Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Regulatory Capital; Impact of Modifications to Generally Accepted Accounting Principles; Consolidation of Asset-Backed Commercial Paper Programs; and Other Related Issues

COMMENT

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In our view, the proposed capital standards do not appear to fully reflect the 2009 GAAP modifications and are inconsistent with the objectives of the present Risk-Based Capital Guidelines by not acknowledging the provisions of FAS 167 which provide for the separate classification of those consolidated assets and liabilities that do not increase risks to the consolidating banking institution. The full provisions of FAS 167 should be explicitly acknowledged and applied to the determination of capital ratios.

The importance of a risk-based approach to capital requirements has been most recently emphasized by the Department of the Treasury in its enunciation of "Principles for Reforming the U.S. and International Regulatory Capital Framework for Banking Firms" (September 3, 2009) particularly Core Principle #4: "Risk-based capital requirements should be a function of the relative risk of a banking firm's exposures, and risk-based capital ratios should better reflect a banking firm's current financial condition" emphasizing that "…it is crucial that relative risk weight be appropriately calibrated" (p.5). In the proposed standards the banking agencies state the belief "…that the broader accounting consolidation requirements implemented by the 2009 GAAP modifications will result in a regulatory capital treatment that more appropriately reflects the risks to which banking organizations are exposed" (p.13) and further state that "…the capital treatment of many exposures that would be consolidated under the new accounting standards aligns with risk-based capital principles and results in more appropriate risk-based capital charges" (p.14). Consistent with these statements, the banking agencies have requested specific

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comment with regard to the nature of the risks posed by the putatively consolidated entities in Questions 2 and 6, among others.

Notwithstanding the agencies' intent to align the new accounting standards with risk-based capital principles, the proposed standards omit reference to the provisions of FAS 167 (particularly paragraphs 22A and 23A, and A80, and A81) which provide for separate classification of assets and liabilities reflecting the inherent risklessness to the consolidating institution posed by those separately classified assets and liabilities. By not acknowledging that separately classified assets and liabilities should either be excluded from capital ratios or given a zero risk weight, the proposed standards do not provide for alignment taking into account the inherent risklessness to the consolidating institution of separately classified assets and liabilities.

Paragraph 22A of FAS 167 addressing separate classification under the title of "**Presentation**" states the following:

> A reporting enterprise shall present separately on the face of the statement of financial position (a) assets of a consolidated variable interest entity that can be used only to settle obligations of the consolidated variable interest entity and (b) liabilities of a consolidated variable interest entity for which creditors (or beneficial interest holders) do not have recourse to the general credit of the primary beneficiary.

FAS 167 further requires that the primary beneficiary make disclosures about such separately presented assets and liabilities that clarify the nature of the restrictions placed on the assets and the absence of recourse to the credit of the primary beneficiary. In particular, paragraph 23A of FAS 167 requires the primary beneficiary to disclose:

a. The carrying amounts and classification of the variable interest entity's assets and liabilities in the statement of financial position that are consolidated in accordance with this Interpretation, including qualitative information about the relationship(s) between those assets and liabilities. ***For example, if the variable interest entity's assets can be used only to settle obligations of the variable interest entity, the enterprise shall disclose qualitative information about the nature of the restrictions on those assets.***

b. ***Lack of recourse if creditors (or beneficial interest holders) of a consolidated variable interest entity have no recourse to the general credit of the primary beneficiary***. (Emphasis added).

The separate classification of (a) assets that can be used only to settle obligations of the consolidated variable interest entity and (b) liabilities of a consolidated variable interest entity for which creditors do not have recourse to the credit of the primary beneficiary, necessarily recognizes that the primary beneficiary has neither the right to cash generated by these (separately classified) assets nor the responsibility to settle the (separately classified) liabilities. Since the rights and obligations underlying the separately classified assets and liabilities are not legally enforceable by or against the consolidating institution, they do not satisfy the definition of accounting assets and liabilities under the FASB Statement of Financial Accounting Concepts, Elements of Financial Statements (FASB, December, 1985) ("FASB Statement of Accounting Concepts"). See Comment on Exposure Draft, Amendments to FASB Interpretation No. 46(R) by Joshua Ronen and Kenneth Sagat, October 6, 2008, ("Ronen-Sagat FASB Comment") attached as Appendix.

The theory embraced by FAS 167 under which the assets and liabilities of the variable interest entity are consolidated into the financial statements of the primary beneficiary is premised on control over the variable interest entity being consolidated, rather than control over the individual assets or the obligation to settle individual liabilities. Indeed, the criterion for consolidation -- anchored in ARB 51 -- is whether the primary beneficiary has a "controlling financial interest" in the variable interest entity ("VIE"). Accordingly, under paragraph 14 A of FAS 167, the essential characteristics for consolidation involve "the power to direct the activities of a variable interest ***entity*** that most significantly impact the ***entity's*** economic performance," and "the obligation to absorb the losses of the ***entity*** . . . or the right to receive benefits from the entity that could potentially be significant to the variable interest ***entity.***" (emphasis added)

The unmistakable emphasis of the FASB on an entity-conceptual approach as a basis for consolidation inevitably results in the co-mingling of "non-assets" and "non-liabilities" with the otherwise proper assets and liabilities of the primary beneficiary. See Ronen-Sagat FASB Comment. Hence, the separate classification provisions of paragraphs 22A and 23A of FAS 167 rectify the obfuscation of assets and liabilities caused by co-mingling so as to make the financial statements more transparent and permit the accurate measurement of the capital of financial institutions, particularly with respect to separately classified “off balance sheet” assets and liabilities which are not conceptually assets and liabilities of the consolidating financial institution under the FASB Statement of Accounting Concepts.

The assets that are classified as restricted to the settlement of obligations of the consolidated entity are not accounting assets of the consolidating institution under the definition of assets in the FASB Statement of Accounting Concepts, nor are the liabilities classified separately as associated with no recourse to the consolidating institution accounting liabilities of the consolidating institution under the definition of liabilities. See Ronen-Sagat FASB Comment. Inherently, these "non--assets" and "non-liabilities" are qualitatively different from assets and liabilities of the consolidating institution recognized and defined under the FASB Statement of Accounting Concepts.

A concern that reputational risk may result in some circumstances in assuming off balance sheet exposures does not detract from the inherent risklessness to the consolidating institution of separately classified assets and liabilities. An assumption of non-contractual (and legally unenforceable) exposure as a result of solely reputational risk is in many instances nothing more than a mere possibility.[1] A mere possibility of an assumption of exposure without evidence showing that it is probable does not change the inherent risklessness to the consolidating institution of separately classified assets and liabilities.[2]

[1] It is by no means clear that smaller banks would have the same reputational concerns as banks participating in SCAP.

[2] Presumably, the examinations conducted by the agencies would reveal any evidence of changed circumstances showing that an assumption of off balance sheet exposures is probable. In that event, the capital ratios may be adjusted accordingly.

There is precedent for excluding certain assets that are consolidated from a bank's risk-weighted assets. Section 1 (c) (1) of 12 C.F.R. Part 3 states: "[E]ven though the assets of the non-financial company are consolidated for accounting purposes, these assets (as well as the credit equivalent amounts of the company's off-balance sheet items) are excluded from the bank's risk-weighted assets." The FASB has required separate presentation of assets and liabilities falling under paragraphs 22A and 23A precisely because the former do not contribute to future cash inflows to the consolidating institution and the latter do not require future cash outflows from the consolidating institution even though those assets and liabilities are consolidated for financial statement presentation purposes. Likewise, it is more consonant with risk-based capital objectives for risk-based capital ratios to reflect the inherent risklessness to the consolidating institution associated with separately classified assets and liabilities.

Recognition that separately presented assets and liabilities under FAS 167 are inherently riskless to the consolidating institution will enable continued use of securitizations as an important part of the financial system.[3] While risk-based asset weights do not affect the calculation of leverage ratios, separately classified assets and liabilities should likewise be excluded from leverage ratios to rectify the consolidation of what essentially are “non-assets” and “non-liabilities” of the consolidating institution. This exclusion will give full recognition to the separate classification provisions of FAS 167.

[3] We cannot envision the impact of the proposed standards upon securitizations and related economic activity as less than significant, if not draconian.