interest and rights to service the trust, it could still avoid consolidating the QSPE if the collections on the receivables were distributed according to a predetermined formula.¹³¹ Sponsors retention of significant interests in their SPEs resulted in unaccounted for exposure to risk.¹³²

Additionally, QSPEs had a fundamental underlying flaw: they were expected to “continually roll over their liabilities in all market conditions,” but were extremely vulnerable to disruptions in liquidity.¹³³ This liquidity risk refers to the risk that institutions will be unable to meet their obligations because of the inability to obtain adequate financing or liquidate their assets at reasonable prices.¹³⁴ With the turmoil of the financial crisis, QSPEs that financed long-term assets with short-term liabilities could not renew their debt because of market concerns over the quality of the receivables.¹³⁵ Likewise, selling the assets was not often a viable option, as the price of the assets fell with the market crisis.¹³⁶ For example, the asset-backed commercial paper (“ABCP”) market was one of the first markets to collapse during the recession because the QSPEs used in ABCP transactions financed receivable assets with short-term debt.¹³⁷

By design, QSPEs could maintain very little or no capital.¹³⁸ Because QSPEs issued mortgage-backed securities, asset-backed securities, and

See also Angela Petrucci, “Accounting for Asset Securitization in A Full Disclosure World” (2004) 30 J. Legis. 327 at 350 (noting that FASB established a framework that can create incentives for sponsors to use off-balance sheet financing for manipulative or misleading purposes).

¹³¹ CRMPG III, *supra* note 8 at 45-46 (retaining a residual interest often meant that the sponsor would retain the risk and rewards of the lowest rated tranches). See Basel Report, *supra* note 3 at 20.

¹³² *Ibid* at 49.

¹³³ Emmons, *supra* note 4 at 2.

¹³⁴ US, Government Accountability Office, *Financial Markets Regulation: Financial Crisis Highlights Need to Improve Oversight of Leverage at Financial Institutions and Across System* (GAO-09-739) (Washington, DC: US Government Printing Office, 2009) at 56, online: GAO <<http://www.gao.gov/assets/300/292757.pdf>> [GAO Report].

¹³⁵ *Ibid* at 57.

¹³⁶ *Ibid* at 4.

¹³⁷ See Part VI, below.

¹³⁸ See Part IV-D, above (explaining the requirement of qualifying special purpose entities to hold

collateralized debt obligations, which derived their underlying cash flows from mortgage payments, auto loans, credit cards, and other receivables, they relied on consumers to make payments to continue their current course.¹³⁹ When the financial crisis materialized, many borrowers defaulted on their loans. In many cases, these defaults resulted in the inability of QSPEs to pay their investors and residual interests to their sponsors. Thus, the ability to transfer and de-recognize assets in QSPEs affected both sponsoring financial institutions through their residual interests and investors of the QSPE's issued securities.

B. Implicit Guarantee of SPEs

In addition to the unaccounted for exposure to risk associated with QSPEs, sponsor firms often created implicit contractual relations with their investors to support their SPEs.¹⁴⁰ Courts and the accounting rules view implicit recourse as if a true-sale never took place.¹⁴¹ If a court could identify implicit recourse agreements, creditors of a sponsor could “claw back” the assets of the SPE in the sponsor's bankruptcy proceeding.¹⁴² However, to avoid consolidation treatment, firms violated the accounting rules and colluded with their investors to provide recourse for their troubled QSPEs without openly acknowledging the existence of the agreement.¹⁴³

Although these implicit guarantees were not legally binding and violated the non-consolidation accounting rules for both VIEs and QSPEs,¹⁴⁴ investors relied on this support when purchasing the securities issued by SPEs.¹⁴⁵ These guarantees frequently occurred in situations where a QSPE held low quality assets, but the sponsor retained high-quality assets on its balance sheets.¹⁴⁶ Thus, these guarantees often existed in situations where it was more likely the guarantee would materialize.

By treating the transfer of assets from a sponsor to an SPE as an off-balance sheet sale despite these implicit guarantees, the accounting rules

only “passive” receivables).

¹³⁹ Emmons, *supra* note 4 at 2.

¹⁴⁰ See generally Taylor, *supra* note 9.

¹⁴¹ Gorton & Souleles, *supra* note 2 at 553.

¹⁴² Taylor, *supra* note 9 at 1023.

¹⁴³ See *ibid* at 1023-27; see also Gorton & Souleles, *supra* note 2 at 554

¹⁴⁴ See FASB, *Statement of FAS No 140*, *supra* note 8; FASB, “Interpretation 46R”, *supra* note 8.

¹⁴⁵ Gorton & Souleles, *supra* note 2 at 551.

¹⁴⁶ *Ibid* at 553.

could not account for the full economic effects of these transactions.¹⁴⁷ These implicit guarantees were not a secret.¹⁴⁸ FASB should have required sponsors to disclose their SPE assets and liabilities regardless of whether the QSPEs or VIEs deserved off-balance sheet treatment.¹⁴⁹ By not doing so, FASB did not fully account for the risk to sponsors of their SPEs failing. Although FASB recently enacted two accounting statements that require these disclosures, this collusion problem caused massive losses before the Great Recession.¹⁵⁰

VI. THE REPERCUSSIONS THROUGH THE SECURITIZATION PIPELINE

With inadequate capital and no access to liquidity, many QSPEs began collapsing.¹⁵¹ This created the question of whether sponsors would maintain the required disconnect with their QSPEs.¹⁵² In many cases, the answer was no.¹⁵³ The implicit agreements frequently required sponsors to provide help for their under-capitalized QSPEs.¹⁵⁴ To keep up their end of the bargain, sponsors either issued lines of credit or provided capital support through instituting loss-sharing programs.¹⁵⁵ Many sponsors chose to fund their QSPEs to avoid the repercussions associated with allowing “disruptive collapses of the entities they had created.”¹⁵⁶ In bailing out their SPEs, sponsors were likely trying to avoid reputation harm and wariness from future investors, as it was public knowledge that they had

¹⁴⁷ Amiram et al, *supra* note 16 at 39-40.

¹⁴⁸ For a list of sources that show implicit guarantees were known, see text accompanying note 16. See also Gorton & Souleles, *supra* note 2 at 591 (concluding that efficient off-balance sheet financing is facilitated by implicit contractual arrangements between sponsors and investors); see also Taylor, *supra* note 9 at 1023 (detailing Citibank and HSBC’s implicit recourse for their SPEs).

¹⁴⁹ See Amiram et al, *supra* note 16 at 40.

¹⁵⁰ FASB, “Statement of FAS No. 166”, *supra* note 17; FASB, *Statement of FAS No 167*, *supra* note 18; See generally Taylor, *supra* note 9.

¹⁵¹ Emmons, *supra* note 4 at 2.

¹⁵² *Ibid* at 2-3.

¹⁵³ *Ibid* at 3.

¹⁵⁴ *Ibid*. See also Gorton & Souleles, *supra* note 2 (“[b]ecause the SP[E]’s business activities are constrained and its ability to incur debt is limited, it faces the risk of a shortfall of cash below what it is obligated to pay investors” at 559-60).

¹⁵⁵ Emmons, *supra* note 4 at 3.

¹⁵⁶ *Ibid*.

set up these entities.¹⁵⁷ These implicit recourse agreements and the ease of off-balance sheet recognition through using QSPEs facilitated the expansion of securitization in the years leading up to the financial crisis.

However, the blame for this expansion does not rest solely with FASB's consolidation rules. Even when firms had explicit support agreements, they were not forced to hold adequate capital against their commitments.¹⁵⁸ Thus, while FASB's rules meaningfully contributed to the expansion of securitization transactions and allowed for the creation of QSPEs, other regulators also contributed to the expansion of securitization by failing to account for the risks of explicit guarantees.¹⁵⁹

Following its normal course, regulatory arbitrage behaved in its typical manner—Banks and other financial institutions sought the least regulated environment.¹⁶⁰ Through the securitization of loans, regulated banks booked assets off their balance sheets.¹⁶¹ The pre-crisis accounting rules and the shadow banking system facilitated the avoidance of capital requirements and permitted higher levels of leverage than those required under normal banking regulations.¹⁶² Indeed, firms grew the shadow banking system largely for the purpose of hiding leverage from regulators.¹⁶³ Some larger institutions created as many as two thousand SPEs.¹⁶⁴ The growth of securitization resulted in banks holding

¹⁵⁷ See *ibid* at 3-4; see also Taylor, *supra* note 9 at 1025 (discussing the necessity for a sponsor to honor its implicit agreements and maintain a credible reputation to continuously access securitization markets).

¹⁵⁸ See GAO Report, *supra* note 134 at 56-57 (noting that when banks provided contingent funding support to their SPEs, they only needed to hold a small amounts of or no capital against their commitments). See also OCC, *Interagency Guidance*, *supra* note 13 at 2-3 (explaining that the interagency rules allow for lower risk-based capital requirements under recourse agreements than their on balance-sheet counterparts); Charles W. Calomiris, "Financial Innovation, Regulation, and Reform" (2009) 29 *Cato Journal* 65, online: CATO <<http://www.cato.org/pubs/journal/cj29n1/cj29n1-7.pdf>> [Calomiris] ("[s]everal of the capital requirement rules for the treatment of securitized assets originated by banks, and for the debts issued by those conduits and held or guaranteed by banks, were specifically and consciously designed to permit banks to allocate less capital against their risks if they had been held on their balance sheets" at 65-66).

¹⁵⁹ See *ibid* and accompanying text.

¹⁶⁰ See CRMPG III, *supra* note 8 at 38 (explaining that firms engaged in regulatory arbitrage through securitization because off-balance sheet vehicles called for little or no capital charges).

¹⁶¹ Calomiris, *supra* note 158 at 65-66.

¹⁶² Emmons, *supra* note 4.

¹⁶³ See Margaret M. Blair, "Leverage, Bubbles and Income Distribution" (2012) *Banking & Fin Services Poly Rep* at 11-12 [Blair].

¹⁶⁴ See Basel Report, *supra* note 3 at 35.

“insufficient amounts of equity capital per unit of risk undertaken in their subprime holdings.”¹⁶⁵

The lack of risk retention through transferring assets to QSPEs allowed originators to engage in what is known as the “originate-to-distribute” model of lending.¹⁶⁶ Under this model, sponsors, knowing that their originated loans would be sold off-balance sheet (and eventually to investors), did not screen their borrowers and generated poor quality mortgages and other loans.¹⁶⁷ Compensation for the managers of sponsor firms was often based on issuance volume instead of quality, leading originators to maximize their short-term returns by lowering underwriting standards and engaging in more transactions.¹⁶⁸ Further, in the mid-2000s, riskier and more highly structured CDOs surfaced, which often combined the lowest rated tranches of other CDOs, MBSs, and ABSs.¹⁶⁹ Credit rating agencies joined in on the race-to-the-bottom, assigning AAA or minimal credit risk ratings to the highest tranches of these re-securitizations.¹⁷⁰

Regulators and institutions did not realize the scale and risk of these off-balance sheet entities until it was too late.¹⁷¹ The misaligned incentives and lack of risk retention through the securitization pipeline created moral hazard problems and caused significant harm to the economy.¹⁷²

¹⁶⁵ Calomiris, *supra* note 158 at 66.

¹⁶⁶ US, Financial Stability Oversight Council, *Macroeconomic Effects of Risk Retention Requirements* (2011) online: US Department of the Treasury <[http://www.treasury.gov/initiatives/wsr/Documents/Section%20946%20Risk%20Retention%20Study%20%20\(FINAL\).pdf](http://www.treasury.gov/initiatives/wsr/Documents/Section%20946%20Risk%20Retention%20Study%20%20(FINAL).pdf)> at 3, 10-11 [FSOC, *Macroeconomic Effects*]; see also Schwarcz, “Protecting Investors”, *supra* note 47 (explaining the moral-hazard problems associated with the originate-to-distribute model of lending).

¹⁶⁷ FSOC, *Macroeconomic Effects*, *supra* note 166 at 3.

¹⁶⁸ *Ibid.*

¹⁶⁹ Basel Report, *supra* note 3 at 7 (explaining the prevalence and demand for increasingly complex and risky products that were made through re-securitizations).

¹⁷⁰ *Ibid.*; see generally John C. Coffee, “Ratings Reform: The Good, the Bad, and the Ugly” (2011) 1 Harv Bus L Rev 231 (for more information on the credit rating agencies role in the Great Recession).

¹⁷¹ Emmons, *supra* note 4 at 2-3 (stating that the regulatory community and financial institutions did not completely understand the risks off-balance sheet transactions posed to the economy).

¹⁷² See generally FSOC, *Macroeconomic Effects*, *supra* note 166 (“[a]s the recent financial crisis demonstrates, securitization, without appropriate reforms, can cause significant harm to the economy. Risk retention can help align the interests of the participants in the securitization chain, reduce the risks inherent in securitization, and promote the stable formation of credit and efficient allocation of capital in the United States” at 4). See also Jean Tirole, “Illiquidity and All Its Friends” (2011) 49:2 JEL 287 (“[s]ecuritization of assets is fraught with asymmetric information hazards: moral hazard to the extent that issuers have little incentive to create high-

QSPEs served as securitization's vehicle to expose investors to these risks.¹⁷³ Sponsors and investors paid a hefty price for their actions. In addition to securitization transactions, the ease of transferring assets to a QSPE and receiving off-balance sheet treatment facilitated the growth of the ABCP markets.

A. Asset-Backed Commercial Paper and Structure Investment Vehicles

ABCP refers to the use of QSPEs in financing "the purchase of receivables primarily through commercial paper."¹⁷⁴ Unlike ABSs, ABCP conduits generally had maturities of under three months, retained explicit liquidity support provided by sponsors for protection of investors, carried diversified portfolios of assets, and the administrators could change the level of credit enhancement to reflect credit concerns.¹⁷⁵

Most ABCP conduits received a 100 percent liquidity backup line from the issuing bank to insure investors' repayments when the commercial paper matured.¹⁷⁶ However, banks needed to maintain only a capital charge for a backup liquidity line for these ABCP conduits.¹⁷⁷ Put differently, even though a bank could provide a 100 percent backup liquidity line for an ABCP conduit, this allowed banks to hold less capital than would have been required if the loan had existed on the bank's balance sheet.¹⁷⁸ Thus, banks retained exposure to these off-balance sheet

value instruments if they anticipate to sell a major stake in them" at 299).

¹⁷³ See Part IV-B, above.

¹⁷⁴ Gorton & Souleles, *supra* note 2 at 558.

¹⁷⁵ Blackrock Investments, *Understanding ABCP: A Primer* (2011), online: Blackrock <https://www2.blackrock.com/webcore/litService/search/getDocument.seam?contentId=1111124176&Source=SEARCH&Venue=PUB_INS> [Blackrock]

¹⁷⁶ Tobias Adrian, "Dodd-Frank One Year On: Implications for Shadow Banking" (Paper prepared for the Pew Charitable Trust-New York University conference, Washington, DC, 27 June 2011) [unpublished] online: Federal Reserve Bank of New York <http://www.newyorkfed.org/research/staff_reports/sr533.pdf> at 3 [Adrian].

¹⁷⁷ *Ibid.*

¹⁷⁸ See Swasi Bate, Stephany Bushweller & Everett Rutan, "Structure Finance Special Report: The Fundamentals of Asset-Backed Commercial Paper" (3 February 2003) online: Moody's Investor Service <<http://www.imf.org/external/np/seminars/eng/2010/mcm/pdf/Rutan1.pdf>> at 15.

ABCP programs also offer advantages to their bank sponsors. The programs are typically structured and accounted for by the banks as an off-balance sheet activity. If the bank were to provide a direct corporate loan, even one secured by the same assets, it would appear on the bank's balance sheet as an asset and the bank would be obligated to maintain regulatory capital for it. An ABCP program permits the Sponsor (i.e., the commercial bank) to offer receivable financing services to its customers without using the Sponsor's balance sheet or

conduits through their liquidity lines.¹⁷⁹ At its peak, “the ABCP market was approximately \$1.2 trillion in the United States.”¹⁸⁰ As a result of these conduits, banks reported better financial performance without accounting for the risk.¹⁸¹

However, similar to QSPEs in securitization transactions, these ABCP conduits held poorly underwritten asset pools because of the lack of credit standards and risk-retention.¹⁸² During the second half of 2007 many banks had to consolidate assets from these conduits.¹⁸³ Just as the case with QSPEs in securitization, the regulations governing these ABCP conduits did not properly account for the exposure.¹⁸⁴

Structured Investment Vehicles (“SIVs”) posed a similar threat as ABCP conduits. SIVs were bankruptcy-remote special purpose entities that held diversified pools of assets.¹⁸⁵ However, unlike ABCP conduits, SIVs did not have the same liquidity support or credit enhancement.¹⁸⁶ Also, their notes typically had slightly longer maturity dates than those of ABCP conduits.¹⁸⁷ At the peak of their use, it is estimated that commercial banks operated SIVs with assets of approximately \$400 billion.¹⁸⁸ Despite the lower required liquidity lines, many investors believed that the affiliated investment banks would provide implicit liquidity support for their SIVs.¹⁸⁹ Again, the accounting standards lacked transparency in exposing these implicit recourse agreements for the QSPEs used in these transactions.

holding incremental regulatory capital.

¹⁷⁹ Adrian, *supra* note 176 at 3.

¹⁸⁰ Blackrock, *supra* note 175 (“[t]his included examples such as SP[E]s financing longer life assets, not having secondary liquidity available to fund maturing ABCP (so-called market value structures where asset sales or maturity would be the sole source of repayment) and lower levels of pool and program credit enhancement,” at 3).

¹⁸¹ Adrian, *supra* note 176 at 3.

¹⁸² See Blackrock, *supra* note 175 at 3.

¹⁸³ Adrian, *supra* note 176 at 3.

¹⁸⁴ *Ibid.* at 3-4.

¹⁸⁵ Emma-Jane Fulcher et al., “ABCP/Europe Special Report: The Difference Between Traditional ABCP Conduits and SIVs” (8 April 2008) 2 (New York: Fitch, Inc. 2008) at 2, online: IMMFA <<http://www.immfa.org/about/faq/ABC3Pconduits.pdf>>.

¹⁸⁶ *Ibid.* (explaining that SIVs generally operate with only a 5-10 percent liquidity support line as opposed to the 100 percent support line available to ABCP conduits, but many investors still believed that banks would provide implicit support to avoid reputational harm).

¹⁸⁷ *Ibid.*

¹⁸⁸ *Ibid.* at 3.

¹⁸⁹ *Ibid.* at 2.

Financial institutions used ABCP conduits and Structure Investment Vehicles (“SIVs”) to borrow securities with lower-rate, short-term maturities and invest in longer-term and higher yielding assets.¹⁹⁰ For success, the ABCP market required a sustained demand of short-term paper.¹⁹¹ It also relied on the continuing payment streams from long-term receivable assets. With the unprecedented stresses caused by the financial crisis, the “duration mismatch of borrowing short and lending long” was exposed,¹⁹² resulting in the ABCP market being “one of the first markets of the shadow banking system to collapse during the financial crisis.”¹⁹³ Just as in securitization transactions, sponsoring institutions needed to provide support to their SPEs used in these commercial paper transactions.¹⁹⁴

B. Off-Balance Sheet Entities of the Recession in Hindsight

Through securitization, ABCP conduits and SIVs, trillions of dollars flowed into off-balance sheet entities. As a result of the recession, financial institutions experienced vast losses with their on-balance-sheet business.¹⁹⁵ Compounding these losses with needing to provide capital support for their off-balance sheet entities put banks and other financial institutions in a precarious position.¹⁹⁶ The bailouts of SPEs resulted in sponsor firms losing billions of dollars.¹⁹⁷ The bifurcated approach of maintaining both visible assets on balance sheets and hidden assets off-balance sheets created what some have called a “schizophrenic” banking system.¹⁹⁸

¹⁹⁰ Basel Report, *supra* note 3 at 8.

¹⁹¹ *Ibid.*

¹⁹² *Ibid.*

¹⁹³ Adrian, *supra* note 176 at 3.

¹⁹⁴ Basel Report, *supra* note 3 at 8.

¹⁹⁵ Emmons, *supra* note 4 at 3.

¹⁹⁶ *Ibid* at 3-4.

¹⁹⁷ See *ibid* at 4.

¹⁹⁸ See *ibid* at 1-2; see also D’Hulster, *supra* note 71 at 4.

Over the past decades financial innovation has fundamentally changed the structure of the financial system. This trend is exemplified by credit risk transfer instruments such as structured credit products, through which portfolios of credit exposures can be sliced and repackaged to meet the needs of investors. Banks funded a growing amount of long-term assets with short-term liabilities in wholesale markets through the use of off-balance-sheet vehicles, exposing themselves to credit and liquidity risk by providing facilities to these vehicles. Moreover, they also held structured credit instruments on their own balance sheet, exposing themselves to embedded leverage and increasing their asset-liability mismatch and their funding liquidity risk.

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The legislature and other regulators did not intervene under the premise that “less regulation and more innovation would lead to a greater growth in the economy.”¹⁹⁹ Securitization and the lack of regulation in the shadow banking industry caused a greater number of transactions to occur, many of which were wasteful or destructive, resulting in firms incurring far greater risks than they otherwise would have.²⁰⁰ Companies that engaged in greater usage of off-balance sheet entities encountered greater problems in the financial crisis. Senator Jack Reed emphasized the need for transparency in future financial statements following the crisis, and stated:

[T]here is emerging consensus that companies that have more accurately accounted for their balance sheets remain viable, while those companies that were slower to recognize losses are punished by the marketplace. This is a clear signal for investors that there is a premium on improved transparency. . . . Over the last year or so, we have seen revelations of a significant build-up of off-balance-sheet exposures among some of the largest financial institutions. These exposures not only weaken these institutions but, indeed, place significant risks on the entire financial system, contributing to the severity of the current crisis. The drivers of the subprime crisis were not only excess liquidity, leverage, complex

¹⁹⁹ Blair, *supra* note 163 at 11-12.

²⁰⁰ Emmons, *supra* note 4 at 2-3. See also Gorton & Souleles, *supra* note 2 (“[i]f the bank uses the securitization proceeds to expand its loan business, then its default risk tends to increase. This tends to translate also into an increase in its stock beta. On average, a beta increase is confirmed by our empirical findings. Our evidence suggests that many banks use the risk reduction achieved through securitization to take new risks” at 550). See also Basel Committee on Banking Supervision, *Basel III: A global regulatory framework for more resilient banks and banking systems* (Basel: Bank for International Settlements, 2011) at 1, online: Bank for International Settlements <<http://www.bis.org/publ/bcbs189.pdf>>.

One of the main reasons the economic and financial crisis, which began in 2007, became so severe was that the banking sectors of many countries had built up excessive on- and off-balance sheet leverage. This was accompanied by a gradual erosion of the level and quality of the capital base. At the same time, many banks were holding insufficient liquidity buffers. The banking system therefore was not able to absorb the resulting systemic trading and credit losses nor could it cope with the reintermediation of large off-balance sheet exposures that had built up in the shadow banking system. The crisis was further amplified by a procyclical deleveraging process and by the interconnectedness of systemic institutions through an array of complex transactions. During the most severe episode of the crisis, the market lost confidence in the solvency and liquidity of many banking institutions. The weaknesses in the banking sector were rapidly transmitted to the rest of the financial system and the real economy, resulting in a massive contraction of liquidity and credit availability. Ultimately the public sector had to step in with unprecedented injections of liquidity, capital support and guarantees, exposing taxpayers to large losses.

products, and distorted incentives, but accounting rules that allowed mortgage-backed securities be held off the balance sheet. The securities packaged from these mortgages, many of them risky subprime mortgages, remain far from the view of investors and less closely reviewed by regulators. If we have learned anything from this recent mortgage mess—and I hope that we have—it is that we need more transparency in our markets, not less. Holding large amounts of assets off-balance sheet is not more transparency. If firms hold such risk, it should be disclosed so that investors can decide whether they are comfortable with such risk.²⁰¹

VII. POST-GREAT RECESSION

Similar to other economic catastrophes, the credit crisis has led to a crackdown on those who abused the system. Investigations of the largest financial institutions attempt to hold bad actors accountable for our crisis.²⁰² Companies, regulatory agencies and academics are taking a long, hard look at the perverse incentive structures that encouraged short-term profits, large and systemically risky behavior, and other moral-hazard issues.

The lack of disclosure throughout the shadow banking system and the use of SPEs to carry out off-balance sheet transactions necessitated the government's creation of many credit and liquidity facilities.²⁰³ Thus, a part of this re-evaluation of regulations concerns off-balance sheet SPEs. As previously discussed, the accounting standards that determined true

²⁰¹ US, *Transparency in Accounting: Proposed Changes to Accounting for Off-Balance-Sheet Entities: Hearing Before the Subcommittee on Securities, Insurance, and Investment of the Committee on Banking, Housing and Urban Affairs*, 110th Cong (Washington, DC: United State Government Printing, 2008) at 1 (Senator Jack Reed, Chairman) [US, *Transparency in Accounting*].

²⁰² See e.g. Julia Finch, "Twenty Five People at the Heart of the Meltdown . . .", *The Guardian* (25 January 2009) online: [Guardian <http://www.guardian.co.uk/business/2009/jan/26/road-ruin-recession-individuals-economy>](http://www.guardian.co.uk/business/2009/jan/26/road-ruin-recession-individuals-economy) (blaming Bill Clinton, George W. Bush, Gordon Brown, Phil Gramm, as well as many wall street executives and others for the economic crisis); Nancy Gibbs, "25 People to Blame for the Financial Crisis: The good intentions, bad managers and greed behind the meltdown", *TIME Magazine* (23 February 2009) online: [TIME <http://www.time.com/time/specials/packages/completelist/0,29569,1877351,00.html>](http://www.time.com/time/specials/packages/completelist/0,29569,1877351,00.html).

²⁰³ See US, Government Accountability Office, *Federal Reserve System: Opportunities Exist to Strengthen Policies and Processes for Managing Emergency Assistance* (July 2011), online: [GAO <http://www.gao.gov/highlights/d11696high.pdf>](http://www.gao.gov/highlights/d11696high.pdf) (for information and a list of the different liquidity facilities). These liquidity facilities are in addition to other massive government interventions. For a broad range of government spending in the financial crisis see generally International Bar Association Task Force on Financial Crisis, *A Survey of Current Regulatory Trends* 28-29 (2010), online: [IBA <http://www.ibanet.org>](http://www.ibanet.org) at 28-29; see generally US, Bill S 3217, *Restoring American Financial Stability Act of 2010*, 111th Cong, 2010 (enacted)(sec 1152 specifically references the government's ability to oversee credit facilities).

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sale treatment of asset transfers between sponsors and SPEs formed the crux of these off-balance sheet problems.²⁰⁴

FASB found two fundamental issues with FAS 140 and FIN 46R.²⁰⁵ First, exempting QSPEs from consolidation exacerbated the crisis.²⁰⁶ Second, FIN 46R incorrectly relied “on a mathematical calculation to assess whether a holder of an interest in an SPE should consolidate that entity” instead of using a more appropriate qualitative evaluation of control.²⁰⁷ A qualitative evaluation of control better accounts for the implicit recourse problem.²⁰⁸

In April 2008, FASB announced its intention to revise FIN 46R and eliminate QSPEs.²⁰⁹ Of course, these measures were met with a strong lobbying opposition from various banking associations.²¹⁰ Nonetheless, FASB crafted two statements, FAS 166 and FAS 167 that amended FAS 140 and FIN 46R, respectively, and came into effect in November 2009.²¹¹

FAS 166 and 167 focus on increasing transparency and capital requirements in major financial institutions.²¹² For example, FAS 166 and 167 require firms to list all of their assets and liabilities they originate or have continuing involvement with on their balance sheets.²¹³ Specifically, FAS 166 created new standards that affect institutions that engage in securitization and other off-balance sheet transactions by raising the standard for receiving “true sale” treatment.²¹⁴ Most importantly, FAS 166 eliminated the concept of a QSPE.²¹⁵

²⁰⁴ See Parts V & VI, above.

²⁰⁵ US, *Transparency in Accounting*, *supra* note 201 at 5 (Lawrence Smith).

²⁰⁶ *Ibid.*

²⁰⁷ *Ibid* (discussing the problems with using a mathematical calculation to determine control of an SPE instead of a qualitative measurement that addresses the liquidity risk, reputation risk, and identifies firms that attempt to engineer around the math to avoid consolidation).

²⁰⁸ See *ibid.*

²⁰⁹ The Committee on Capital Markets Regulation, *The Global Financial Crisis: A Plan for Regulatory Reform* (May 2009), online: CCMR <[http://www.capmksreg.org/pdfs/TGFC-CCMR_Report_\(5-26-09\).pdf](http://www.capmksreg.org/pdfs/TGFC-CCMR_Report_(5-26-09).pdf)> at 189 [Committee on Capital Markets].

²¹⁰ See Susan Pulliam, “Banks Try to Stiff Arm New Rule: Delay Sought in Accounting Change, as Investor Groups Plot Own Response”, *Wall Street Journal* (4 June 2009), online: WSJ <<http://online.wsj.com/article/SB124407146605483021.html>>.

²¹¹ FASB, *Statement of FAS No 166*, *supra* note 17; FASB, *Statement of FAS No 167*, *supra* note 18.

²¹² Emmons, *supra* note 4 at 4-5 (explaining that FAS 166 and 167 will require firms to disclose off-balance sheet commitments that were not adequately reflected on firms’ financial statements during the crisis).

²¹³ See e.g. FASB, *Statement of FAS No 166*, *supra* note 17 at 65-66 (defining continuing involvement for disclosure purposes to include any right to receive cash flows or other benefits from transferred assets and any arrangements to provide financial support or recourse).

²¹⁴ See Financial Accounting Standards Board, News Release, “FASB Issues Statements 166 and

FAS 167 requires institutions to perform qualitative analysis to determine the beneficiaries of their SPEs for deciding consolidation treatment.²¹⁶ This analysis needs to consider whether an enterprise has a controlling financial interest and whether there is an implicit financial responsibility tied to the SPE.²¹⁷ The implicit responsibility mandate is likely a response to the implicit agreements between sponsors and investors, many of which resulted in sponsors bailing out their distressed SPEs. The treatment of VIEs still focuses on the control and residual income and liability aspects, but it applies this qualitative approach. Specifically, it looks at whether an “enterprise with a variable interest ha[s] the power to direct significant matters of the VIE and the right to receive significant benefits or the obligation to absorb significant losses” from the VIE’s activity.²¹⁸

These rules effectively address the two major problems with the accounting of off-balance sheet entities that surfaced during the Great Recession. The elimination of QSPEs closes the opportunity for firms to retain residual interests in their off-balance sheet entities without appropriately accounting for the risk. Additionally, firms can no longer obtain off-balance sheet treatment without engaging in a rigorous analysis. Second, the qualitative approach to determine the real beneficiaries of SPEs and the new requirement for sponsors to disclose all originated assets, liabilities and continuing interests will effectively deal with the implicit guarantees between sponsors and their SPE investors before the crisis. Indeed, FAS 166 and 167 forced commercial banks to consolidate approximately \$437 billion of loans and nearly all ABCP in their first year.²¹⁹

167 Pertaining to Securitizations and Special Purpose Entities” (12 June 2009) online: FASB <http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB/FASBContent_C/NewsPage&cid=1176156240834> [FASB, News Release] (explaining that FAS 166 and 167 will require more information about transfers of financial assets, specifically in securitization transactions and where companies have continuing exposure to the risks associated with transferred assets). See also Emmons, *supra* note 4 at 4 (explaining that the motivation behind the creation of FAS 166 and 167 was to recognize “sham” true sales and require greater disclosures through forcing firms to list all their assets and liabilities on their balance sheets, including previous off-balance sheet entities if they originated them or have any connection to them).

²¹⁵ FASB, News Release, *supra* note 214.

²¹⁶ See *ibid.*

²¹⁷ Committee on Capital Markets, *supra* note 209 at 187-88.

²¹⁸ *Ibid* at 188.

²¹⁹ US, Board of Governors of the Federal Reserve System, *Report to Congress on Risk Retention*

In addition to FASB's changes in the accounting rules, the *Dodd-Frank Act*²²⁰ has many implications for securitization and the ABCP markets. For large banks and other institutions deemed systemically important to the financial system by the Financial Stability Oversight Council,²²¹ section 165 prescribes prudential standards for risk management and capital requirements.²²² This section requires the inclusion of off-balance sheet activities in computing capital requirements.²²³ The definition of "off-balance sheet activities" under the *Dodd-Frank Act* "explicitly includes standby letters of credit, repos, interest rate swaps and credit swaps, among others."²²⁴ In conjunction with the new accounting standards, this resulted in the consolidation of most ABCP programs, effectively eliminating sponsors' abilities to avoid capital requirements through ABCP conduits and SIVs.²²⁵ These requirements aim to better align "risk based capital requirements with the actual risk of certain exposures."²²⁶

Further, the Basel Committee on Banking Supervision recently revised their capital rules with the introduction of Basel III. The new Basel III framework is consistent with the *Dodd-Frank Act* and aims to improve the quality and quantity of regulatory capital in an effort to help banks absorb losses during times of economic stress.²²⁷ Specifically, Basel III

(2010), online: Federal Reserve <<http://federalreserve.gov/boarddocs/rptcongress/securitization/riskretention.pdf>> at 68-69.

²²⁰ *Dodd-Frank Wall Street Reform and Consumer Protection Act*, 111th Cong., 2010, Pub L No 111-203, § 941(b), 124 Stat 1376 at 1889 (2010) [*Dodd-Frank Act*].

²²¹ See *ibid*, s 111 (creates the Financial Stability Oversight Council); *ibid*, s 112 (grants the Council broad rule-making authority; it also establishes the Council's purpose as a protector against economic instability and shielding taxpayers from liability for losses sustained at interconnected institutions).

²²² Adrian, *supra* note 176 ("[t]he prudential standards are to be established by the Board of Governors of the Federal Reserve, and have to include (i) risk-based capital requirements and leverage limits, (ii) liquidity requirements, (iii) overall risk management requirements, (iv) resolution plans and credit exposure report requirements, and (v) concentration limits," at 4).

²²³ *Ibid*.

²²⁴ *Ibid*.

²²⁵ *Ibid* at 5 (noting the requirement for sponsors to consolidate the loans or securities of its SPEs onto its balance sheet when providing a liquidity line, thereby creating greater capital reserves and increasing risk-retention).

²²⁶ *Ibid*.

²²⁷ See US, *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action (Draft)* (HR Rep No 111-517; S Rep No 111-176) online: Federal Reserve <http://www.federalreserve.gov/aboutthefed/boardmeetings/risk-based_leverage_capital_requirements_FR_final_draft_20120607.pdf> at 10-15.

increases the previous capital ratio from 4 to 6 percent and incorporates more off-balance sheet assets in calculating the leverage ratio.²²⁸

VIII. CONCLUSION

It is widely accepted that problems throughout the securitization pipeline contributed to the financial crisis.²²⁹ Off-balance sheet SPEs were the mechanism that allowed the expansion of securitization and the ABCP markets. And, behind the SPEs, were the accounting regulations that laid the groundwork for the abuse of SPEs. Thus, one contributing cause of the moral hazard problems and information asymmetries that flowed through the securitization pipeline and asset-backed commercial paper market stemmed from FASB's poor accounting regulations.

FASB's rules did not appropriately account for the potential abuses arising from the ease of creating QSPEs and obtaining off-balance sheet treatment. Additionally, FASB failed to correctly measure the risks to firms engaging in securitization by not accounting for implicit guarantees and Sponsors' retention of residual interests in their SPEs. Consequently, the off-balance sheet treatment of SPEs facilitated the poor origination models, packaging of risky receivables into highly rated tranches, credit rating agencies' race to the bottom, and banks circumventing capital requirements that persisted through the economy. Thus, SPEs contributed to this multi-faceted problem that resulted in corporations and investors losing trillions of dollars, along with their faith in the United States' financial markets.

The accounting for off-balance sheet transactions was not the only problem in the shadow-banking system.²³⁰ Additionally, FASB is not the only actor to blame for the abuse of SPEs.²³¹ However, if FASB enacted FAS 166 and FAS 167 several years before the Great Recession, it would have prevented a great deal of harm that resulted from the loopholes in

²²⁸ *Ibid* at 17-20.

²²⁹ FSOC, *Macroeconomic Effects*, *supra* note 166 (“[s]ecuritization is an important source of credit formation to the economy, but certain risks of securitization contributed to the financial crisis and macroeconomic instability” at 2).

²³⁰ See e.g. Lynn A. Stout, “Derivatives and the Legal Origin of the 2008 Credit Crisis” (2011) 1 *Harv Bus L Rev* 1 (2011) 1 (blaming the financial crisis on the *Commodities Futures Modernization Act of 2000* and the resulting widespread speculative trading of over-the-counter financial derivatives).

²³¹ See note 158 and accompanying text.

this poorly understood area of accounting for off-balance sheet transactions.

The future of SPEs and off-balance sheet treatment remains uncertain. However, the new accounting standards and rules under the Dodd-Frank Act create large barriers for sponsors to obtain off-balance sheet treatment. These new changes effectively address the problems that SPEs created during the Great Recession. Some have questioned these changes for eliminating the lending benefits of securitization.²³² However, to create better functioning markets, appropriate regulation of financial institutions and increased transparency is a necessary evil.²³³

The use of SPEs has expanded into the public forum, providing different potential disclosure issues and abusive situations.²³⁴ While the accounting has changed to better reflect the problems associated with SPEs leading up to the Great Recession, it appears new avenues may open for the misuse of these entities. Moving forward, regulators must attempt to foresee firms' next opportunistic move and take appropriate measures to prevent the potential negative externalities.

²³² See e.g. Wendy Milling, "Why FAS 166 and 167 Rules are Wrong" *Real Clear Markets* (18 October 2011), online: Real Clear Markets <http://www.realclearmarkets.com/articles/2011/10/18/why_fas_166_and_167_rules_are_wrong_99315.html>. See also FSOC, *Macroeconomic Effects*, *supra* note 166 at 30 (acknowledging that securitization provides an important source of credit formation, capital, and is a source for firms to manage their risks, but noting the inherent risks of misaligned incentives, and lack of transparency and disclosure in the securitization process).

²³³ See Robert H. Herz, "History Doesn't Repeat Itself, People Repeat History—Front-Line Thoughts and Observations on Creating a Sounder Financial System" (National Press Club Address, delivered 26 June 2009), online: FASB <<http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175819182530&blobheader=application%2Fpdf>> at 8-9.

In modern times, the proper operation of capitalism depends on the appropriate regulation of institutions, of financial products, and of market participants and on the existence of infrastructures that support transparency and the smooth functioning of markets. Far from constraining markets and capitalism, these are essential elements in its effective operation and in public trust in the system.

²³⁴ See Steven L. Schwarcz, "The Use and Abuse of Special-Purpose Entities in Public Finance" (2012) 97:2 *Minn L Rev* 369 (discussing potential transparency, monitoring, constitutional and democratic abuses that could result from the increased use of SPEs in public finance).