FIN 46: An Enigma Wrapped in a Puzzle

Summary
On Jan. 17, 2003, in an effort to clarify accounting policy for special purpose entities (SPEs), the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 46 (FIN 46). The purpose of this report is to outline the fundamentals of FIN 46 in response to frequently asked questions and to inform market participants about discussions currently circulating regarding how the market may change over the next year.

Objective of FIN 46
The objective of FIN 46 is to improve financial reporting and disclosure by companies involved with variable interest entities (VIEs). In the wake of Enron’s reported abuse of SPEs, FASB determined that the then-current accounting rules — applied to determine if one entity should consolidate another — were insufficient and too narrowly drawn. More specifically, prior to the release of FIN 46, a company was only required to include another entity in its financial statements if it controlled that entity by holding a majority of the voting interests. By using the binary threshold of majority voting interests as the sole barometer for consolidation requirements, the pre-FIN 46 rules did not contemplate the possibility that a company might effectively control another entity without having a majority voting interest in that entity.

To remedy this perceived shortfall, FIN 46 incorporates new measures of financial control and requires a VIE to be consolidated by an entity if that entity holds a majority of the risk of loss from that VIE’s activities or benefits from a majority of the VIE’s residual returns or both.

Therefore, the objective of FIN 46 is to enhance the current accounting guidance by requiring the consolidation of any entity that is controlled by financial, rather than voting, means. Furthermore, in the interest of expanding disclosure to users of an entity’s financial statements, FIN 46 requires that, in addition to disclosing VIEs that must be consolidated, a company also is required to disclose VIEs that it does not consolidate but in which it has a significant variable interest.

Entities Subject to FIN 46
To avoid a potentially contentious and protracted discussion regarding the definition of an SPE, FASB decided that, rather than define an SPE, it would be more prudent to cast a wide net around entities that would be subject to FIN 46. Therefore, FASB decided to eliminate the term SPE altogether for purposes of FIN 46 and instead introduced a broader term, VIE, which encompasses any entity subject to variability in losses and/or returns.

In addition, rather than further defining a VIE, FIN 46 only exempted certain types of entities from consideration. Most notably, FIN 46 does not apply to qualifying special purpose entities (QSPEs) as defined...
in FAS 140. Other exclusions include employee benefit plans, separate accounts, not-for-profit organizations, and enterprises subject to Securities and Exchange Commission (SEC) regulation S-X Rule 6-03(c)(1). More simply stated, traditional SPEs that are not QSPEs are within the scope of FIN 46.

However, it is important to note that only those entities that follow U.S. generally accepted accounting principles (GAAP) — required for public U.S. companies — are subject to FIN 46 and that non-GAAP accounting does not necessarily follow the framework of GAAP.

■ Understanding FIN 46 Document

Given the complexity of the objective of FIN 46, it is a difficult document to summarize. However, the key concepts are highlighted below.

Variable Interests

Variable interests are key to understanding FIN 46. As discussed, FIN 46 is designed to identify levers of financial control, and the primary measure of financial control is represented through variable interests. Variable interests are defined as interests that are contractual, ownership, or other pecuniary interests that are subject to and fluctuate with changes in an entity’s net asset value. These include equity investments, senior beneficial interests (listed, though unlikely to qualify), guarantees/puts, forward contracts, other derivatives, variable service contracts, and leases. All are explored further in Appendix B of the FIN 46 document.

Role of Variable Interests in Analysis

In the June 2002 exposure draft, FASB introduced the concept of a primary beneficiary. That concept is furthered in FIN 46 such that the primary beneficiary is the entity responsible for consolidation. Specifically, the holder of a majority of either the downside or upside of variable interests is considered to be the primary beneficiary; however, if a majority downside holder is identified, no further analysis is required. Therefore, FIN 46 first seeks to use variable interests as a measure of financial control and then to identify the majority holder of those interests (the primary beneficiary) as the entity that should consolidate a VIE.

As in the exposure draft, there can be only one primary beneficiary, and it remains possible to effectively disperse risks such that no primary beneficiary exists.

Role of Equity in Determining Consolidation Requirement

While it is possible to determine if there is sufficient equity at risk to avoid consolidation per FIN 46, the requirements are strict. Specifically, if either of the following is true, equity is deemed to be insufficient and all variable interest holders must assess their respective interests for consolidation:

- The overall equity at risk for the VIE is not greater than the expected losses of the entity (equity at risk is defined as equity that participates significantly in profits and losses, was not received in exchange for equity in another VIE, and was not provided to or financed for the investor by a parent/sponsor).
- Equity exists but the equityholders lack an equitable ability to make decisions related to the entity’s activities, the responsibility to absorb losses (without guarantee support) or realize gains, or an equity/voting interest that is pro rata to their equity investments (i.e. no one holder can have greater voting interests than another with the same equity contribution).

If equityholders do not have the potential for true upside and/or downside or lack the ability to make material decisions, equity is not considered to be substantive or sufficient and the variable interest test applies.

In further assessing the sufficiency of equity at risk, the document states that any amount of true external equity under 10% — setting a loose bar at 10% — will only be considered sufficient if, in addition to the aforementioned:

- The entity can financially support itself without any further investment.
- The equity level is comparable to others in the same business that operate without additional support.
- The amount of equity exceeds the amount of expected losses.

The document also states that an entity may require more than 10% equity based on the risk profile of the assets and activities of the VIE.

Silos

The exposure draft spoke more to silos than the final interpretation. The silo concept, as it appeared in the exposure draft, would simply have allowed each seller into a multiseller vehicle to consider its respective retained interest (overcollateralization) as a variable interest. If this were allowed, most programs would appear to have effectively dispersed risk, such that no variable interest holder has the majority of the risk, and consolidation would be unlikely.
Fitch Ratings

Structured Finance

During the FASB discussions on this topic and in FIN 46 as issued, silos, or the consideration of seller interest as a variable interest, were severely restricted. FIN 46 only permits the consideration of seller interest in the variable interest calculation if the seller contributes a majority of the assets held by the VIE under consideration or has another variable interest in the entity as a whole. In addition, paragraph 13 of the document makes a further provision that sellers may consider their interest as variable interest if the sellers’ assets are the only source of repayment for the associated liabilities issued against them. If these requirements are met and a program is structured to maintain its operational requirements, the silo concept may prove to be a viable means to maintain off balance sheet treatment. While the approach seems reasonable on the surface, the requirements imposed by FIN 46 are quite restrictive and may prove too constraining for day-to-day conduit operations.

FIN 46 Effective Date and Disclosures Requirements
Upon its release on Jan. 17, 2003, FIN 46 was put into effect immediately for all entities created after Jan. 31, 2003. For previously existing entities and related variable interest holders, the effective date is the first fiscal year or interim period beginning after June 15, 2003. For most U.S. companies, this will be June 30, 2003.

Assets are to be brought on balance sheet at their fair values with extraordinary losses recorded as such and extraordinary gains handled in the same manner as a business combination (i.e. with adjustments to the newly consolidated asset values). Disclosures by the consolidator are fairly standard and variable interest holders that do not have to consolidate are also required to make disclosures regarding their involvement with and potential exposure to VIEs.

Current and Potential Market Impact of FIN 46
Within structured finance, FIN 46 will likely have the greatest impact on some aspect of the collateralized debt obligation (CDO) or asset-backed commercial paper (ABCP) markets. More specifically, depending on how FIN 46 is applied, the interpretation may require that banks consolidate some portion of the CDOs they originate or ABCP conduits that they sponsor onto their balance sheets. While Fitch Ratings acknowledges that such consolidation would affect bank regulatory capital ratios, it would not likely be sufficient to impact the banks’ ratings.

Not surprisingly, a consolidation requirement would alter the economics of these businesses, prompting questions about the sponsoring banks’ interest in remaining active in these markets or businesses. Though some sponsors may elect to exit the industry, other bank sponsors will simply pass on the increased costs to their conduit customers. In fact, certain bank sponsors have already begun adding provisions into their purchase documents requiring higher fees in the event of a consolidation determination. By doing so, the bank sponsor can guaranty an acceptable level of return despite the fact that it will have to hold capital again the conduit portfolio. Other bank sponsors are pursuing restructuring solutions (see Structural Changes Under Consideration below) that would enable them to keep their conduit programs off their balance sheet.

While the ABCP market has demonstrated extraordinary growth over the past 10 years, it has retrenched recently from previous highs as market participants contemplate the true effect of FIN 46. Overall, Fitch believes that FIN 46 has adversely affected the ABCP market thus far and in the absence of structural changes (or regulatory relief) permitting the continuance of off balance sheet treatment for these vehicles, market participants have suggested that FIN 46 may cause the market to contract by as little as 10% or as much as 40%. In the event that accounting firms become comfortable with structural changes and permit off balance sheet treatment, Fitch expects the market to temporarily spike from pent-up demand but to eventually continue growing at a more even pace, as in the recent past.

Structural Changes Under Consideration
As FIN 46 continues to be analyzed, three significant structural changes are being considered.

Selling Equity in the Event of Expected Losses: One option is to sell a large enough piece of equity such that the equity investment at risk is greater than the expected losses of the entity. This solution is currently the most widely discussed remedy to FIN 46. If it can be implemented and auditors are comfortable with the sponsors’ methodology for sizing this equity piece — per FIN 46, the equity piece must be greater than expected losses — off balance sheet treatment may be maintained.

FASB has provided its definition for expected loss and outlines an approach to derive expected losses in Appendix A of FIN 46. However, the example used in Appendix A is overly simplistic and does not provide sufficient guidance for the complexities of ABCP programs. In addition, the FASB expected loss term is a misnomer relative to the more commonly used...
definition of expected losses, as FASB contemplates the variability of expected cash flows (positive and negative) rather than simply true asset-based losses.

Ultimately, if a model can be developed and validated for calculating FASB’s definition of expected losses and VIEs are able to sell equity in excess of expected losses to one or more third-party investors, consolidation may be avoided. However, in addition to selling the equity, program sponsors would also have to bequeath to the holder(s) of that equity piece proportional voting rights over the activities of the VIE and be required to release any residual returns that may be realized.

Programs that restructure in this manner may be excused from FIN 46 as they would qualify as traditional voting interest entities. Recently, market participants have suggested that the appropriate amount of equity per FIN 46 would be between three and 30 basis points.

Create Silos for Each Seller into a Conduit: The silo option is being explored in two ways. First, sponsors are considering establishing new programs dedicated to each seller, such that each seller would consolidate its assets onto its own balance sheet. Under this structure, the sponsor becomes an operational service provider and the seller maintains diversified funding while forfeiting off balance sheet treatment.

Second, if it is operationally possible and efficient for a sponsor to pair the issuance of liabilities against specific pools of assets (i.e. issue CP versus one seller’s assets), the seller’s interest will be considered a variable interest in those assets and the seller will consolidate its assets back to its balance sheet. The attractive feature of the silo approach is that, while the seller would be required to consolidate its assets onto its balance sheet, it would continue to have access to relatively low cost funding.

Form a Joint Venture: Under FIN 46, if a company is involved with a variable interest entity (in this case, if a bank sponsors an ABCP conduit), such VIE must be consolidated by the company if that company is subject to a majority of the risk of loss from that VIE’s activities or benefits from a majority of the VIE’s residual returns or both. In the case of bank-sponsored multiseller conduits where the sponsoring bank is providing both programwide credit and liquidity support, the bank could be viewed as having the majority risk of loss and, as such, must consolidate the conduit assets onto its balance sheet.

Certain market participants have discussed the possibility of a joint venture structure, whereby two or more sponsors contribute assets/pools to a newly formed conduit platform and multiple entities provide credit and liquidity support. Under this structure, the risk of loss is effectively dispersed among the parties involved and no single entity is forced to consolidate the conduit assets.

While a joint venture structure is initially appealing, the solution has several obvious limitations. From a competitive perspective, sponsors will likely be reluctant to reveal information on their customers, pricing, and general business strategy. Moreover, agreeing on a common set of credit and structuring guidelines could prove daunting. Though not insurmountable, the issue of conduit administration must also be addressed. It must be decided whether or not one or all of the sponsoring institution(s) should participate in the new conduit administration or a third party be selected as conduit administrator. Getting several competing entities to agree on a common approach with regard to all aspects of a single conduit enterprise poses tremendous business challenges.

Market Outlook for FIN 46
The impact of FIN 46 may be mitigated by regulatory relief expected to be finalized over the next few weeks. Reportedly (not yet issued), federal regulators plan to grant temporary relief to sponsoring entities and not require Tier 1 or 2 capital to be held against conduit assets that are consolidated per FIN 46. This temporary relief is expected to be effective through the first quarter of 2004, with a final solution to be implemented by that time. While this relief would restore some of the economics of the conduit business, regulators have indicated that they will not exclude consolidated assets for purposes of the leverage capital calculation; therefore, conduits will experience some increase in the cost of these programs, although it will not be as severe as originally proposed.

Credit Implications: Although Fitch has not yet received many restructuring proposals, the credit impact of FIN 46 on conduits will likely be minimal, if any. Hence, any structural change that might be effected by a conduit sponsor will be undertaken solely to address accounting requirements and have nothing to do with credit. While various restructuring options are under consideration (see Structural Changes Under Consideration, page 3), Fitch does not expect any of the proposed changes to materially affect the credit quality of ABCP conduits.