

Financial Institutions
U.S.A.
Special Report

Off-Balance Sheet Accounting Changes

SFAS 166 and SFAS 167

Analysts

Financial Institutions

Meghan Crowe, CFA
+1 212 908-9121
meghan.crowe@fitchratings.com

Christopher D. Wolfe
+1 212 908-0771
christopher.wolfe@fitchratings.com

Credit Policy-Accounting

Dina Maher, CPA
+1 212 908-9175
dina.maher@fitchratings.com

Olu Sonola, CFA, CPA
+1 212 908-1583
olu.sonola@fitchratings.com

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Overview

On June 12, 2009, the Financial Accounting Standards Board (FASB) published two new accounting standards (Statement of Financial Accounting Standard [SFAS] 166 and SFAS 167) that determine whether securitizations and other transfers of financial instruments are given off-balance sheet treatment. The revisions to the standards, expected to be effective Jan. 1, 2010 for issuers with calendar year ends, will result in many existing off-balance sheet securitizations being treated as secured financing and returning on-balance sheet. SFAS 166, “Accounting for Transfers of Financial Assets,” will amend SFAS 140 and SFAS 167, “Amendments to FASB Interpretation (FIN) No. 46(R),” will amend FIN 46(R).

Fitch Ratings does not expect these accounting changes to result in any rating action, as the economics of the off-balance sheet transactions remain the same. However, there will be challenges for issuers and analysts in transitioning to a new set of accounting rules. These include:

- Structuring of financial products could change, as the qualified special purpose entity ceases to exist and the test for consolidation of variable interest entities switches to a qualitative focus from a quantitative one.
- Regulatory capital arbitrage will be eliminated, which could produce lower ABS volumes, although Fitch believes the ABS markets will remain an important funding alternative.
- Changes in financial statement content could hamper the evaluation of credit on a historical and relative basis, and it could become more difficult to identify unencumbered assets with more secured financing added to the balance sheet.
- Adjustments to covenant packages may be necessary as balance sheet debt increases.
- The different measurement methods for reconsolidation could make peer comparisons difficult.

In this report, Fitch will:

- Discuss the analytical implications associated with the accounting changes.
- Outline the four methods for reconsolidation permitted by FASB.
- Present a hypothetical example of adjustments made to the balance sheet and income statement as a result of reconsolidation.

Background

Historically, many securitized assets were placed in qualified special purpose entities (QSPEs) that allowed issuers to automatically remove the assets and related debt from their consolidated balance sheets. Those QSPEs were considered “brain dead” and their assets were not intended to be actively managed. However, the QSPE concept collapsed over questions raised regarding the extent to which servicers could modify and restructure the instruments within the QSPE structure. The QSPE concept and its automatic “off” are being eliminated under the revised standards and all securitizations

will now be reviewed pursuant to a revised standard for consolidation of variable interest entities (VIEs).

Mind the VIEs and QSPEs

A VIE is an entity in which equity investors lack certain decision-making abilities such that they do not exhibit a controlling financial interest. Such an entity can also have insufficient equity at risk to finance its activities without additional subordinated financial support. Former standards required the primary beneficiary that absorbed the majority of the expected losses or received a majority of the expected gains to consolidate the VIE.

A QSPE is a qualifying special purpose entity, legally structured as a trust, which automatically got off-balance sheet treatment because of its defined passive nature. The conditions for a QSPE limit the types of assets, ability to modify or pledge those assets, and activities of the trust so that no one party has control.

QSPEs were exempted from consideration for consolidation under VIE requirements.

The new requirements eliminated the QSPE concept in part due to difficulties in defining activities that would be permitted while remaining “passive.” Thus, all former QSPEs will be considered for consolidation as VIEs.

Currently consolidation of a VIE (*see definition above*) is determined by a quantitative test of who is expected to absorb the majority of the entity’s expected losses, receive a majority of the entity’s expected residual returns, or both (the “primary beneficiary”). However, the quantitative analysis for determining the primary beneficiary will be replaced by a qualitative test. This qualitative test focuses on:

- Who has the power to direct the most significant activities of the VIE?
- Who has the right to receive benefits and/or the obligation to absorb losses that could potentially be significant?

The entity with the power to direct VIE activities or with the right to receive benefits/losses will need to consolidate. However, if the entity can show that the power to direct the activities of the VIE is shared among multiple parties and that no one party can direct the activities of the VIE, then no primary beneficiary can be established. If this is the case, consolidation will not occur. Fitch believes this loophole provides some insight as to where future financial structuring is headed, so that issuers can get the desired accounting result. Nonetheless, Fitch will be more focused on substance over form.

The new standard also requires ongoing consolidation assessments every reporting period. Therefore, an unexpected market event that significantly alters the risk profile of a structure could result in consolidation. Under current rules such events have not consistently triggered reassessment. These consolidation changes were effected in response to the lack of transparency to the risks that off-balance sheet accounting masked for many issuers.

According to the Federal Reserve’s recently completed Supervisory Capital Assessment Program (SCAP), or stress test, amendments to these accounting standards would result in the reconsolidation of approximately \$700bn of risk-weighted assets at the top 19 financial institutions in the U.S. While Fitch recognizes that the economic structure of the securitizations remains intact regardless of GAAP reporting requirements,

reconsolidation will yield adjustments to financial statements and disclosures that could make the analytical process more challenging. Furthermore, should the chosen measurement method of reconsolidation differ among industry peers, comparative metrics could be less useful.

Analytical Implications

Amendments to SFAS 140 and FIN 46(R) are expected to have the biggest impact on providers of ABCP conduits and issuers of ABS backed by credit cards, student loans, auto loans, and mortgages. Fitch believes reconsolidation will have several analytical implications including impacts on regulatory capital ratios, disclosures, optics, covenants, and operating trends. The following sections will discuss each in turn.

Regulatory Capital Ratios

Fitch's review of an issuer's funding and capitalization has historically been considered on a managed basis, with on- and off-balance sheet assets and debt consolidated for analytical purposes. Therefore, the accounting amendments, in and of themselves, should not result in negative rating action for large off-balance sheet securitizers. However, for financial institutions subject to minimum regulatory capital requirements, the addition to risk-weighted assets comes at a time when capital ratios are already under strain from mounting credit costs. The Federal Reserve's SCAP did consider the impact of SFAS 140 amendments on the largest 19 institutions, and risk-weighted assets were increased by about \$700bn to reflect expected consolidation. Therefore, the need to fill any capital shortfalls stemming from reconsolidation and/or other credit issues, at the largest banks, should have already been identified by regulators.

To be considered "well-capitalized," Tier I capital to risk-weighted assets must be at least 6%, and to be considered "adequately capitalized," the ratio must be at least 4%. If, for example, a \$50bn portfolio of credit cards needs to be reconsolidated, risk-weighted assets would increase by \$50bn (less the risk-weighting of any retained interests in securitizations already included in the calculation), because credit cards fall into the 100% risk-weighting category, and the incremental Tier I capital needed to remain well-capitalized would be approximately \$3bn. Most financial institutions hold capital in excess of well-capitalized minimums to retain flexibility for cyclical downturns and fair market value adjustments, but the recent economic picture has had an unprecedented impact on bank capital ratios. Recently, banks have sought to boost regulatory ratios by selling preferred stock to the government through the Treasury's Capital Purchase Program (CPP), raising common equity, or converting debt instruments into equity.

As of March 31, 2009, the average Tier I capital to risk-weighted assets ratio for the top five credit card issuers (American Express, Bank of America, Capital One, Citigroup, and JPMorgan Chase) was 12.26%. This metric already includes the addition of a large portion of Bank of America's and Citigroup's off-balance sheet credit card receivables to risk-weighted assets for regulatory capital purposes because they both have recently supported their off-balance sheet vehicles by adding enhancement to their trusts. Citigroup's Tier I ratio as of March 31, 2009 was 11.9% and already included \$82bn of incremental risk-weighted assets associated with the addition of the majority of off-balance sheet credit card vehicles. Citigroup disclosed that further reconsolidations, including mortgages, student loans, municipal bonds, and other assets, would add \$10.9bn of incremental risk-weighted assets, or 1.1% of the most recent balance.

American Express and JPMorgan Chase are also expected to consolidate credit card trusts for regulatory capital purposes because of plans to add enhancement to trusts. American Express believes consolidation will add approximately \$20.5bn to its risk-

- Reconsolidation will impact regulatory capital ratios, although this was considered in the SCAP test.
- Recent issuer actions to enhance trusts have accelerated consolidation for regulatory capital purposes.
- Absence of regulatory capital arbitrage could hurt ABS issuance, but should remain an important funding market.

- Tier I capital includes common stock and surplus, retained earnings, qualifying non-cumulative perpetual preferred stock, minority interest in the equity accounts of consolidated subsidiaries, and selected identifiable intangible assets less goodwill and other intangible assets.

weighted assets. The company had approximately \$28bn of off-balance sheet credit card loans as of March 31, 2009, but the net impact on risk-weighted assets would be less than the full \$28bn because retained interest assets have already been included in the risk-weighted assets calculation.

JPMorgan Chase believes it may need to reconsolidate \$145bn of total assets, including credit cards, mortgages, and conduits, among others, which could have a negative 80bps impact on its Tier I capital ratio. That ratio stood at 11.4% as of March 31, 2009.

Credit cards are not the only asset category impacted by the change in accounting treatment, although they could have a relatively larger impact on regulatory capital, given their 100% risk-weight. Student loans guaranteed by the government against default are afforded a 20% risk-weight, while performing closed-end, first-lien loans on one- to four-family or multifamily residential properties are in the 50% category. Fitch recognizes that there is a substantial amount of off-balance sheet mortgage loans in the market, but a sizable portion of those loans are conforming mortgages, meaning government-sponsored enterprises (GSEs) like Freddie Mac and Fannie Mae would bear the ultimate credit risk, while the issuer just earns origination and servicing fees from the portfolio and would not have to consolidate. According to SFAS 167, GSEs will need to consolidate all loans they guarantee. However, there may be nonguaranteed mortgages serviced by issuers that will need to be consolidated.

Selected ABS Issuers

(\$m, As of March 31, 2009)

	Potential Reconsolidation of GAAP Assets	ABS Issuance: 2008	Primary Collateral
American Express Company ^a	27,455	11,737	Credit Cards
AmeriCredit Corp ^a	—	1,503	Auto Loans
Capital One Financial Services ^a	44,808	7,364	Credit Cards
CIT Group, Inc. ^a	1,300	2,757	Corporate Finance, Vendor Finance
Citigroup, Inc. ^b	165,800	9,053	Credit Cards, ABCP Conduits, Mortgage, Student Loans, Muni Bonds, Others
Discover Financial Services ^c	22,854	3,500	Credit Cards
Ford Motor Credit ^a	500	8,941	Auto Loans
JPMorgan Chase & Co. ^b	145,000	21,317	Credit Cards, Residential Mortgage, Commercial Real Estate, ABCP conduits
SLM Corporation ^a	34,961	18,352	Student Loans
Subtotal	442,678	84,524	

^aFitch estimate. ^bCompany published estimates of potential reconsolidation resulting from accounting amendments. ^cOff-balance sheet assets as of Feb. 28, 2009. Note: Bank of America off-balance sheet assets approximate \$470bn, although not all will be reconsolidated in accordance with accounting amendments.
Source: ABS Alert, company filings.

All issuers will need to evaluate consolidation for GAAP purposes beginning Nov. 15, 2009 or Jan. 1, 2010, for issuers with calendar year ends, barring any extensions or delays. Issuers are prohibited from accelerating the reconsolidation process, although some may take actions that force consolidation for reasons outside the accounting amendments. For example, on May 15, 2009, State Street Corporation was required to consolidate four of its special purpose, multiseller, and ABCP conduits for GAAP because it voluntarily redeemed the conduits' outstanding subordinated debt.

Historically, regulatory capital relief has been a primary motivator for financial institutions to use off-balance sheet ABS. With the regulatory arbitrage now gone, Fitch believes the volume of ABS issuance will decline, although many issuers will continue to tap the ABS market to retain funding flexibility. Additionally, for those issuers not

subject to regulatory capital requirements, the motivation to issue ABS remains the same.

Required Disclosures

The principle objectives of the required disclosures for entities with transfers of financial assets should provide financial statement users with an understanding of the following:

- A transferor's continuing involvement with financial assets that it has transferred in a securitization or asset-backed arrangement.
- The nature of any restrictions on assets reported by an entity on its balance sheet that relate to a transferred financial asset, including the carrying amount of such assets.
- How servicing assets and servicing liabilities are reported.

Additionally, for those transfers of financial assets accounted for as secured borrowings:

- The carrying amount and classification of assets and associated liabilities recognized in the transferor's balance sheet at the end of each period presented, including qualitative information about the relationship(s) between those assets and associated liabilities. For example, if assets are restricted solely to satisfy a specific obligation, the carrying amount of those assets and associated liabilities, including a description of the nature of restrictions placed on the assets.

- Disclosures should allow analysts to readily identify unencumbered assets.
- The economics of the off-balance sheet trusts remain intact, and deconsolidated disclosures will allow analysts to identify potential risk to issuer from residual interests.

Disclosures

From an analytical perspective, the most obvious impact from the accounting amendments will be a change in disclosures. Currently, most active users of off-balance sheet vehicles report managed results, which allow analysts to calculate managed loss metrics, margins, and return levels, while GAAP financial statements often allow analysts to readily identify unencumbered asset balances. Managed metrics will now be easily calculated by looking at the GAAP income statement and balance sheet, but Fitch believes the ability to identify unencumbered assets may be more difficult as securitized trusts are added to the balance sheet. The level of unencumbered assets is a critical component to assessing the relative risk of corporate unsecured debt because recovery prospects, in the case of liquidation, are dependent on the level of assets without perfected interests. While holders of ABS notes will still not have access to assets outside of the trust for recovery purposes, it will be more difficult to discern which loans are securitized when looking at the balance sheet, as all loans may be presented together in one category. Therefore, Fitch will look for issuers to continue to present some form of deconsolidated information, or at a minimum, unencumbered and encumbered asset levels.

Additionally, with disruptions in the capital markets it has been more difficult for ABS issuers to economically sell subordinated bonds; so many issuers have retained the bonds in their available-for-sale (AFS) portfolios, marking them to market on a quarterly basis. The valuation of these bonds has been volatile in recent quarters, given significant credit deterioration. While the carrying value of the securities may not reflect the ultimate value of the assets, the fair value mark does highlight the risk associated with holding the lower rated notes in a securitization. However, once reconsolidation occurs, these subordinated notes will be moved from AFS securities to

the loan portfolio, where they may be carried at cost. Issuers are currently required to report the fair value of their financial assets in the notes to the financial statements on an annual basis, and that disclosure will now be required quarterly, but it is not clear whether the subordinated securities will be broken out for fair value purposes or aggregated into the loan category.

Fitch believes recording these assets in the loan category, when the issuer owns the bonds, does not adequately reflect their relative risk, since structurally they are subordinated to the notes rated 'AAA'. Additionally, in recent months several issuers have injected enhancement into trusts to support current rating levels by creating class D, or first-loss, securities. Once reconsolidation occurs, these too will be included in the loan portfolio. Therefore, Fitch would expect issuers to continue to include information about the true economics of the trust, so that analysts can determine the risk to an issuer's earnings and capital.

Optics and Covenants

For many issuers, these accounting amendments will present a significant change in the "optics" of the balance sheet and income statement. For banks, reconsolidation will result in an increase in the level of GAAP assets and debt. However, more importantly, the reconsolidation process will impact equity capital, as issuers true up their allowance for loan losses and write off excess spread assets, even though the true economics of the transaction have not changed. Discover Financial Services, for example, has been dealing with this issue gradually as recent ABS maturities have been refinanced on balance sheet with deposit funding. Bringing these assets back on the balance sheet has the same optical impact on the financial statements as reconsolidation. In its first fiscal quarter of 2009, the company refinanced \$3.1bn of off-balance sheet ABS on balance sheet with deposits, which resulted in a \$164m provision expense to true up reserves and an \$18m writeoff of excess spread assets.

American Express recently disclosed that upon reconsolidation its shareholders equity would decline by approximately \$1.1bn as a result of loan loss reserve additions and other adjustments. Therefore, Fitch believes analysts will need to consider these one-time adjustments when assessing issuer performance trends. Adjustments made to the balance sheet upon initial reconsolidation will be recognized as a cumulative effect adjustment to retained earnings. However, according to SFAS 167, adjustments "may be applied retrospectively in previously issued financial statements for one or more years, with the cumulative effect adjustment to retained earnings as of the beginning of the first year restated." Fitch believes this retrospective nature could make it more challenging to understand the reconsolidation impacts.

For nonbanks, the addition of off-balance sheet assets and debt could affect the way certain ratios are calculated. For example, many nonbanks may have debt-to-equity covenants in their financing agreements and the reconsolidation of additional debt may alter the covenant calculations. While current debt documents may not explicitly require adjustments for changes in GAAP accounting, Fitch would expect lenders to renegotiate covenants in good faith, as necessary, to maintain the substance of the original covenant. Cash flow coverage ratios may also be skewed by reconsolidation. If, for example, cash begins to trap in an ABS trust due to declines in excess spread, the ratio of EBITDA to interest expense or EBITDA to debt could be misleading because, in reality, a portion of that EBITDA is available only for trust debt holders. Fitch expects the notes to the financial statements to include enough detail to allow analysts to make the appropriate adjustments.

- Net impact of reconsolidation will hit equity account and can be retrospective.
- True-up of loan reserves expected to be significant factor.
- Covenant calculations could be impacted by accounting adjustments.

Comparison with International Financial Reporting Standards

Many securitization transactions are consolidated under International Financial Reporting Standards (IFRS). IFRS looks to whether the issuer retains control of a financial asset for which some but not substantially all risks and rewards have been transferred. The upcoming changes to U.S. GAAP focusing on control of the underlying assets and the ability to receive benefits cause the two sets of standards to effectively converge. Using IFRS, the issuer continues to recognize the financial asset (or group of financial assets) to the extent of its continuing involvement. IFRS principles require that an issuer transfer its rights to receive cash flows from the asset(s) for de-recognition. In those cases where the issuer retains the rights to the cash flows but assumes a contractual obligation to pay the cash flows to one or more recipients, de-recognition is only allowed when the issuer has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset, the issuer is prohibited by the terms of the transfer contracts to sell or pledge the original assets to others, and the issuer has an obligation to remit any cash flow collected to the eventual recipients without material delay. Overall, the U.S. GAAP consolidation changes bring the standards closer to the IFRS principles. Consolidation of VIEs under U.S. GAAP or SPEs under IFRS, is based on qualitative assessments which are similar in nature. However, there may be some divergence of practice between U.S. GAAP and IFRS issuers since the VIE concept does not exist in IFRS.

- Removal of gain-on-sale accounting should aid core earnings assessments.

Operating Trends

Fitch believes the accounting amendments will improve the integrity of the income statement as gain-on-sale accounting and excess spread assets are removed. Analysts have often had a difficult time normalizing gain-on-sale income when projecting future earnings potential as it is highly dependent on the level of securitization activity and market conditions and it is a noncash item. SLM Corporation, an active issuer of student loan ABS, has historically reported “Core Earnings” measures, which adjust for securitization accounting, derivative mark-to-markets, and amortization of intangibles, to help analysts assess core operating trends. With the removal of securitization accounting, analysts will now be able to focus on forecasts of managed asset growth, credit loss expectations, and funding costs when predicting earnings potential, and peer comparisons may be easier to understand.

Separately, excess spread assets have wreaked havoc on income statements in recent quarters as rising credit losses have resulted in material and frequent writedowns of interest-only (IO) strips and/or retained interests. Excess spread assets will be backed out upon reconsolidation, so quarterly fair market value movements of ABS assets will no longer impact reported earnings.

- Four measurement methods could make peer comparisons difficult.
- Historical cost method expected to be the most difficult, operationally, to implement.
- Fair value methods could result in initial gains on liabilities.

Initial Reconsolidation Methods

There is no grandfathering of existing off-balance sheet issues. All outstanding VIEs and QSPEs must be evaluated for consolidation under the new requirements. Unfortunately for analysts, FASB will allow four different ways to measure the assets and liabilities upon consolidation of existing structures, which could hamper comparative analysis. The measurement methods are as follows:

1. Issuers should initially measure the assets, liabilities, and noncontrolling interests of a VIE at their carrying amounts as if the amendments had been effective when the issuer first met the conditions to be the primary beneficiary.

2. If measurement under method one is not practicable, the issuer should measure the assets, liabilities, and noncontrolling interests of the variable interest entity at fair value at the date of adoption of the new standard.
3. For VIEs that are primarily related to securitizations or other forms of asset-backed financings or in those cases where the assets can be used only to settle obligations of the VIE, the assets and liabilities of the entity, other than those that are required to be measured at fair value, may be measured at their unpaid principal balance at the date of adoption. The issuer that consolidates such a VIE must also recognize any accrued interest, allowance for credit losses, and other-than-temporary impairments.
4. Issuers are allowed to elect the fair value option for all eligible financial assets and liabilities of the VIE. This option can only be applied on an entity by entity basis.

Operationally, Fitch believes the first method would be the most difficult to implement, because it would require a significant amount of historical information. However, we believe it may be the encouraged method of reconsolidation, particularly for issuers that continue to have some level of involvement in their off-balance sheet entities. The revolving nature of a credit card trust, for example, and its shorter average duration, would likely make it a good candidate for measurement method one.

The second method may be attractive for its relative simplicity; however, it could understate issuer leverage to some extent. Credit spreads have widened materially on ABS bonds due to deteriorating asset performance and investor risk aversion, which means the fair value of the bonds has declined. Consolidating these bonds at fair value, would understate leverage because the ultimate obligation of the trust remains the higher par value (not fair value) of the bonds. The fair value would accrete over time through the income statement, reaching par at maturity.

Options three and four could result in some VIEs being consolidated at unpaid principal balances, others being consolidated at fair value, and still others being consolidated as if the off-balance sheet sale never took place. Fitch believes this could make it extremely difficult to track the true economics of an issuer's assets and liabilities over time. Furthermore, option number four would require the assets and liabilities of the VIE to be marked to market on a quarterly basis, in accordance with SFAS 159, with any unrealized fair value marks hitting the balance sheet and income statement. If, for example, the issuer's bond spreads contracted materially in a quarter, the company would need to mark the value of the ABS bonds up, creating an unrealized loss on its liabilities. While Fitch makes adjustments to consider debt at par, the volatility on the issuer's financial statements could make it more difficult for analysts to track.

- Numerous balance sheet and income statement adjustments required.

Hypothetical Example: Method 1

To gain a better understanding of the accounting impact of the standard changes, Fitch has created financial statements for a hypothetical credit card issuer that securitizes a portion of its business. The adjustments to create the pro forma financial statements demonstrate the impact the accounting changes will have on the balance sheet and income statement, assuming the issuer reconsolidates using the first method permitted by FASB.

The hypothetical structure is a credit card trust, which assumes the issuer has an excess spread asset in the form of an IO and that the issuer has recently retained subordinated notes issued out of the trust in its AFS securities portfolio and has been marking those notes to fair value on a quarterly basis.

Hypothetical Balance Sheet

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	As Reported	Adjustments	Pro Forma
Assets			
Cash	20,000	—	20,000
Interest Bearing Deposits in Other Banks	5,000	—	5,000
Total Cash and Cash Equivalents	25,000	—	25,000
Accounts Receivable, Net	19,500	—	19,500
Loans	50,000	35,000 a	85,000
Allowance for Loans	(4,000)	(2,800) b	(6,800)
Net Loans	46,000	—	78,200
Investment Securities	20,000	(1,300) d	19,100
	—	400 e	—
Property and Equipment	2,000	—	2,000
Other Assets	10,000	(140) f	10,785
	—	(55) g	—
	—	980 c	—
Total Assets	122,500	32,085	154,585
Liabilities			
Customer Deposits	55,000	—	55,000
Accounts Payable	4,000	—	4,000
Short-Term Debt	7,000	—	7,000
Long-Term Debt	28,000	35,000 a	61,700
	—	(1,300) d	—
Other Liabilities	8,000	—	8,000
Total Liabilities	102,000	33,700	135,700
Stockholders' Equity			
Common Stock	1,000	—	1,000
Additional Paid-in-Capital	16,000	—	16,000
Retained Earnings	6,500	(2,800) b	4,625
	—	(55) g	—
	—	980 c	—
Accumulated Other Comprehensive Income/(Loss)	(3,000)	400 e	(2,740)
	—	(140) f	—
Total Shareholders' Equity	20,500	(1,615)	18,885
Total Liabilities and Shareholders' Equity	122,500	32,085	154,585

Below is a description of the material adjustments to the balance sheet:

- a) Increase loans and related debt by the amount of the investors' interest in the securitizations.
- b) True up the allowance for loan losses to account for loans being reconsolidated from securitization trusts. If this figure is not disclosed, utilize the loan loss reserve percentage for the unsecuritized portion of the loan book. The offsetting entry is a reduction to retained earnings.
- c) Adjust for the tax impact of recognizing the loan loss reserves. Create a deferred tax asset recorded in other assets and decrease retained earnings by an amount equal to the loan loss reserve times the effective tax rate.
- d) Eliminate the cost basis of the retained interests included as investments on the balance sheet. The corresponding debit reduces the amount of debt initially recognized in adjustment a.

- e) Reverse any fair value adjustment made to the cost basis of retained interests (if included in AFS investments) into accumulated other comprehensive income (AOCI).
- f) Adjust for the deferred tax impact of the fair value adjustment for retained interests. For fair value losses, reduce deferred tax assets and AOCI by an amount equal to the effective tax rate times the difference between the cost basis and fair value.
- g) Write off the book value of any IO strip asset by reducing other assets and retained earnings.

Hypothetical Income Statement

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	As Reported	Adjustments	Pro-forma
Interest Income			
Loans	6,500	3,200 a	9,700
Interest on Investments	1,500	–	1,500
Deposits with Banks	250	–	250
Total Interest Income	8,250	3,200	11,450
Interest Expense			
Deposits	1,100	–	1,100
Short-Term Debt	210	–	210
Long-Term Debt	2,000	2,300 b	4,300
Other	500	–	500
Total Interest Expense	3,810	2,300	6,110
Net Interest Income	4,440	900	5,340
Provision for Loan Losses	(2,800)	(2,100) c	(4,900)
Net Interest Income after Provision for Loan Losses	1,640	(1,200)	440
Non-Interest Income			
Servicing and Securitizations	1,500	(1,500) d	–
Service Charges and Other Fees	3,900	(600) e	3,300
Other	750	–	750
Total Non-Interest Income	6,150	(2,100)	4,050
Non-Interest Expense			
Salaries and Benefits	3,500	–	3,500
Sales and Marketing	1,200	–	1,200
Other	850	–	850
Total Non-Interest Expense	5,550	–	5,550
Pretax Income	2,240	(3,300)	(1,060)
Income Tax Provision	(800)	1,100 f	300
Net Income	1,440	(2,200)	(760)

Below is a description of the material adjustments to the income statement. These amounts may be disclosed or they may have to be estimated using the metrics for income and expense for similar instruments that were not securitized.

- a) Increase the interest income on the loans included in the securitization.
- b) Increase interest expense for the debt associated with the securitization.
- c) Increase provision for loan losses for the period for those loans included in the securitization.
- d) Eliminate income from securitization transactions. This can include excess spread income, servicing fees, gains/(losses) on sales from securitization transactions, and revaluation of retained interest assets.

- e) Add back commission and other fee income associated with securitized loans. The trust is often afforded interchange income, card fees, and other commissions earned on securitized loans in the trust. When the trust is reconsolidated, that income must be added to the income statement.
- f) Include the tax effect of the total pretax adjustments to income using the effective tax rate.

Fitch believes making these adjustments will give analysts a close proxy as to what impact the accounting amendments will have on an issuer's balance sheet and income statement. However, the individual line item adjustments may not be fully disclosed in the initial public filings following the accounting change. Fitch believes the biggest optical challenge for analysts to absorb will be the hit to equity resulting from a true-up of the allowance for loan losses.

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