

Warning: Credit Crunch

By Robert Lenzner and Matthew Swibel
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Accounting regulators want \$1 trillion or more of hidden corporate debt moved into plain view. The reform could pull the rug from under the credit-driven economy.

For all the evils at Enron et al. And the damage done to America's faith in the markets, the worst impact may be on its way--from some of the fixes that regulators and politicians are now pursuing. Who knows whether the inevitable crackdowns on options or accounting firm consultants will sap incentives and productivity? We're talking about a more obscure, but potentially far more devastating, change in accounting. It has to do with securitized lending. If it's implemented, it could throw a giant monkey wrench into a weak economy.

Securitization describes a form of financing in which a bank or other lender wraps up a package of assets--car loans, for example, or mortgages or credit card receivables--and issues securities against that package. (The securities are traded as bonds; hence the "securitizing.") Investors such as money market funds and pension plans buy those securities. That provides cash that lenders can recycle in another round of car loans, mortgages and credit card charges.

Such financial alchemy keeps America's buy-now-pay-later consumers swimming in credit. It helps explain why, despite two years of layoffs and 401(k) disasters, people are buying cars and houses at a furious pace. Securitized lending has its antecedents in Ginnie Mae, created in 1968 to package home mortgages. In the past decade it took off, having climbed to a staggering total of \$6 trillion, most of it to finance consumers. For comparison, all household debt in the U.S. totals \$7.7 trillion.

With the right attention to detail, the lender securitizing its book of car loans or credit card balances gets both the stream of income from assets (that is, the consumer loans) and virtually all the liabilities (the securities issued to investors) off its balance sheet. The investors are thrilled with the arrangement. They can look to a predictable stream of consumer loan repayments to back up the debt securities they have purchased; if the lender gets into trouble, they get first dibs on that cash stream. **For lenders, keeping these assets and liabilities buried in footnotes rather than on the balance sheet is vital. Consolidate them and some lenders would look dangerously leveraged.**

Securitization is a big business for some finance companies. Citigroup has \$204 billion of asset-backed debt outstanding, J.P. Morgan Chase \$75 billion. Credit-card issuer MBNA, a master of the art, has \$73 billion--compared to on-balance-sheet assets of \$45.4 billion and a comparative sliver of shareholders' equity, \$7.8 billion. Ford Motor Credit was able to save several hundred million dollars over the past 18 months using off-balance-sheet financing. GMAC is another big player. Without securitization you might not see as many 0% car loans.

What could stop this happy arrangement? Enron-wary reformers are agitating to have some or all of that \$6 trillion consolidated on the balance sheets of lenders. Some lenders are fighting this tooth and nail. It would force a lot of them to raise the price of consumer credit or drastically cut back on it. It could, if you believe the people lobbying against the reform proposal, stop the economic recovery in its tracks.

Investors are already hesitant to provide all the credit this economy needs, says bond manager Paul McCulley, who has 5% of the Pimco Short-Term Fund parked in asset-backed

securities. "A period of rising risk aversion is the worst time to tighten the rules," he says. A worst-case outcome of the accounting change: a credit meltdown, with "everyone trying to sell at the same time."

Andrew Smithers, chairman of Smithers & Co., economic consultants in London, warns, "If they have to put the debt back on their balance sheets, it will violate the debt covenants of leading banks." If banks' balance sheets lard up with the extra debt, "banks will have less propensity to lend in similar size and pricing. It will diminish the return on equity," says Michael Malter, head of asset-backed securities at J.P. Morgan Chase.

Money Machine

MBNA earns over 50% on income from its off-balance-sheet portfolio, collecting a 2% servicing fee and a spread of 7.25%.

MBNA Securitization Cash Flow	
Portfolio Yield (%)	17.00
Investor Coupon	(2.25)
Servicing fee	(2.00)
Net Int. Margin Before Losses =	12.75
Gross Credit Losses =	(5.50)
Net Interest Margin =	7.25

Source: MBNA.

The Financial Accounting Standards Board, which is set to decide on the rule change in the fourth quarter, dismisses all the hand-wringing. "We're trying to increase transparency and disclosure on the financial statements. If the markets or regulators think that consolidating all the debt is being overleveraged, I can't control that," says Edward Trott, a member of the seven-person board.

FASB just got some more ammunition for its reform campaign. The Securities & Exchange Commission accused PNC Financial Services, the big Pittsburgh bank, of inflating income last year by hiding loan losses in off-balance-sheet entities. PNC agreed on July 18 to consolidate the entities in question without admitting or denying charges. Presumably, if FASB gets its way and banks have to consolidate some or all of their off-balance-sheet entities, it will be harder to hide any problems. No bank examiner or securities cop wants to be blamed for the next Enron.

For now FASB is targeting only one portion of securitization, amounting to \$1 trillion or so of off-balance-sheet debt. Consolidation would be mandatory whenever the parent company fully controls the entity (usually set up as a trust) that holds the assets and floats the securities. If, in contrast, the trust is on autopilot--if assets are assigned to it according to prearranged rules, and if the parent has no say in when the trust is liquidated--then it would escape consolidation.

Who would get hit? It appears that a portion of asset-backed securities issued by banks would be consolidated. Same goes for Ford Motor Credit, GMAC and the financing arms of Boeing, Sears and other retailers.

Who would escape? MBNA, for sure. It has skillfully set up its trust of credit card receivables to put it at arm's length from the parent company. Among other things, MBNA is not on the hook if the trust, despite its ample dose of collateral, winds up bankrupt.

FASB's opponents fear that the pending rule is only the opening wedge in a frontal assault that will eventually force all off-balance-sheet entities out into the open. After all, distinctions having to do with "control" are almost beside the point. Who cares what the legal mechanism is for liquidating a trust? In economic substance, just about all of the entities that securitize assets are the alter egos of their parent companies. If the assets do well--if the cars don't wind up with the repo man, if the credit cards mostly stay out of the hands of deadbeats--the parent does well. If the assets do badly, the parent suffers through the reduced payout from the trust's income. Investors wouldn't want it any other way. If the parent were genuinely indifferent to the financial results of the trust, it would put in all its worst assets and walk away.

Moody's, the credit rater, doesn't make FASB's distinction between controlled and independent trusts. Looking at the economic substance of what is going on, it adds off-balance-sheet debt back onto the main balance sheet to determine the parent company's credit rating. MBNA gets a Baa2 rating and would have 93% debt and only 7% equity if the MBNAMaster Credit Card Trust were included in the parent's assets and liabilities. Note, though, that the credit card trust itself gets an Aaa for the most senior tranche of its paper. That translates into a low cost of borrowing for MBNA, and thus into profits for MBNA shareholders. Since MBNA went public in early 1991, its stock has climbed elevenfold.

It is a credit to the skill of the financial engineers setting up these securities-issuing entities that few have blown up. "The extent of credit defaults on securitized debt is far less than with unsecured corporate debt," says Tanya Azarchs, a credit analyst at Standard & Poor's.

Case in point: An off-balance-sheet vehicle of J.P. Morgan Chase called Park Avenue Securities took part in a \$1.5 billion receivables-backed financing earlier this year to WorldCom--as bad a bet as any bank could make. When WorldCom confessed to doctored accounts, Park Avenue and other financiers were able to demand extra collateral from WorldCom (in the form of WorldCom's own receivables, owed by phone customers). J.P. Morgan Chase expects that the buyers of Park Avenue paper will suffer no loss.

That kind of insulation has impressed even Federal Reserve Chairman Alan Greenspan, who said publicly in April: "A major contributor to the dispersion of risk has been the wide-ranging development of markets in securitized commercial and residential mortgages, bank loans and credit card receivables. ... Shocks to the overall economic system are accordingly less likely to create cascading credit failure."

"The ability to securitize has made a significant contribution to the world economy," says Vernon Wright, 59, chief corporate finance officer at MBNA and architect of its credit card trust. "There isn't a need to change the existing accounting for securitizations."

From his point of view there isn't, but the public mood is hostile to anything that has "off balance sheet" in its name. Under the circumstances, securitizers should take the precaution of assuming that the FASB rule will go through.