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Securitizations and the financial crisis: Is accounting the missing link?

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ABSTRACT

In this paper we focus on the interplay between securitization accounting and regulatory capital rules to discuss how the misalignment between these two sets of regulations offered banks the opportunity to engage in opportunistic behaviors and incented them to take on too much risk.

We do so in five steps. First, we describe the securitization process and analyze the complexity reached by securitization transactions in the pre-crisis period. Second, we discuss the contribution of securitization to the financial crisis and the role of securitization practices in the boom of the US's subprime market. Third, we present US GAAP and IFRS accounting for securitization and review the main requirements that banks had to meet in order to account for securitization transactions *as a sale*. Four, we analyze the role of securitization accounting in the crisis and show the effects of securitization on banks' regulatory capital and performance. Finally, we describe the evolution of securitization accounting in the post-crisis period.

Overall we claim that the combination of incentives stemming from accounting rules and bank regulation led to a banking business model that introduced high risks to the financial system and that obfuscated the transparency of financial transactions.

1. Introduction

The causes of the recent financial crisis continue to be a source of debate among academics, the business press, politicians, and financial experts, but there is consensus that the most essential causes of the crisis originated in the financial industry. Diamond and Rajan (2009) argue that the issuance of exotic new financial instruments played a prominent role in the crisis because they induced the financial sector to misallocate resources to real estate. Securitization transactions, which consist of converting illiquid assets into liquid securities, were the engine of financial innovation in the pre-crisis years and gave rise to exotic financial instruments that found their way, either directly or indirectly, onto commercial and investment bank balance sheets. When the subprime mortgage market collapsed in 2007, these financial instruments revealed their high risk and swamped the financial industry.

Following the passage of the Riegle-Neal Interstate Banking Act in 1994 and the subsequent repeal of the Glass–Steagall Act in 1999 financial institutions were allowed to enter new markets and change their business model, thus increasing non-interest income (see Stockhammer, 2004). In this line, Basu (2003, p. 232) posits that "financial liberalization has increased

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the intensity of the competitive atmosphere within the financial sector, which in turn has often caused banks to undermine the importance of credit standard in order either to maintain their existing market share or to increase it".

As extensively discussed in Heilpern, Haslam, and Andersson (2009), securitization facilitated an expansion of the US mortgage market and modified the structure of the value chain within which financial assets, risk and liquidity were managed. Moreover, permissive regulatory conditions and favorable accounting treatments, incented bank executives to engage heavily in securitization transactions. As highlighted by Heilpern et al. (2009, p. 103), "banking executives were encouraged to pass on [. . .] complex collateralized products to investors to value skim, improve banking returns and their own bonuses". Clearly, understanding banks' incentives for increasing securitization transactions is of fundamental importance in drawing a full picture of the causes of the financial crisis.

In this paper, we focus on the interplay between securitization accounting and regulatory capital rules to discuss how the misalignment between these two sets of regulations incented banks to take on too much risk.

Accounting has been blamed for contributing to the financial crisis through the use of *fair-value accounting* and *securitization accounting*. While fair-value accounting has received a good deal of attention from academic research (e.g., Laux & Leuz, 2009; Laux & Leuz, 2010), securitization accounting is an emerging issue in the accounting and finance literature. Most of the accounting literature on securitization is rooted in three major research streams: a first set of papers focuses on the lack of transparency that permeates securitization transactions (Cheng, Dhaliwal, & Neamtiu, 2011) and shows that securitizations increased the information asymmetry among investors. A second research stream investigates the sources of credit risk associated with asset securitizations (Barth, Ormazabal, & Taylor, 2012; Landsman, Peasnell, & Shakespeare, 2008) and how these sources have changed with the advent of the crisis (Amiram, Landsman, Peasnell, & Shakespeare, 2011). A third research strand focuses on the opportunistic use of securitization in order to maximize financial statement "window dressing" and manage earnings (Dechow & Shakespeare, 2009; Dechow, Myers, & Shakespeare, 2010).

Our paper takes a different perspective in that it investigates in-depth securitization accounting under US GAAP and IFRS and discusses how accounting rules and bank regulation might have affected banks' accounting and real investment decisions. In fact, the combination of incentives stemming from these two sets of unrelated regulations led to a banking business model that introduced high risks to the financial system and that obfuscated the transparency of financial transactions. Therefore, our contribution is related to those few papers that deal with the analysis of the accounting rules that may have created a fertile field for the securitization market in the pre-crisis period (Barth & Landsman, 2010; Kothari & Lester, 2012; Ryan, 2008) and to those papers analyzing the drivers of the financial crisis (Basu, 2003; Hatherly & Kretzschmar, 2011; Heilpern et al., 2009; Lewis, 2009; Stockhammer, 2004). We take this literature a step further by focusing on securitization accounting; adopting an international viewpoint by comparing US GAAP and IFRS rules; and exploring the link between accounting rules and other sources of regulation that might have incented banks to exploit the favorable securitization accounting treatments. It is important to note that we do not aim at demonstrating any causal relation between securitization and the financial crisis, rather we offer several stimuli for reflection about the interplay between accounting rules and bank regulations that might have offered opportunities for opportunistic behavior. Moreover, our work can serve as a one-stop reading for readers who have not kept up on a regular basis on the research around securitization and are interested in learning about the potential role of securitization in the financial crisis and the rules governing such transactions.

2. The securitization process

Asset securitization consists of converting illiquid assets-usually small loans that could not be separately sold into liquid securities, or asset-backed securities (ABS), that are sold to investors in the financial market. Asset securitization is the key mechanism in the *originate and distribute* (O&D) bank business model, which encompasses the following three steps:

1. The origination of loans to companies or consumers (*origination*) and the management of their payments (*servicing*).
2. The "packaging" of these loans in ABS.
3. The distribution of these securities to outside investors through the creation of *off-balance* entities.

Securitization offers several benefits to banks, as it allows banks to diversify their investments, to increase lending activities, to reduce regulatory capital by accounting *off-balance* assets and liabilities, and to increase profitability from the gains that arise from these transactions.

Thus, securitization has transformed the simple lender–borrower structure into the complex one illustrated in Fig. 1.

As Fig. 1 shows, the securitization process starts when the originator, typically a commercial bank ("bank B" hereafter), has generated some loans. The originator[1] transfers the loans to a *special purpose entity* (SPE), becoming a sponsor of the SPE. The first SPE (SPE1) then creates a pool of loans, sometimes pooling the originator's loans with other originators' loans, and sells the pool to another special purpose entity (SPE2), usually a trust.[2] The role of SPE2 is to manage the loan pool and issue ABS. When SPE2 issues ABS, it divides them into tranches (*senior*, *mezzanine*, and *junior*), each of which has its

[1] The sponsor can be the same bank B as assumed in Fig. 1 or another bank that bought the originated loans.

[2] This *two-step transfer* procedure, which requires the creation of a second SPE, was introduced by banks to meet US GAAP conditions, under which the bank does not have to recognize on its balance sheet the assets transferred.