Off-Balance Sheet Financing

On-balance sheet financing is any form of direct debt or equity funding of a firm. If the funding is equity, it appears on the firm's balance sheet as owners' equity. If it is debt, it appears on the balance sheet as a liability. Any asset the firm acquires with the funding also appears on the balance sheet.

Off-balance sheet financing, by comparison, is any form of funding that avoids placing owners' equity, liabilities or assets on a firm's balance sheet. This is generally accomplished by placing those items on some other entity's balance sheet.

A standard approach is to form a special purpose vehicle (SPV) and place assets and liabilities on its balance sheet. Also called a special purpose entity (SPE), an SPV is a firm or legal entity established to perform some narrowly-defined or temporary purpose. The sponsoring firm accomplishes that purpose without having to carry any of the associated assets or liabilities on its own balance sheet. The purpose is achieved "off-balance sheet."

Under most accounting regimes, if a sponsoring firm wholly owns an SPV, the SPV's balance sheets are consolidated into its own. Rather than have the SPV appear on its balance sheet as an asset, the sponsoring firm has all the SPV's individual assets and liabilities appear on its balance sheet just as if they were the sponsoring firm's assets and liabilities. This is on-balance sheet financing, which largely defeats the purpose of the SPV. For this reason, a sponsoring firm typically takes only a partial ownership position in the SPV. In other arrangements, it takes no ownership interest in the SPV whatsoever.

SPVs are used in a variety of transactions, including securitizations, project finance, and leasing. An SPV can take various legal forms, including corporations, US-style trusts or partnerships.

Off-balance sheet financing is attractive from a risk management standpoint. When assets and liabilities are moved from one balance sheet to another, the risks associated with those assets and liabilities go with them. For example, if a firm transfers credit risky assets to an SPV, the credit risk goes with those assets.

Off-balance sheet financing also affords considerable flexibility in financing. An SPV doesn't utilize the sponsoring firm's credit lines or other financing channels. It is presented to financiers as a stand-alone entity with its own risk-reward characteristics. It can issue its own debt or

establish its own lines of credit. Often, a sponsoring firm overcapitalizes an SPV or supplies it with credit enhancement. In this circumstance, the SPV may have a higher credit rating than the sponsoring firm, and it will achieve a lower cost of funding. A BBB-rated firm can achieve AAA-rated financing costs if it arranges that financing through a sufficiently capitalized SPV.

Off-balance sheet financing is often employed as a means of asset-liability management. Obviously, if assets and liabilities are never placed on the balance sheet, they don't have to be matched! They do need to be matched on the SPV's balance sheet, but the SPV can be structured in a way that facilitates this. A pass-through is a security issued by a special purpose vehicle. The SPV holds assets and pays the pass-through's investors whatever net cash flows those assets generate. In this way, the SPV's assets and liabilities are automatically cash matched, so there is no asset-liability risk. Many securitizations are structured as pass-throughs. See, for example, the discussion of mortgage pass-throughs.

Off-balance sheet financing has other applications. SPVs can be used in tax avoidance. Banks use off-balance sheet financing to achieve reductions in their regulatory capital requirements. This is a compelling reason for many securitizations. It is also the purpose of trust preferred securities.

While SPVs and off-balance sheet financing have many legitimate purposes, they can also be used to misrepresent a firm's financial condition. Prior to its bankruptcy, Enron created numerous SPVs and used them to hide billions of dollars in debt. That abuse, as well as other scandals during 2001-2002, prompted a reexamination of SPVs. Laws, regulations and accounting rules were tightened as a result.