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THE STATISTICAL TREATMENT OF SECURITISATION VEHICLES

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THE STATISTICAL TREATMENT OF SECURITISATION VEHICLES

The attached paper formed part of the Bank of England's response to the UN request for comments on the draft Chapter 4 of SNA Rev1. The paper reflects the Bank's concern that the current proposed treatment of Special Purpose Entities (SPEs) established for the securitisation of assets, as separate institutional units within the System may not be appropriate in all circumstances because the economic reality of their operation can differ materially from their legal form. The Bank argues that the treatment adopted can carry important implications for the presentation and interpretation of the Monetary Statistics.

The Working Party are invited to: Review the arguments set out in the Bank's paper;

- Comment on how the issues described relate to securitisation activity in their own economies; and
- Consider whether tests for the institutional status of securitisation SPEs are needed and, if so, whether those proposed in the paper could form a practical way forward.

BANK OF ENGLAND COMMENTS ON SNA REV1, REVISED CHAPTER 4

Overview

1. The Bank of England's Monetary and Financial Statistics Division offers the following comments and suggestions on the proposed replacement Chapter 4 of the SNA Rev1, 'Institutional units and sectors'.[1] These relate to the proposed treatment of those special purpose entities (SPEs) used by banks for the securitisation of balance sheet assets. Specifically, the Bank questions the universal designation of such entities as separate institutional units (4.48-4.51), arguing that many of these constructs lack both the autonomy of action and the degree of risk separation implied by this status. The legal and operational form of securitisation vehicles can vary considerably both within and between jurisdictions. Within the United Kingdom, an alternative designation as Artificial Subsidiaries to be recorded as an integral part of the parent corporation (4.52-4.54) often appears more appropriate, not least because the securitised assets now commonly fail the IFRS tests for derecognition from the balance sheet of the originating institutional unit. This paper proposes a new condition for such alternative designation of SPEs which draws upon business accounting standards on derecognition of assets and consolidation of subsidiaries.

2. The designation of these subsidiaries is of particular analytical interest due to the consequences for the calculation of the monetary aggregates. For the present, the provisional nature of these comments is emphasised: the Bank of England believes that further debate on definitional issues relating to monetary aggregates, particularly in relation to how these may be affected by continuing rapid innovation in financial markets, is warranted and would be welcomed by users and by other monetary statistical authorities. Pending a widely agreed treatment, it is hoped that the SNA Rev1 text can be drafted in a way which can readily accommodate the diversity of structures used for this type of operation.

Treatment of SPEs as institutional units, and consequences for monetary aggregates

3. The way in which the SNA definition of institutional units applies to special purpose entities (SPEs) used for securitisation purposes by banks, has important implications for the definitions of money and credit. This is of particular relevance for the UK, but may also be an issue in many other economies.

4. If an SPE owned or controlled by a bank is deemed *not to be* an institutional unit, then its accounts are consolidated with those of its parent, and the balance sheet of the SPE will form part of the depository corporations sector ('monetary financial institutions' in ESA terminology), that is, the money-issuing sector. Conversely, if the SPE is treated as an institutional unit, but is not itself a bank, then it will be classified to the other financial corporations sector and its balance sheet will form part of the money-holding sector.

UK experience

5. As noted, a variety of legal and operational structures can be observed within and between different countries for the securitisation of assets. The stylised example assumed in these comments relates to one particular form which is prevalent in the United Kingdom. An originating bank establishes a special purpose entity to acquire a pool of its own mortgage loans, or other assets, which the SPE finances by selling into the market various tranches of debt securities secured on the asset pool. The originating bank

[1] This paper has been seen by colleagues at the UK Office for National Statistics and incorporates their comments.

would retain a residual financial interest in the SPE, sometimes termed an equity or first loss tranche, and might typically satisfy business accounting tests for control of the SPE, that is, as the parent corporation.

6. With the growth of securitisation, these alternative classifications now matter enormously in quantitative terms: for example, at end-2006, aggregate credit on the UK M4 lending definition (under which SPEs are treated as institutional units) stood at £1,871bn, whereas the estimate of credit excluding the effects of securitisations of loans was £2,058bn. Moreover, the very large size of individual securitisation deals now typically conducted by UK reporting institutions, sometimes up to several £ billion at a time, now introduces considerable short term volatility into the M4 lending flows.

Current standards

7. The 1993 SNA does not contain specific guidance on the treatment of securitisation activities, although subsequent related standards such as the IMF Monetary and Financial Statistics Manual (MFSM 2000)[2], and the European System of Accounts (ESA 1995)[3] do guide that securitisation SPEs should be classified as 'other financial intermediaries'. Logically, the prior question is whether SPEs should qualify or not as institutional units.

8. The criteria for separate institutional status in the 1993 SNA require that an institutional unit should be:

> *An economic entity that is capable, in its own right, of owning assets, incurring liabilities and engaging in economic activities and in transactions with other entities.*[4]

In ESA 1995 there are similar criteria plus an emphasis on a concept of autonomy.

9. The 1993 SNA provides guidance on 'ancillary corporations', and also on trusts excluding pension fund trusts, both of which categories are treated as not being institutional units. It can be argued that securitisation SPEs share some characteristics of each of these. Like ancillary corporations, SPEs can be wholly owned subsidiaries of, or under the control of, their parent corporations. In the context of International Financial Reporting Standards (IFRS), where these apply, criteria have been developed to determine when SPEs are controlled by parent entities; these are discussed below. SPEs are also like trusts, in that their principal purpose is to give effect to arrangements on the management of financial assets and liabilities for particular beneficiaries, but they engage in little or no economic production in their own right. An implication of 1993 SNA might therefore be the principle that an entity, such as an SPE, which engages in little or no economic production on its own account should not qualify as an institutional unit.

10. The draft IMF Compilation Guide for Monetary and Financial Statistics (MFS CG)[5] goes further than the 1993 SNA, or MFSM 2000, in addressing the institutional status of SPEs. It states:

> *SPE can be separate corporations, but they are often organized as trusts, or as vehicles that are created solely to hold a specific portfolio of assets or liabilities. […] When deciding to classify a SPE within the other financial intermediaries subsector, or within*

2 MFSM 2000, para 100.

3 ESA, para 2.55

4 1993 SNA, para 4.2

5 'Monetary and Financial Statistics: Compilation Guide', Pre-publication version, August 2007, at: http://www.imf.org/external/pubs/ft/cgmfs/eng/index.htm

> *the subsector to which the parent unit belongs, it is essential to establish whether the SPE sells a new financial asset and bears risks, or whether it is simply a trust that passively holds assets.*[6]

And:

> *Special purpose entities are classified within the other financial intermediaries subsector when they actively manage their portfolio of assets, place themselves at financial risk, and have a full set of accounts. Very often, however, SPEs are created simply for accounting purposes, in order to take off-balance sheet some operations of the parent corporation. These SPEs are created with legal arrangements that heavily restrict the decision capacity of their governing board (autopilot arrangements), and all the risks and profits of their operations are transferred to the parent corporation.*[7]

This latter case broadly describes the status of securitisation vehicles prevalent in the United Kingdom. The economic reality is that all aspects of administration of loans, debt servicing, financial management activities are carried out by the parent bank, and that it is the parent bank which is exposed to the first tranche of risk and to the residual rewards of the SPE. While the financial position of the SPE remains within the first loss tranche or better, the interests of the SPE are fully aligned with that of the parent bank.

11. The situation for other models of securitisation activities may differ. For example, where an originating bank has disposed of its entire economic interest in a portfolio of assets, either in a single sale, or through a sequence of transactions concluding with the disposal of the equity (or 'first loss') tranche in a securitisation SPE, an appropriate treatment could be that the assets have moved to a distinct, separate entity.

Accounting Standards

12. Business accounting standards may require under certain conditions that assets sold by a parent bank to an SPE for securitisation purposes should be retained on the balance sheet of the parent bank. In the case of International Financial Reporting Standards (IFRS), where these apply, IAS 39 on 'Financial Instruments: Recognition and Measurement', specifies a sequence of criteria which are assessments of: whether the financial assets have been transferred to the SPE; whether substantively all of the risks and rewards of the financial assets have been transferred; and whether control of the assets has been retained by the parent bank.[8] Depending on these criteria, all or a part of financial assets that have been legally transferred to the SPE may be required to be retained on the balance sheet of the parent bank, with the recognition of a corresponding financial liability to the SPE. In this situation, the boundary of the balance sheet in business accounting terms will not coincide with that of the institutional unit, if this definition remains tied to its legal form. This, it might be argued, would undermine the consistency of the national accounts- same assets reported on more than one balance sheet, or would undermine the economic meaningfulness of the SPE's accounts if they are removed from it.

13. The criteria for consolidation of special purpose entities under IFRS may also be relevant for the System's treatment of SPEs as institutional units. The IASB's Interpretation SIC-12[9] gives a number of

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6 MFS CG Para 3.112

7 MFS CG Para 3.156

8 IAS 39 'Financial Instruments: Recognition and Measurement', paras 18 to 20; in IFRS 2006, pp1722-1723, publ. IASB.

9 SIC Interpretation 12 'Consolidation – Special Purpose Entities'; in IFRS 2006, p2229-2234, publ. IASB.

examples of situations in which a relationship of control of an entity, for example a parent corporation, over an SPE might be said to hold, meaning that the SPE should be consolidated with the entity. These might be paraphrased as follows[10]:

> *(a) that the activities of the SPE are carried out to meet the specific business needs of the entity;*
>
> *(b) the entity enjoys decision-making powers to obtain the majority of the benefits of the activities of the SPE, or has delegated these powers through an 'autopilot' mechanism;*
>
> *(c) the entity has rights to obtain the majority of the benefits of the SPE and may be exposed to the risks of the SPE;*
>
> *(d) the entity retains the majority of the residual or ownership risks related to the SPE.*

14. The draft IMF Compilation Guide again goes further than earlier statistical standards in recognising the potential role of financial reporting standards when guiding on the institutional status of SPEs within the System:

> *The new international financial accounting standards recommend that the consolidated statements of the parent corporation include the statements of all SPEs in which the corporation has a controlling financial interest. This approach takes into account the economic substance of the relationship parent corporation/SPE, rather than merely their legal form, considering the SPE not as an independent unit, but solely as an ancillary of the parent corporation. Consistent with this approach, this Guide recommends that the accounts held by such SPEs at financial corporations be reported as belonging to the economic sector of their parent corporations, rather than as accounts of OFCs.*[11]

The SNA Rev1 draft text

15. The draft revised text for Chapter 4 retains the 1993 SNA definition of an institutional unit:

> *An institutional unit is an economic entity that is capable, in its own right, of owning assets, incurring liabilities and engaging in economic activities and in transactions with other entities. (Rev 1, 4.2)*

16. The revised chapter also retains the general approach that in the case of groups of corporations, it is the individual companies and subsidiaries, and not the 'group', that are to be treated as institutional units:

> *Although the management of a subsidiary corporation may be subject to the control of another corporation, it remains responsible and accountable for the conduct of its own production activities. (Rev 1, 4.44)*

17. Both extracts demonstrate the relevance of production and of autonomy of action as characteristics of institutional units.

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10 From IASB SIC-12, para 10.

11 MFS CG Para 3.157

18. The draft text also retains the 'balance sheet' attribute of an institutional unit from the 1993 SNA:

> *Either a complete set of accounts, including a balance sheet of assets and liabilities, exists for the unit, or it would be possible and meaningful, from both an economic and legal viewpoint, to compile a complete set of accounts if they were to be required. (Rev 1, 4.2(d))*

19. Paragraphs 4.48 to 4.51 discuss the special case of 'institutional units with no employees and little production activity', while paragraphs 4.52 to 4.54 discuss 'artificial subsidiaries'. These categories are distinguished from each other. Entities covered by the first case are to be regarded as institutional units, whereas the entities in the second case, artificial subsidiaries, are not.

20. Included under 'institutional units with no employees and little production activity', are special purpose entities created for issuing debt securities, or securitisation vehicles, although it is noted that no standard definition of such SPEs exists. Included under 'artificial subsidiaries', however, are wholly owned subsidiaries which are created:

> *[...] to provide services to the parent corporation or other corporations in the same group in order to avoid taxes, to minimise liabilities in the event of bankruptcy, or to secure other technical advantages under the tax or corporate legislation in force in a particular country. (Rev1, 4.52)*

21. There are a number of issues:

- The criterion of 'engaging in economic activities' in the definition of institutional units would seem to be contradicted by the inclusion, as special cases, of institutional units with no employees and little production activity.

- The business accounting treatment of SPE assets, if they are retained on the balance sheet of a parent corporation, would conflict with the attribute of an institutional unit that it should have an economically meaningful set of accounts, and would undermine sectoral balance sheets in the System.

- The distinction drawn in paragraph 4.51 between SPEs created for securitisation purposes, and examples of artificial subsidiaries created for minimising bankruptcy liabilities, is not at all clear and, in many instances, may well be spurious.

Recommendations

22. The Bank of England considers that the current designation of SPEs, established for the securitisation of assets, as separate institutional units within the System may be inappropriate in many situations. It accordingly proposes that:

- the role, process and implications of asset securitisation be added to the longer term research agenda of the international statistical community; and

- in the mean time, paragraphs 4.48-4.54 of SNA Rev1 be modified to permit national compilers to designate entities such as SPEs established as securitisation vehicle companies either as separate institutional units or as an integral part of their parent company as appropriate for the specific nature of securitisation operations within their jurisdiction.

23. The Bank of England would welcome specific discussion of the nature and treatment of securitisation vehicles within the SNA Rev1 text and, to this end, a suggested alternative text is offered at Appendix 1 below. This text proposes that an entity such as a resident SPE with little or no production activity should *not be* an institutional unit when business accounting standards require reporting of its assets on the balance sheet of the parent and it meets the criteria for consolidation with parent. To facilitate comparison, the current text of paragraphs 4.48-54 is reproduced at Appendix 2.

APPENDIX 1: Alternative proposals for Paragraphs 4.48-4.54

Entities with no employees and little production activity

4.48 A holding company that simply owns the assets of subsidiaries is one example of an entity that is not primarily established to carry out production. Other examples include investment funds and pension funds and structures known variously as special purpose entities (SPEs) or special purpose vehicles. There is no common definition of an SPE but some purposes that such structures are used for are holding and managing wealth for individuals or families, holding assets for securitization, issuing debt securities on behalf of related companies (such a company may be called a conduit), securitization vehicles and to carry out other financial functions.

4.49 Such entities typically have no employees and no non-financial assets. They may have little physical presence beyond a "brass plate" confirming their place of registration. They are always related to another corporation, often as a subsidiary, and SPEs in particular are often resident in a territory other than the territory of residence of their related corporations.

4.50 Entities of this type are commonly managed by employees of another corporation which may or may not be a related one. The SPE may pay fees for services rendered to it and in turn may charge its parent or other related corporation fees to cover these costs. This may be the only production that such entities are involved in though they will often incur liabilities on behalf of their owners and will usually receive investment income and holding gains on the assets they hold.

4.51 Many entities falling within this description may be regarded as separate institutional units, even though they have no employees and little production activity, because they have autonomy of action or they exercise some substantive control over their assets and liabilities. Such units should be classified in the Financial Corporations sector. But there are also other entities in this grouping which do not adequately satisfy the SNA definition of an institutional unit, perhaps because they lack autonomy of decision making or because they do not bear the full unfettered rights and obligations associated with the assets held in their name. For such entities it may be appropriate to treat them as artificial subsidiaries and to integrate their operations with those of their parent corporation (see below).

Artificial subsidiaries

4.52 A subsidiary corporation, wholly owned by a parent corporation, may be created to provide services to the parent, or other corporations in the same group, in order to avoid taxes, to minimize liabilities in the event of bankruptcy, or to secure other technical advantages under the tax or corporation legislation in force in a particular country. For example, the parent may create a subsidiary to which ownership of its land, buildings or equipment is transferred and whose sole function is to lease them back again to the parent corporation; the subsidiary may be the nominal employer of all the staff who are then contracted to other corporations in the group, or the subsidiary may keep the accounts and records of the parent one a separate computer installation; and so on. Or the role of the subsidiary may be to ring-fence risk for favourable funding or regulatory treatments. In other cases, corporations may create "dormant" subsidiaries that are not actually engaged in any production but which may be activated at the convenience of the parent corporation.

4.53 Such entities do not normally satisfy the criteria for treatment as separate institutional units in the System because they lack the ability to act independently from their parent corporation and may be subject to restrictions on their ability to hold or transact assets held on their balance sheets. This approach would include the case of SPEs created to perform securitisation activities, where these have little or no production activity, and under national business accounting rules the conditions for the financial assets of the SPE to be retained on the balance sheet of the parent corporation, and for consolidation of the SPE with the parent, are satisfied. These sorts of entities are not treated as separate institutional units in the System but should be treated as an integral part of the parent and their accounts consolidated with those of the parent.

4.54 Artificial subsidiaries are to be distinguished from units conducting ancillary activities as described in chapter 5.

4.55 When an artificial subsidiary is established in an economic territory other than the country of the parent company it should be considered as a resident of the host economy, even if it has little or no physical presence there and would not otherwise have satisfied the tests for treatment as a separate institutional unit. In these cases, they should be treated as separate Financial Corporations in the host economy.

APPENDIX 2: Current Draft of SNA Rev 1, Paragraphs 4.48-4.54

Institutional units with no employees and little production activity

4.48 A holding company that simply owns the assets of subsidiaries is one example of a unit that is not primarily established to carry out production. Other examples include investment funds and pension funds and units known variously as special purpose entities (SPEs) or special purpose vehicles. There is no common definition of an SPE but some purposes that such structures are used for are holding and managing wealth for individuals or families, holding assets for securitization, issuing debt securities on behalf of related companies (such a company may be called a conduit), securitization vehicles and to carry out other financial functions.

4.49 These units typically have no employees and no non-financial assets. They may have little physical presence beyond a "brass plate" confirming their place of registration. They are always related to another corporation, often as a subsidiary, and SPEs in particular are often resident in a territory other than the territory of residence of the related corporations.

4.50 The units are managed by employees of another corporation which may or may not be a related one. The unit pays fees for services rendered to it and in turn charges its parent or other related corporation a fee to cover these costs. This is the only production the unit is involved in though it will often incur liabilities on behalf of its owner and will usually receive investment income and holding gains on the assets held.

4.51 These units are distinct from the artificial units discussed below and are treated as institutional units, all of which are classified in the financial corporations sector.

Artificial subsidiaries

4.52 A subsidiary corporation, wholly owned by a parent corporation, may be created to provide services to the parent corporation, or other corporations in the same group, in order to avoid taxes, to minimize liabilities in the event of bankruptcy, or to secure other technical advantages under the tax or corporation legislation in force in a particular country. For example, the parent may create a subsidiary to which ownership of its land, buildings or equipment is transferred and whose sole function is to lease them back again to the parent corporation; the subsidiary may be the nominal employer of all the staff who are then contracted to other corporations in the group, or the subsidiary may keep the accounts and records of the parent on a separate computer installation; and so on. In some cases, corporations may create "dormant" subsidiaries that are not actually engaged in any production but which may be activated at the convenience of the parent corporation.

4.53 These sorts of corporations are not treated as separate institutional units in the System but should be treated as an integral part of the parent and their accounts consolidated with those of the parent.

4.54 Artificial subsidiaries are to be distinguished from units conducting ancillary activities as described in chapter 5.