

SPEs as Off-Balance Sheet Vehicles



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Session Objectives

What is an Off Balance Sheet (OBS) Item?

- An item or activity is an off-balance-sheet asset if, when a contingent event occurs, the item or activity moves onto the asset side of the balance sheet.
- An item or activity is an OBS liability if, when the contingent event occurs, the item or activity moves onto the liability side of the balance sheet

Off-Balance-Sheet Items

- Less obvious and often **invisible** to all but the best-informed investor or regulator
- Usually appear "**below the bottom line**," frequently just as footnotes to financial statements.
- In economic terms, are contingent assets and liabilities that affect the **future**, rather than the current, shape of an FI's balance sheet.
- Have a direct impact on the FI's **future** profitability and performance.

Off Balance Sheet Risks

- FIs sell various performance **guarantees**, especially guarantees that their customers will not default on their financial and other obligations.
- Examples of such guarantees include **letters of credit**. Should a customer default occur, the FI's contingent liability (its guaranty) becomes an actual liability and it moves onto the liability side of the balance sheet.
- Indeed, FI managers and regulators are just beginning to recognize and measure the **risk** of OBS activities and their impact on the FI's **value**.
- While some part of OBS risk is related to interest rate risk, credit risk, and other risks, these items also introduce **unique risks** that must be managed by FIs.
- Since off-balance-sheet items are contingent assets and liabilities and move on the balance sheet with a probability less than 1, their **valuation** is difficult and often highly **complex**.

Benefits

- By moving activities off the balance sheet, banks hope to earn more fee income
- Avoid regulatory costs or taxes, since reserve requirements, deposit insurance premiums, and capital adequacy requirements are not levied on off-balance- sheet activities.

Types of OBS activities

The major types of OBS activities for banks are:

- Loan commitments.
- Letters of credit.
- Futures, forward contracts, swaps, and options.
- When-issued securities.
- Loans sold.

Catalysts for Off Balance Sheet Activity

- Deregulation
- Technological progress
- Diminishing margins on on-balance- sheet business
- Escape/fleeing capital requirements
- Innovation

Challenges

- Management
- Regulators-Micro/Macro-prudential issues
- Traders and market experts
- Accountants

What is a SPV/SPE?

- A Special Purpose Vehicle (SPV) sometimes referred to as a Special Purpose Entity (SPE) is an off-balance sheet vehicle (OBSV) comprised of a **legal entity** created by the **sponsor** or originator, typically a major investment bank or insurance company, to fulfill a **temporary** objective of the sponsoring firm.
- SPVs can be viewed as a method of disaggregating the risks of an underlying pool of exposures held by the sponsor and reallocating them to investors willing to take on those risks.
- This allows investors access to investment opportunities which would not otherwise exist, and provides a new source of revenue generation for the sponsoring firm.

Common Uses of SPVs

- **Securitisation** – SPVs are the key characteristic of a securitisation and are commonly used to securitize loans and other receivables. This was the case with the US subprime housing market whereby banks converted pools of risky mortgages into marketable securities and sold them to investors through the use of SPVs. The SPV finances the purchase of the assets by issuing bonds secured by the underlying mortgages.
- **Asset transfer** – Many assets are either non-transferable or difficult to transfer. By having a SPV own a single asset, the SPV can be sold as a self-contained package, rather than attempting to split the asset or assign numerous permits to various parties.
- **Financing** – A SPV can be used to finance a new venture without increasing the debt burden of the sponsoring firm and without diluting existing shareholders. The sponsor may contribute some of the equity with outside investors providing the remainder. This allows investors to invest in specific projects or ventures without investing in the parent company directly. Such structures are frequently used to finance large infrastructure projects.

Common Uses of SPVs - cont

- **Risk sharing** – SPVs can be used to relocate the risk of a venture from the parent company to a separate orphan company (the SPV) and in particular to isolate the financial risk in the event of bankruptcy or a default. This relies on the principle of ‘bankruptcy remoteness’ whereby the SPV operates as a distinct legal entity with no connection to the sponsor firm. This has been challenged recently, post financial crisis with several court rulings that SPV assets and funds should be consolidated with the originating firm.
- **Financial engineering** – The SPV structure can be abused to achieve off-balance-sheet accounting treatment in order to manipulate more desirable financial and capital ratios or to manage regulatory requirements (for example to meet Basel II Tier 1 capital ratio requirement) or as a method for CFOs to hide losses and debts of the firm (as was the case with Enron)
- **Raising capital** – Such vehicles can be used by financial institutions to raise additional capital at more favorable borrowing rates. Since the underlying assets are owned by the SPV, credit quality is based on the collateral and not on the credit quality of the sponsoring corporation. This is an advantage for non-investment grade companies which can achieve lower funding costs by isolating the assets in a SPV.

Key Benefits to Sponsoring Firms

- **Asset ownership** – An SPV allows the ownership of a single asset often by multiple parties and allows for ease of transfer between parties.
- **Minimal red tape** – Depending on the choice of jurisdiction, it is relatively cheap and easy to set up an SPV. The process may take as little as 24 hours, often with no governmental authorisation required.
- **Clarity of documentation** – It is easy to limit certain activities or to prohibit unauthorised transactions within the SPV documentation.
- **Freedom of jurisdiction** – The firm originating the SPV is free to incorporate the vehicle in the most attractive jurisdiction from a regulatory perspective whilst continuing to operate from outside this jurisdiction.
- **Tax benefits** – There are definite tax benefits of SPVs where assets are exempt from certain direct taxes. For example, in the Cayman Islands, incorporated SPVs benefit from a complete tax holiday for the first 20 years.
- **Legal protection** – By structuring the SPV appropriately, the sponsor may limit legal liability in the event that the underlying project fails.
- **Isolation of financial risk**– By structuring the SPV as an ‘orphan company’, the SPV assets may not be consolidated with the firm’s on-balance sheet assets and are ‘bankruptcy remote’ in the event of bankruptcy or a default.
- **Meeting regulatory requirements** – By transferring assets off-balance sheet to an SPV, banks are able to meet regulatory requirements by freeing up their balance sheets..

Key Risks to Sponsoring Firms

- **Lack of transparency;** The complexity of SPVs - often in the form of layers upon layers of securitised assets - can make it near impossible to monitor and track the level of risk involved and who it lies with.
- **Reputational risk;** The firm's own perceived credit quality may be blemished by the underperformance or default of an affiliated or sponsored SPV.
- **Signalling effect;** The poor performance of collateral in an SPV attracts a high degree of attention and assumptions are made that the quality of the firm's own balance sheet can be judged on a similar basis.
- **Franchise risk;** There is a risk that investors in an affiliated SPV are upset and this affects other relationships between the sponsor and these investors, for instance as holders of unsecured debt.
- **Liquidity and funding risk;** The poor performance of an affiliated SPV may affect the firm's access to the capital markets.
- **Equity risk;** The firm might hold a large equity tranche in a vehicle (e.g. an SIV). If the firm does not step in and support or save the vehicle from collapse in difficult situations, the resulting wind-down of the SPV and sale of the assets at depressed valuations is likely to erode the firm's equity in the SPV, to a greater extent than the firm stepping in and either affecting an orderly wind-down of the vehicle or bringing its assets back onto its balance sheet.
- **Mark-to-market risk:** The forced sale of assets from an affiliated SPV could depress the value of related assets that the firm holds on the balance sheet. The firm will want to prevent a large negative mark-to-market impact on its own balance sheet
- **Regulation;** The same regulatory standards do not apply to assets contained within an SPV as to the firm's assets on balance sheet. This is a reason that many firms opt for these vehicles in the first place. However, this lax regulation poses an indirect risk to the originating firm.

Understanding SPEs/SPVs

- They allow large corporations to meet specific objectives
 - obtaining finances-easy credit conditions
 - transferring risk and
 - performing specific investment activities.
- SPV/SPEs have been used extensively as a means of securitisation for property-based financial products.
- Because of flexibility they remain vulnerable to misuse with potentially devastating consequences. This has been proven time and time again with mammoth corporations like Enron and Lehman Brothers being decimated due to inappropriate usage of these entities.

Benefits

- allow investors access to investment opportunities which would otherwise not exist.
 - facilitating and supporting securitisation,
 - financing,
 - risk sharing and
 - raising capital.
- In the absence of SPVs, these objectives would not be possible without putting the entire corporation at risk.
- It also provides significant benefits to the parent firm
 - by allowing ease of asset transfer,
 - reducing 'red tape',
 - providing tax benefits and
 - legal protection.

SPEs Risks

- Some of the key risks SPVs pose to the sponsoring firm are;
 - lack of transparency,
 - reputational risk,
 - liquidity and funding risk and
 - equity risk.

Lessons learnt from these collapses and their knock-on effects have led regulators to take strong measures that subject these vehicles to even more scrutiny than before.

- Stronger governance,
- increased oversight and
- more transparent reporting are some of the measures that form part of a tighter regulatory framework governing SPVs. A key example of this is the BASEL III regulation forcing banks to maintain adequate levels of capital and liquidity.

Beneficial Usage of SPEs

- SPVs contribute to the efficient operation of the global financial markets by providing finance opportunities for a wide range of securities to meet investor demand. Where parties to an SPV develop a comprehensive understanding of the structural behaviours and risks associated of these entities under various scenarios, they can effectively benefit from SPVs.
- With correct guidelines and good management, SPVs can be an extremely beneficial tool for both banks and investors alike and therefore it is useful to look at ways in which the risks associated with SPVs can be effectively managed.

Special Purpose Entity (SPE)

- Subsidiary, partnership, etc. set up for specific, finite period, activity.
- Often highly leveraged (high ratio of debt/equity or debt/assets).
- Also for ongoing investments, subs, joint ventures.

Key SPV related failures

- SPVs were used to hide massive losses and overstate earnings prior to **Tower Financial** declaring bankruptcy in 1994.
- By 2000, **Enron** had created hundreds of SPVs to hide billions of dollars in debt from failed deals, projects and ventures. In the meantime, share price of Enron continued to soar and the company announced large profits. When such debts were uncovered, the share price fell from \$90 to less than \$1 in a matter of weeks in 2001 with shareholders taking losses of nearly \$11bn. On Dec 2 2001, Enron filed for Chapter 11 bankruptcy.
- Having taken on huge amounts of exposure to mortgage-backed assets, via SPFs, **Bear Stearns** collapsed after a failed emergency rescue and was finally sold to JP Morgan Chase in 2008.
- The insolvency of **Lehman Brothers** in 2008 highlighted significant structural weaknesses in SPV documentation, particularly in structured finance transactions where Lehman acted as swap counterparty. This vagueness stress-tested the SPVs often leaving them with unforeseen liabilities.

Regulatory Approaches to Reporting

- SPVs on or off-balance sheet? International Financial Reporting Standards (IFRS)
 - IFRS requirements demand that an SPV's assets are consolidated if the vehicle is 'controlled' by the main entity. In this case the SPVs assets and associated funding are shown as assets and liabilities respectively.
 - Four tests as indicators to determine whether the originator is in 'control':
 - It is undertaking activities on its behalf and it benefits from this
 - It effectively controls the SPV.
 - It has the majority of the risks of the SPV
 - It receives the majority of the benefits of the SPV

Summary of Standards

- IAS 27- Consolidated and Separate Financial Statements
- IAS 28 – Investment in Associates and Joint Ventures
- IFRS 3 – Business Combinations
- IFRS 12 – Disclosure of Interests in Other Entities

Other Standards

- Since the bankruptcy of Lehman Brothers in 2008, a number of regulatory changes have taken place around SPVs and other OBSVs. In particular there has been:
 - A tightening of covenants in lending documentation
 - Significant firming up of legal risk management practices both in banks and by regulators
 - Increased emphasis on counterparty risk in capital market structures
 - An increase in the use of pre-packs and debt-for-equity conversion in restructurings, as well as disputes over valuation models
- BASEL III is a new global regulatory standard on bank capital adequacy and liquidity. It was developed in response to the deficiencies identified in financial regulation by the global financial crisis.

Basel 111

- The capital standards and new capital buffers will require banks to hold more capital and higher quality of capital than under current Basel II rules. The new leverage and liquidity ratios ensure that adequate funding is maintained in case of crisis. The intended objectives of Basel III can be defined by three primary pillars:
 - I. Enhanced minimum capital & liquidity requirements
 - II. Enhanced supervisory review process for firm-wide risk management & capital planning
 - III. Enhanced risk disclosure and market discipline

Consolidation of Subs, SPEs

To avoid consolidation of SPE

subsidiary, investment, or joint venture, parent must have:

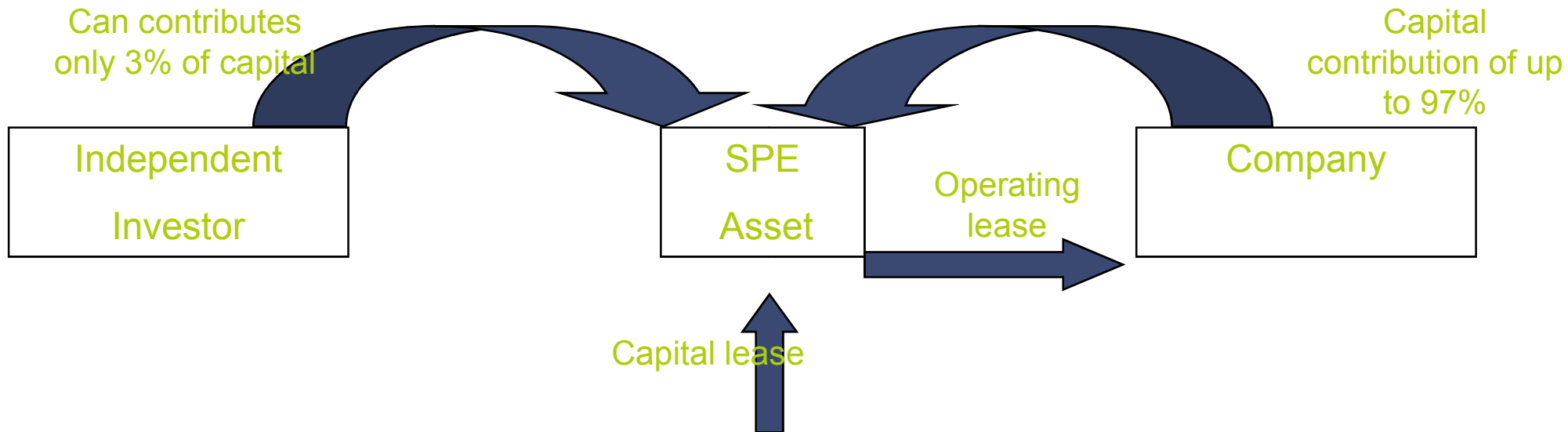
1. 50% or less of sub's common O/E, or
2. for SPE's outside residual claim must bear substantial risk; de facto implementation has required 3% of total assets.

<u>Example:</u>	A	=	L	+	E
SPE	100		94		6
P = parent	97		94 (upto 97)		3 (or less)
Outside owner	3		0		3

key point: keep debt off of the Balance Sheet

Synthetic Leases

- A synthetic lease is created when an SPE buys an asset on behalf of the company (or sometimes from the company itself) and leases this asset (back) to the company.



Synthetic Leases (cont'd)

- The company records the synthetic lease as an operating lease; if it had leased the asset directly and not through a SPE it would have recorded it as a capital lease.
- The operating lease treatment is preferred by companies because it allows them to keep the lease obligation off-balance-sheet.
- There are also tax motives to use a synthetic lease.

- The SPE vehicle that was initially used in the context of synthetic leases started to be more pervasively and creatively applied during the 1990s.
- Companies use SPEs as a back door to remove debt, obligations and other liabilities off the balance sheet.
- Enron case is an example for that.

Enron case

- Enron was one of high-flyer stocks in wall street throughout the 1990s.
- At the end of 2001 it was revealed that for years Enron hid billions of dollars in off-balance sheet entities and used these entities to camouflage losses and artificially inflate its income.
- Within weeks of these revelations Enron collapsed and filed for bankruptcy - the largest in US history at the time.

Enron case: off-balance sheet debt

- During the late 1990s, Enron grew rapidly and moved into new and lucrative profit areas. This growth required large initial capital investments.
- Enron made these new investment using off-balance sheet debt. Why?
- Enron already had a substantial debt load; and
- Although these investments were expected to generate great value for Enron in the long run, they were not expected to generate significant earnings or cash flow in the short run.

Enron case: off-balance sheet debt

- Had Enron financed these investments by directly issuing additional debt, what would have been the impact on its credit ratings?
- clue: How much cash is needed in order to serve debt?
- SPEs (and other kind of entities) took loans and made the investments on Enron's behalf. These entities were constructed to allow Enron not to consolidate them – and so the debt was kept off the balance sheet.
- At the time of bankruptcy, the on-balance sheet debt was \$13.15 billion. When including off-balance sheet liabilities and contingent liabilities Enron's debt was \$27 billion dollar!!!

Enron Case: Hiding Losses in Subsidiaries

- Near the end of the 3rd and 4th quarters of 1999, Enron sold interests in seven assets to entities it controlled, called LJM1 and LJM2.
- (1) Enron bought back five of the seven assets after the close of the financial reporting period.
- (2) the LJM partnerships made a profit on every transaction.
- (3) according to a presentation Enron's CFO made to the Board's Finance Committee, those transactions generated, "earnings" to Enron of \$229 million in the second half of 1999.

- From 1993 through the first quarter of 2000, Enron picked up its share of income from JEDI using the equity method of accounting.
- Changes in fair value of the assets were recorded in JDEI's income statement.
- JDEI held 12 million shares of Enron stock, at fair value.
- First quarter of 2000, Enron recorded \$126 million in Enron stock appreciation! (i.e. recording appreciation in own stock)

Bringing Transparency in Off Balance Sheet Accounting

- **Governance;** Firms should ensure the governance process of an SPV is commensurate with the complexity of structure and the degree of active intervention required by the various parties involved
- **Reporting capability;** Firms should have the capability to assess and report on a continual basis their aggregate SPV exposure in conjunction with other firm-wide risks
- **Motivation;** The purpose of the SPV should be reconsidered throughout the life of the vehicle in order to distinguish between risk transfer and risk transformation
- **Oversight;** Firms should monitor on an on-going basis the quality of transferred exposures in relation to the firms remaining on-balance sheet components
 - There should be regular oversight and monitoring of the use of SPV activity in order to identify developments that could lead to systematic weakness
 - Market participants should be able to assess and risk manage factors that increase transaction capability

Bringing Transparency in Off Balance Sheet Accounting

- **Regulation;** -Tighten reporting requirements and consolidation of accounts requirements on the use of SPVs
 - Make external regulators one-product firms whereby they no longer are able to provide consulting services to the same clients whom they provide ratings for
- **Simplification;** - Simpler structures - an end to layers upon layers of multi-tiered securitisation
 - Standardisation of documentation and disclosure requirements of SPVs should be adopted and any material divergence from these standards should be communicated to investors
- **Consolidation;** - If there is evidence that the SPV is receiving financial support from the sponsor firm, then the activities of the SPV should be consolidated with those of the institution for both supervisory and internal risk management purposes
 - Retention of an equity tranche by the sponsoring firm to ensure the firm has an incentive not to package low quality assets and sell to investors
- **External ratings;** -Ratings of securitised assets by external rating agencies
 - This however raises the question of whether the rating agencies are in a position with enough information and experience to make these judgements

Questions & Answers

If you can't explain it **simply**, you
don't understand it well enough.

— Albert Einstein

Thank you

