

fasb 140

Securitization Accounting under FASB 140 The Standard Formerly Known as FASB 125

by Marty Rosenblatt and Jim Johnson

1ST
EDITION
JAN
2001

**Deloitte
& Touche**

	Preface	2
1	What is FASB 140, and when does it apply? FASB 140 applies to: FASB 140 does not apply to:	5 5
2	Determining whether a <i>securitization</i> meets the sale criteria When is a <i>securitization</i> accounted for as a sale? What does it take to be a QSPE? Do I ever have to consolidate a QSPE? How about an SPE? If you don't put it to me, can I call it from you? Can I still hold on to the <i>ROAPs</i> ? Can I have my cake and eat it too with debt-for-tax and a sale for GAAP? Can warehouse funding arrangements be off-balance sheet? Can I metaphysically convert loans to securities on my balance sheet? Do banks have to use a two-tier structure to get sale treatment? Do I always need to bother my lawyer for an opinion letter? Should I join the pack who is abandoning Gain on Sale Accounting?	7 10 13 16 19 20 21 23 24 25 27
3	Questions related to calculating gain or loss on sale How do I calculate gain or loss when I retain some bond classes or a residual? How is gain or loss calculated in a revolving structure? Is there a sample gain on sale worksheet that I can use as a template? How about a credit card example? And a lease example? Is fair value in the eyes of the "B-holder"? What are the auditors' responsibilities for fair value? What if I can't estimate fair value? Can I record an asset for servicing? Should I record a liability for retained credit risk? How are cash reserve accounts handled? <i>Desecuritizations</i> -What if we put Humpty-Dumpty back together again?	32 33 34 35 36 37 38 39 40 43 44 45
4	Investor Accounting How do I account for securities with prepayment and/or credit risk?	47
5	Through the looking glass—The FASB's new required disclosures	55
6	What's slated for 2001?	61
7	Are You Ready to Play <i>Who Wants to Be an Accountant</i> ?	63
	Index	

fasb

140

Securitization Accounting under FASB 140
The Standard Formerly Known as FASB 125

1ST
EDITION

JAN 2001

Just when we thought we had mastered FASB 125, the Financial Accounting Standards Board went ahead and replaced it with FASB 140. The new statement keeps the same title, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities*, but calls for some sweeping changes. As a result, securitizers should carefully review their deal templates used in past transactions. What's worked for you in the past might need to be tweaked to work in the future.

This booklet only deals with securitizations. It does not attempt to deal with the other transactions covered in FASB 140—repos, dollar rolls, securities lending, wash sales, loan syndications, loan participations, banker's acceptances, factoring arrangements, debt extinguishments and in-substance defeasances. This FASB 140 transaction potpourri explains why many securitization marketplace participants find it cumbersome to work with the actual Statement.

We highlight below some of the more significant provisions of FASB 140 affecting securitization deal-structuring beginning with the answer to the question, *What's so good about being a QSPE?*:

✓ **FASB 140** states unequivocally that the assets and liabilities of a Qualifying Special Purpose Entity (QSPE) do not get consolidated into the financial statements of the transferor. This is true even when the transferor retains 100 percent of the so-called equity class and even when there is no "equity class." If the issuer fails to qualify as a QSPE, third-party investors must make equity investments that are substantive (e.g., more than 3 percent of assets), controlling (e.g., more than 50 percent of ownership), bear the first dollar risk of loss and take the legal form of equity; otherwise, the transferor or other sponsor consolidates.

✓ **FASB 140** adds additional qualifications to be a QSPE. It has to be more brain-dead than ever (i.e., DOA), with additional restrictions on the activities it can conduct, the assets and derivatives it can hold and which assets it can sell and when.

✓ **FASB 140** significantly beefs up disclosures about securitization transactions and residual interests (when the transaction is accounted for as a sale). The new disclosures include (1) static pool actual and projected losses; (2) stress tests showing the reductions in fair value of retained interests that would result from adverse changes in prepayments, losses and discount rates; (3) all cash flows between the securitization SPE and the transferor during the period; and (4) delinquencies at the end of the period and net credit losses during the period for both on and off-balance sheet assets the transferor manages.

✓ **FASB 140** narrows the types of **ROAPs** (Removal of Accounts Provisions) compatible with sale accounting. ROAPs are commonly featured in revolving structures such as credit card master trusts.

✓ **FASB 140** eliminates the special exemption that FDIC-insured banks enjoyed. They now have to demonstrate that the securitized assets are **legally isolated**. But with the FDIC's recent securitization-friendly ruling, we anticipate that attorneys will be able to conclude that most bank securitizations will meet the legal isolation test.

FASB 140 applies to new transfers of financial assets occurring after March 31, 2001. It cannot be applied to earlier transfers. But, it's not quite that simple. FASB 140 does not apply to those transfers of assets made after March 31, 2001 that are required by commitments made by the transferor before that date. These commitments are found in revolving securitizations. Similarly, a pre-existing QSPE that fails to conform to FASB 140 requirements is grandfathered if it maintains its QSPE status under today's GAAP, does not issue new beneficial interests after March 31, 2001, and does not receive new assets after that date (except pursuant to preexisting commitments of the type described above).

The securitization disclosures have an earlier effective date. They are required in **annual** financial statements for companies with year-ends as early as December 2000.

The FASB and its Emerging Issues Task Force still face the challenge of keeping pace with the continuous innovations in the securitization market and, perhaps developing additional guidance (see section 6). We make a constant effort to stay current in this ever-changing market, and hope that this effort is reflected in the following pages. Thank you for your continuing interest. We look forward to providing further updates in the months and years ahead.

Sincerely,

Marty Rosenblatt *Jim Johnson*

If you would like to receive our periodic bulletin, S.O.S.-Speaking of Securitization, covering accounting, tax, regulatory and other developments affecting the securitization market, just send an email to securitization@deloitte.com

what is

fasb

140

it

AND WHEN DOES

APPLY?

FASB 140 applies to:

- public and private companies;
- public and private offerings;
- all transfers of financial assets; and
- resecuritizations of existing ABS, MBS, CMBS and CDO classes

FASB 140 does not apply to:

- transfers of nonfinancial assets such as operating leases, unguaranteed lease residuals from capital leases, servicing rights, stranded utility costs, or sales of future revenues such as entertainers' royalty receipts;
- investor accounting (but see section 4, How do I account for securities with prepayment and/or credit risk?);
- income tax sale vs. borrowing characterizations or tax gain/loss calculations;¹
- regulatory accounting or risk-based capital rules for depository institutions;²
- statutory accounting or risk-based capital rules for insurance companies;³
- accounting principles outside of the United States (but FASB 140 **does** apply to:
 - foreign companies that follow U.S. GAAP (e.g., for SEC filings)
 - transactions by foreign subsidiaries in consolidated financial statements of U.S. parents).⁴

-
1. The Financial Asset Securitization Investment Trust (FASIT) tax legislation became effective September 1, 1997, but FASITs have not been popular vehicles. See page 30.
 2. Federally chartered banks and thrifts are required to follow generally accepted accounting principles (i.e., FASB 140) when preparing Call Reports and Thrift Financial Reports. However, pursuant to the risk-based capital rules, in asset sales in which the bank provides recourse, the bank generally must hold capital applicable to the full outstanding amount of the assets transferred. The "low-level recourse" rule limits the risk-based capital charge to the lower of (a) the bank's maximum contractual exposure under the recourse obligation (e.g., the book value of a spread account or subordinated security) or (b) the amount of capital that would have been required, had the assets not been transferred. The federal banking agencies issued a notice of proposed rule making in October 2000 that would require dollar-for-dollar capital for all retained interests that provide credit enhancement and would limit the maximum amount of these assets a bank could hold as a percentage of Tier 1 capital. Stay tuned for further developments.
 3. The National Association of Insurance Commissioners (NAIC) has adopted, in Statement of Statutory Accounting Principles No. 33, the securitization guidance in FASB 125 except (a) sales treatment is not permitted for transactions where recourse provisions or call or put options exist and (b) servicing rights assets are non-admitted assets. "Recourse" for these purposes does not include the retention of a subordinated class in a securitization.
 4. Our firm has compiled descriptions of the accounting for securitizations in 33 countries. Excerpts are included in the 1999 Annual Database published by *International Securitisation Report*, and can also be obtained by contacting Frank Dubas at +1 212 436 4219, fdubas@deloitte.com.

determining

whether

the

SECURITIZATION MEETS THE

SALE

CRITERIA

WHEN IS A SECURITIZATION ACCOUNTED FOR AS A SALE?

A securitization is accounted for in one of the following ways, depending on the deal structure and terms:

- As a sale (when the transferor has no continuing involvement with the transferred assets).
- As a financing (when the transfer fails to meet one or more of FASB 140's criteria for sale accounting discussed below).
- As neither a sale nor a financing (when no proceeds are raised other than interests in the transferred assets, as in a swap of mortgage loans for mortgage-backed securities).
- As a partial sale (when the transferor retains servicing and/or one or more of the bond classes and the FASB 140 sale criteria are met for the sold classes). This is probably the most prevalent treatment of securitizations today. The cash funding is "off-balance sheet" and the retained interests continue to be on-balance sheet assets of the transferor, albeit assets of a different kind. Partial sale is also used to describe transactions in which only a partial interest (e.g., a pro rata nine-tenths interest in loans) is securitized.
- As a part sale and part financing (when the sale of certain classes meet the FASB 140 sale criteria while the "sale" of other classes do not, such as when the transferor holds a call option on a particular class).

Sale Criteria

A securitization of a financial asset, a portion of a financial asset, or a pool of financial assets in which the transferor (1) surrenders control over the assets transferred and (2) receives cash or other proceeds is accounted for as a sale (or partial sale). Receiving beneficial interests in the same underlying assets does not count as proceeds for this purpose. Control is considered to be surrendered in a securitization only if all three of the following conditions are met:

- 1. The transferred assets have been isolated from the transferor — put beyond the reach of the transferor, or any consolidated affiliate of the transferor, and their creditors (either by a single transaction or a series of transactions taken as a whole) even in the event of bankruptcy or receivership of the transferor or any consolidated affiliate. [9a and 27] ⁵**

This is a "facts and circumstances" determination, which includes judgments about the kind of bankruptcy or other receivership into which a transferor or affiliate might be placed, whether a transfer would likely be deemed a true sale at law, and whether the transferor is affiliated with the transferee. In contrast to the "going-concern" convention in accounting, the transferor must deal with the possibility of bankruptcy, regardless of how remote it may seem in relation to the transferor's current credit standing. For example, in spite of its enviable credit standing, a double-A rated issuer of auto paper must take steps to isolate the assets in the event of bankruptcy. It cannot simply assert that it is unthinkable that a bankruptcy situation could develop during the relatively short term of the securitization.

5. Numbers within brackets refer to paragraph numbers of FASB 140.

Many securitizations use two transfers to isolate transferred assets beyond the reach of the transferor and its creditors:

STEP 1: The corporation transfers assets to a special-purpose corporation (SPC) that, although wholly owned, is designed in such a way that the possibility that the transferor or its creditors could reclaim the assets is remote. This first transfer is designed to be judged a true sale at law, in part because it does not provide “excessive” credit or yield protection to the SPC.

STEP 2: The SPC transfers the assets to a trust or other legal vehicle with a sufficient increase in the credit and yield protection on the second transfer (provided by a junior retained beneficial interest or other means) to merit the high credit rating sought by investors. The second transfer may or may not be judged a true sale at law and, in theory, could be reached by a bankruptcy trustee for the SPC. However, the SPC’s charter forbids it from undertaking any other business or incurring any liabilities, so that there can be no creditors to petition to place it in bankruptcy. Accordingly, the SPC is designed to make remote the possibility that it would enter bankruptcy, either by itself or by substantive consolidation into a bankruptcy of its parent should that occur. [83]

See page 25 for the form of lawyer’s letter needed to provide reasonable assurance that the transferred assets would be “beyond the reach.”

2. **The transferee (or, in a two-tier structure, the second transferee) is a QSPE and each holder of its beneficial interests (including both debt and equity securities) has the right to pledge, or the right to exchange its interests. If the issuing vehicle is NOT a QSPE, then sale accounting is only permitted if the issuing vehicle itself has the right to pledge or the right to exchange the transferred assets.** [9b and 29]

Any restrictions or constraints on the rights of a holder of a QSPE’s securities to pledge or to sell their security have to be carefully evaluated to see if they preclude sale accounting, particularly if they provide some benefit to the transferor. Similarly, if the issuing entity is not a QSPE, any restrictions or constraints on the entity’s right to pledge or sell the transferred assets, have to be carefully evaluated. See page 16, *If you don’t put it to me, can I call it from you?*

Whether a securitization vehicle is a QSPE is extremely important because a transferor does not consolidate the assets and liabilities of a QSPE. QSPEs are basically designed to operate on “automatic pilot.” A non-qualifying vehicle may need to be consolidated. See page 13, *Do I ever have to consolidate a QSPE? How about an SPE?*

Note that in a two-tier structure (see above), the entity that issues the securities (e.g., the trust) needs to be the QSPE. The “intermediate SPE” (e.g., the Depositor) is typically not considered a QSPE. As long as the “issuing SPE” is a QSPE, the nature of the intermediate entities should not affect consolidation accounting. This is also true with respect to “rent-a-shelf” transactions. See page 10, *What does it take to be a QSPE?* FASB 140 does not address the balance sheet or

income statement accounting by the SPC, which is usually the registrant for SEC filing purposes, or the related trusts which are usually the issuers.

Holders of a QSPE's securities are sometimes limited in their ability to transfer their interests, due to a requirement that permits transfers only if the transfer is exempt from the requirements of the Securities Act of 1933. The primary limitation imposed by Rule 144A of the Securities Act, that a potential secondary purchaser must be a sophisticated investor, does not preclude sale accounting. Neither does the absence of an active market for the securities. [30]

3. The transferor does not effectively maintain control over the transferred assets either through:

(a) an agreement that calls for the transferor to repurchase the transferred assets (or to buy back securities of a QSPE held by third-party investors) before their maturity (in other words, the agreement both entitles and obligates the transferor to repurchase as would, for example, a forward contract or a repo); or

(b) the ability to unilaterally cause the SPE or QSPE to return specific assets, other than through a cleanup call. (See discussion on page 16 of cleanup and other types of calls.)

There is some overlap between the second and third tests. They both look at aspects that suggest direct or indirect seller control. The second test focuses on restrictions faced by the transferee. The third test looks to rights of control over the specific assets transferred (which may continue following a transfer of those assets by the transferee to a third party).

The FASB chose to preclude sale accounting if the transferor to a QSPE has any ability to unilaterally take back specific assets on terms that are potentially advantageous (e.g., fixed or determinable price)—whether through the liquidation of the entity, a call option, forward purchase contract, removal of accounts provision or other means. In these cases, the transferor maintains effective control. It is able to initiate an action to reclaim specific assets. The transferor knows that a QSPE still holds the assets because of the restrictions placed on it. [232]

In a significant change from current GAAP, a transferor holding a residual interest is precluded from participating in a QSPE's auction process at the scheduled termination of a QSPE's existence. If the transferor holds the residual interest in the QSPE and the assets are to be auctioned at a specified date, the transferor effectively would have unilateral control over the assets if it were allowed to bid in the auction. It could "pay" any price to ensure that it would win the auction and thus get back the assets. Any excess the transferor pays over fair value would go from its left pocket into its right pocket via the QSPE's final distribution of remaining assets to the residual interest holder. [235]

Failure to comply with the sale criteria

If the transfer does not qualify as a sale, the proceeds raised (other than retained interests) will be accounted for as a liability—a secured borrowing, with no gain or loss recognized, and the assets will remain on the balance sheet. They should be reclassified separately from other assets not encumbered and labeled as being restricted for the repayment of the borrowing. [12]

Even accounting for a securitization as a financing requires the use of many subjective judgments and estimates and could still cause volatility in earnings due to the usual factors of prepayments and credit losses. After all, the company still effectively owns a residual even though you cannot find it on the balance sheet. It is the excess of the securitized assets over the associated debt albeit at their original amounts, not at a repriced amount based on the securitization scenario.

WHAT DOES IT TAKE TO BE A QSPE?

A lobotomy. If the QSPE isn't totally brain dead, it must at least be on automatic pilot. A QSPE is a trust or other legal vehicle that meets all four of the following conditions: [35]

CONDITION	QUALIFICATIONS (ITALICIZED TERMS ARE DEFINED IN THE CHART FOLLOWING THIS ONE)
a. It is <i>“demonstratively distinct”</i> from the transferor	It can not be <i>unilaterally dissolved</i> by the transferor, its <i>affiliates</i> or its <i>agents</i> AND either (1) at least 10% of the fair value of its beneficial interests is held by independent third parties or (2) the transfer is a <i>guaranteed mortgage securitization</i> . [36] The 10% requirement (for non-guaranteed mortgage securitizations) must be met at all times including the ramp up or wind down phase of a deal. When not met, the SPE is consolidated.
b. Limits on permitted activities	<p>Its permitted activities :</p> <p>(1) are significantly limited</p> <p>(2) are entirely specified upfront in the legal documents that created the SPE or its beneficial interests</p> <p>(3) may be changed only with the approval of the holders of at least a majority of the beneficial interests held by <i>independent third parties</i>. [37 and 38]</p> <p>It is not always clear which decisions are inherent in servicing the asset and which go beyond the customary responsibilities of servicing, which also vary by the type of asset.</p>
c. Limits on the assets it can hold	<p>It may hold only:</p> <p>(1) <i>Passive</i> financial assets transferred to it [39]</p> <p>(2) <i>Passive</i> derivative financial instruments that <i>pertain</i> to beneficial interests owned by independent third parties [39 and 40]</p> <p>(3) Financial assets such as guarantee policies or other rights of reimbursement for inadequate servicing by others or defaults or delinquencies on its assets provided such agreements were entered into when the entity was established, when assets were transferred to it, or when securities were issued by it</p> <p>(4) Related servicing rights</p> <p>(5) Temporarily, nonfinancial assets obtained in the process of foreclosure or repossession</p> <p>(6) Cash and <i>temporary investments</i> pending distribution to security holders</p>
d. Limits on permitted sales, exchanges, puts, or distributions of its assets [189]	<p>It can only dispose of assets in automatic response to one of the following events:</p> <p>(1) Occurrence of an event that:</p> <p>a. is specified in the applicable legal documents;</p> <p>b. is outside the control of the transferor, its affiliates and its agents; and</p> <p>c. causes or is expected to cause the fair value of those assets to decline by a specified degree below their fair value when the SPE obtained them [42 and 43]</p> <p>(2) Exercise of a put option by a third-party beneficial interest holder in exchange for:</p> <p>a. a full or partial distribution of assets</p> <p>b. cash (which may require that the SPE dispose of assets or issue beneficial interests to generate cash to fund the settlement of the put)</p> <p>c. new beneficial interests in those assets [44]</p> <p>(3) Exercise of a call option or ROAP by the transferor [51-54 and 85-88]</p> <p>(4) Termination of the SPE or maturity of the beneficial interests on a fixed or determinable date that is specified at inception [45]</p>

Here's a lexicon of terms needed to apply the guidance in the preceding table:

unilaterally dissolved	An ability to unilaterally dissolve an SPE can take many forms, including holding sufficient beneficial interests to demand that the trustee dissolve the SPE, the right to call all the assets transferred to the SPE, and a right to call or prepay the securities held by independent third parties. [36]
independent third parties	Parties other than the transferor, its affiliates or its agents. Affiliates are parties that, directly or indirectly through one or more intermediaries, control, are controlled by, or are under common control with the transferor. [FASB57, ¶24(a)] Control is the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of an enterprise through ownership, by contract, or otherwise. [FASB57, ¶24(b)] Agents are parties that act for and on behalf of the transferor. [153]
guaranteed mortgage securitization	A securitization of mortgage loans that includes a "substantive" guarantee by a third party (a guarantee that adds value or liquidity to the security). [182]
passive	A financial asset or derivative is passive only if the SPE is not involved in making decisions other than the decisions inherent in servicing. [39] It is not always clear which decisions are inherent in servicing the asset and which go beyond the customary responsibilities of servicing, which also vary by the type of asset.
pertain to	See table on derivatives on page 12
temporary investments	Money-market or other relatively risk-free instruments without options and with maturities no later than the expected distribution date. [35]

Limits on the Assets a QSPE Can Hold

The FASB concluded that it is inconsistent with a QSPE's limited purpose for it to actively purchase its assets in the marketplace; instead a QSPE should passively accept those assets transferred to it. The FASB also concluded that it is inconsistent for a QSPE to hold assets that are not passive, because holding nonpassive assets involves making decisions (a responsibility inconsistent with the notion of only acting as a passive custodian for the benefit of beneficial interest holders). Accordingly, the FASB does not allow a QSPE to hold equity investments large enough either in themselves or in combination with other investments that enable it (or any related entity) to exercise control or significant influence over an investee. For the same reasons, the FASB does not allow a QSPE to hold equity securities that have voting rights attached unless the SPE (and the transferor) have no ability to exercise the voting rights or to choose how to vote. [185]

EXAMPLE *The following example deals with restrictions on a QSPE's temporary investments: An SPE has cash balances that will not be distributed to beneficial interest holders for 200 days. The documents that establish the SPE give it the discretion, in these circumstances, to choose between investing in commercial paper obligations that mature in either 90 or 180 days. This discretion does not preclude the SPE from being qualifying. If, in these circumstances, the SPE also has the discretion to invest in 360-day commercial paper with the intent to sell it in 200 days, the SPE is not qualifying.*

Limits on the Derivatives a QSPE Can Hold

A QSPE only may hold passive derivative financial instruments that pertain to beneficial interests sold to independent third parties. The transferor can be and often is the counterparty to a

derivative contract with a QSPE. A derivative is passive only if holding it does not involve the SPE in making decisions. A derivative is not passive if, for example, its terms allow the SPE a choice, such as an option to call or put other financial instruments. Some derivatives are indeed passive; for example, interest rate caps, floors and swaps (since they payoff automatically when they are in the money). Forward contracts are passive if they do not allow a choice in the settlement mechanism. [39]

The objective of the following provisions is to effectively prevent transferors from avoiding the accounting requirements of FASB 133 by utilizing securitization trusts to package derivatives. [40] A derivative financial instrument pertains to beneficial interests issued only if it:	
a. Is entered into: (1) when the beneficial interests are purchased by independent third parties (2) when another derivative must be replaced upon a pre-stipulated occurrence of an event outside the control of the transferor, its affiliates, or its agents (e.g., the default or downgrading of a derivative counterparty)	The FASB was concerned that some derivatives or hedging strategies require too many decision-making abilities to be held by a QSPE. [187]
b. Has a notional amount that does not initially exceed the amount of beneficial interests held by outsiders and is not expected to exceed them subsequently	The FASB wanted to ensure that the derivatives pertain only to the interests held by outsiders. [188] They noted that if the transferor wants to enter into derivatives pertaining to the interests it holds, it could accomplish that by entering into such derivatives on its own behalf, while accounting for them under FASB 133. [187]
c. Has characteristics that relate to, and partly or fully (but not excessively) counteract, some risk associated with those beneficial interests held by outsiders or the related transferred assets	Because leverage can make a derivative more potent than its notional amount indicates, the FASB decided to impose some risk management criteria short of mandating that the derivative qualifies as a fair value or cash flow hedge under the rigorous requirements of FASB 133. [188]

EXAMPLE BankNet transfers \$100 million of fixed rate term loans to an SPE. The SPE issues \$90 million of variable rate bonds to third parties. BankNet retains the residual. The vehicle enters into a \$100 million notional amount floating-for-fixed interest rate swap to address the mismatch between its assets and the bonds. BankNet expects that some loans will default or prepay. The swap’s notional amount automatically decreases for prepayments or credit losses on individual transferred loans.

The vehicle is not a QSPE because the interest rate swap “pertains” to beneficial interests held by third parties **and** by the transferor. If the initial notional amount of the swap was \$90 million (and the automatic amortization provision appropriately modified), the derivative would be permitted.

Limits on QSPE Sales of Assets

A QSPE or its agents cannot have the power to choose whether or when it disposes of specific assets. As shown in the earlier table and in the following four situations, the FASB limits asset dispositions to those that are effectively forced on the QSPE or are premeditated:

- 1] The trustee or management of the QSPE (under fiduciary duties to protect the interests of all parties to the structure) is required to dispose of assets in response to certain pre-ordained adverse events outside their control (see examples below).

- 2] The QSPE is required to dispose of assets, if funds are needed, to repurchase beneficial interests upon the exercise of an option held by third-party holders.
- 3] The transferor removes assets from the SPE under ROAPs or call provisions. Even though the transferee might still qualify as a QSPE, that's probably not good enough! These provisions might preclude sale accounting for the transferred assets; so merely escaping consolidation via the QSPE status might not get the transaction off-balance sheet.
- 4] The entity is required to liquidate or otherwise dispose of its assets on a determinable date set at its inception (however, a transferor who also holds the residual interest cannot purchase the assets). [189]



Examples of acceptable triggering events (see item 1 above):

- Servicing failures that jeopardize a 3rd party guarantee
- Obligor default
- Rating downgrades below a specified minimum rating
- Transferor insolvency
- A specified decline in the fair value of the transferred assets below their value at the transfer date [42]



Examples of unacceptable powers to dispose of assets:

- The SPE can choose to either dispose of the asset or hold it in a response to a default, a downgrade, a decline in fair value or a servicing failure. The FASB did not specify a maximum time frame for the sales process (to avoid a fire sale) when disposition is the route that the documents call for. The FASB considered but refused to allow a QSPE or its servicer to exercise a commercially reasonable and customary amount of discretion in deciding whether to dispose of assets in these circumstances. [190]
- The SPE must dispose of a marketable equity security upon a specified decline from its highest fair value if that power could result in disposing of the asset for an amount that is more than the fair value of the asset at the time it was transferred to the entity.
- The SPE must dispose of the asset in response to the technical violation of a contractual provision that lacks real substance. [43]

DO I EVER HAVE TO CONSOLIDATE A QSPE? HOW ABOUT AN SPE?

A QSPE shall **not** be consolidated in the financial statements of a **transferor or its affiliates** (even if for some reason consolidation is the desired outcome). [46] Because FASB 140 focuses on transfers of assets, the FASB declined to extend the special QSPE non-consolidation privileges to parties other than the transferor or its affiliates, namely unaffiliated servicers, sponsors, agents, or other beneficial interest holders not affiliated with the transferor. So those entities (for example, a subsequent investor in the equity of a QSPE) must consider other existing or future rules on consolidation policy to determine whether consolidation of a QSPE might be required by them. [199]

Existing consolidation criteria is summarized briefly below.

If the securitization vehicle fails to meet QSPE criteria (for example, it buys and sells securities for its portfolio), the sponsor (see discussion on page 15 about who is the sponsor) needs to determine whether it must consolidate the entity using the following existing accounting guidance:

- If the sponsor, creator, transferor or third-party investor owns the majority of the equity and voting rights, and the entity is sufficiently capitalized, then the entity should be consolidated by that majority owner pursuant to ARB 51 and FASB 94.
- If the entity is nominally capitalized (see below), then regardless of who nominally owns the majority of the equity, the sponsor, creator or transferor needs to look to the consolidation criteria of EITF Abstracts Topic D-14, and by analogy, EITF 90-15, 96-16, and 96-21 to determine whether the SPE should be consolidated.

In order for the sponsor to escape consolidation when the securitization vehicle is not a QSPE, EITF Topic D-14 and related EITF topics require third-party investments:

- equal to at least three percent of total assets value (not face amounts);
- exposed to the first dollar risk of loss; and
- held by third-party investors who control the entity (via a majority of the voting rights or, in the absence of voting rights, other control features in the deal).

The SEC staff has said legal form is also critical. A third-party investment that does not take the form of equity, regardless of the degree of its risks and rewards, its treatment under the tax law, or its economic similarity to equity, does not qualify for the “3 percent test.”

The SEC staff looks to factors such as the following to support a conclusion that third-party investments are equity for purposes of measuring substantive residual equity capital investments:

- 1] The securities are treated as equity instruments for tax purposes (see page 21 for a listing of debt vs. equity factors for tax purposes).
- 2] The securities are treated as equity instruments for ERISA purposes.
- 3] There is minimal capital subordinate to the securities.
- 4] The holders of the securities have very limited creditor rights.
- 5] The sponsor is able to obtain a legal opinion concluding that the securities would be deemed to be equity under the law.

On the other hand, they’ve said that factors such as the following would lead to a conclusion that the securities were more akin to debt:

- 1] The securities are issued in the form of notes.
- 2] The securities have a principal amount and fixed final maturity date with periodic cash payments.
- 3] The securities are marketed as debt securities. Additionally, investors view the securities in a manner similar to high-yield bonds, emerging market debt, and other high risk fixed income instruments that offer a higher coupon payment to offset the investor’s exposure to event risk.

DETERMINING WHO IS THE SPONSOR (I.E., THE ONE WITH THE CONSOLIDATION RISK)


In many SPE transactions, there are several parties involved, and it may not be clear which party is the sponsor. The SEC staff says that registrants should not apply any one specific factor to determine the sponsor of an SPE, but that all of the facts and circumstances of each transaction should be considered carefully. Entities should consider the following qualitative and quantitative factors in evaluating who the sponsor is of an SPE:

FACTORS	FILL IN APPLICABLE PARTY* BELOW
Purpose. What is the business purpose of the SPE?	_____
Name. What is the name of the SPE?	_____
Nature. What are the types of operations being performed (e.g., lending or financing operations, asset management, and insurance or reinsurance)?	_____
Referral Rights. Who has, and what is the nature of, the relationships with third parties that transfer assets to or from the SPE?	*
Asset Acquisition. Who has the ability to control whether or not asset acquisitions are from the open market or from specific entities?	*
Continuing Involvement. Who is providing the services necessary for the entity to perform its operations, and who has the ability to change the service provider for asset management services, liquidity facilities, trust services and financing arrangements?	*
Placement of Debt Obligations. Who is the primary arranger of the debt placement, and who performs supporting roles associated with the debt placement?	*
Residual Economics. Who receives the residual economics of the SPE including all fee arrangements?	*
Fee Arrangements. Who receives fees for asset management, debt placement, trustee services, referral services, and liquidity/credit enhancement services and how are the fee arrangements structured?	*
Credit Facilities. Who holds the subordinated interests in the SPE?	*

* Insert the applicable party. Applicable parties include the transferor, collateral manager, placement agent, equity investor or other party.

When an SPE is consolidated into another entity's (the "parent") financial statements and the parent does not own 100 percent of the equity of the SPE, 100 percent of the SPE's assets and 100 percent of the SPE's liabilities (as well as 100 percent of the income and expenses) are nonetheless included in the parent's consolidated financial statements. In order to keep things in balance, the portion of the net equity owned by third parties is classified as "Minority (or Non-controlling) Interest in Net Assets of Consolidated Subsidiary" on the right hand side of the consolidated balance sheet and consolidated net income is reduced by the portion of the subsidiary's income relating to outside interests.

At the time of this writing, the FASB has said that they intend to issue an Exposure Draft in the second quarter of 2001 dealing with consolidations of entities that have significant limits on their permitted activities and powers (*aka* SPEs). The scope would not be limited to securitization

vehicles – it would include other types of limited-purpose entities as well. The FASB has tentatively promised that they will not overturn FASB 140's dictum that a QSPE shall not be consolidated in the financial statements of a transferor or its affiliates. [199] STAY TUNED FOR FURTHER DEVELOPMENTS. You can look to the FASB's website at www.fasb.org for updates on the status of that project. 

IF YOU DON'T PUT IT TO ME, CAN I CALL IT FROM YOU?

Let's deal with puts first, because the rules are easier. It's interesting (and to some, counter-intuitive) that options allowing investors to put their bonds back to the transferor generally do not preclude sale treatment (but be sure to check with legal counsel, as put options complicate the "true sale" analysis). The FASB's position here is consistent with the theory that the seller has relinquished control over the transferred assets. Instead, the transferee has obtained control, even if it proves only to be temporary. But a put option that is sufficiently deep-in-the-money when it is written causing it to be probable that the transferee will exercise it is problematic. [32] These puts are the economic equivalent of a repurchase agreement. Put options have been successfully used in transactions in order to provide guaranteed final maturities of short-term tranches to achieve "liquid asset" treatment for thrifts or "money market" treatment for certain classes of investors. Also, hybrid ARMs have been securitized with a put exercisable at the point when the loans turn from fixed to adjustable rate. When a securitization with a put feature is accounted for as a sale, the transferor has to record a liability equal to the fair value of the put obligation. If it is not practicable to estimate its fair value, no gain on sale can be recorded.

FASB 140 defines four types of calls [364], each potentially having a different effect on the sale vs. financing determination:

- Attached calls are call options held by the transferor that become part of and are traded with the transferred asset or beneficial interest.
- Embedded calls are call options held by the issuer of a financial asset included in a securitization that is part of and trades with the financial asset. Examples are call options embedded in corporate bonds and prepayment options embedded in mortgage loans. A call might also be embedded in a beneficial interest issued by a QSPE.
- Freestanding calls are calls that are neither embedded in nor attached to an asset subject to that call. For example, a freestanding call may be written by the transferee and held by the transferor of an asset but not travel with the asset. Freestanding calls are not commonly found in securitization transactions.
- Cleanup calls are options held by the servicer or its affiliate, (which may be the transferor) to purchase the remaining transferred financial assets, or the remaining beneficial interests in a QSPE, if the amount of outstanding assets or beneficial interests falls to a level at which the cost of servicing those assets or beneficial interests becomes burdensome in relation to the benefits of servicing. (Some readers think that "10 percent" is

synonymous with a cleanup call and are surprised that the amount 10 percent does not appear anywhere in the FASB's definition of a cleanup call.)

Any restrictions or constraints on the rights of a holder of a QSPE's securities to monetize all or most of the cash inflows (the primary economic benefits of financial assets) by pledging or selling their security have to be carefully evaluated, particularly if the restrictions or constraints provide some benefit to the transferor. Similarly, if the issuing entity is not a QSPE, any restrictions or constraints on the entity's right to pledge or sell the transferred assets, have to be carefully evaluated.

EXAMPLE *On-the-Ropes Inc. obtains permission from its lenders to acquire a beneficial interest in a QSPE established by Finance Co. However, On-the-Ropes Inc.'s agreements with its lenders preclude it from pledging or selling any assets. Finance Co. is unaware of the constraint. The constraining condition does not preclude sale treatment because Finance Co. cannot benefit from it.*

Rights or obligations to reacquire specific transferred assets or beneficial interests, which both constrain the transferee and provide more than a trivial benefit to the transferor, preclude sale accounting. For example, if beneficial interest holders agree to sell their interests back to the transferor at the transferor's request for a price equal to the holders' initial cost plus a stated return, that arrangement provides more than a trivial benefit to the transferor. [29] On the other hand, if the call option's strike price is at fair market value, the transferor likely does not maintain more than a trivial benefit. Similarly, a call held by the transferor that is so deep out of the money when written that it is probable that it will not be exercised, does not preclude sale accounting.

FASB 140 makes a distinction between call options that are unilaterally exercisable by the transferor and call options for which the exercise by the transferor is conditioned upon an event outside its control. If the conditional event is outside its control, the transferor is not considered to have retained effective control. An example of a conditional call would be a right to repurchase defaulted loans. Another example would be a right to call the remaining puttable beneficial interests, which is exercisable only in the event that holders of at least 75 percent of the securities put their interests.

The FASB staff provided the following unexpected answer in a preliminary draft of a FASB Special Report Question & Answer Guide to Implementation of Statement 140 dated October 27, 2000 (the draft Q&A). According to question 48 of the draft Q&A, a transferor call option may result in part sale, part financing treatment.

The specific fact pattern involves a portfolio of prepayable loans. The transferor holds a call option to repurchase the individual loans that remain unpaid once prepayments have reduced the portfolio balance to 30% of its original balance. The FASB staff's answer is sale accounting is precluded only for the transfer of the principal balance of the loans subject to the call, rather than for the whole portfolio of loans. In other words, the transfer would be accounted for partially as a sale and partially as a secured borrowing. If the FASB sticks to this as their final answer, then

securitizers who have abandoned gain on sale accounting by inserting a 20% call option will need to go back to the drawing board. It is virtually certain that these companies will find other means to meet their objective such as having the issuing SPE fail to qualify as a QSPE.

Also, in question 48 of the draft Q&A, if a transferor holds a freely exercisable call option on a portion of a portfolio consisting of specified, individual loans, then sale accounting is precluded only for the specified loans subject to the call, not the whole portfolio of loans. In contrast, if the transferor holds a call option to repurchase from the portfolio any loans it chooses, then sale accounting is precluded for the transfer of the entire portfolio (even if the option is subject to some specified limit), because the transferor can unilaterally remove specific assets. Note that these FASB staff positions are subject to revision so STAY TUNED FOR FURTHER DEVELOPMENTS. 📢

The FASB rejected a recommendation that would have permitted a transferor who is not the servicer to hold the cleanup call. The FASB believes only a servicer is burdened when the amount of outstanding assets falls to a level at which the cost of servicing the assets becomes excessive—the defining condition of a cleanup call. Any other party would be motivated by some other economic incentive in exercising a call. The Board permits a servicer cleanup call on beneficial interests (e.g., QSPE bonds) because the same sort of burdensome costs vs. benefits may arise when the beneficial interests fall to a small portion of their original level. [236] Parties other than the servicer (like financial guarantors) may hold options to purchase the assets under certain conditions without affecting the transferor’s accounting.

A servicer can hold a cleanup call even if it “contracts out the servicing” to a third party (that is, enters into a subservicing arrangement with a third party) without precluding sale accounting. However, if the transferor sells the servicing rights to a third party (that is, the agreement for servicing is between the QSPE and the third party subsequent to the sale of the servicing rights), then the transferor could not hold the cleanup call without precluding sale accounting. [question 54 of the draft Q&A]

In another surprise move, the FASB staff preliminarily takes the position in question 53 of the draft Q&A that a 10 percent call option held by a transferor, who is the residual holder but not the servicer, does not preclude sale accounting because the call option can only be exercised in response to a third party’s action that has not yet occurred. As a result, the transferor would record the transfer as a sale and record the purchased call option as part of the sales proceeds. When the event occurs (in this case, the assets are paid down to a pre-specified “low level”), the transferor has a call on all remaining assets in the QSPE. The transferor then has regained effective control of the assets, and is required to record them at their fair value at that date (together with a liability), whether or not the call is actually exercised. [55] Note that these FASB staff positions are subject to revision in a final Q&A.

CAN I STILL HOLD ON TO THE ROAPS?

Removal of Accounts Provisions (ROAPs) empower the transferor to reclaim assets, subject to certain restrictions, often without payment of any consideration, other than reduction of the transferor's retained interest (the seller's interest). ROAPs are commonly, though not exclusively, used in revolving transactions involving credit cards or trade receivables.

Why are they needed? For a variety of business reasons. A bank might have an affinity relationship with an organization...say, the Association of Friends and Families of Overworked Accountants (AFFOA). If the bank securitizes member balances, it might need to pull them out of the deal if it loses the relationship with AFFOA. The balances would then be transferred to the credit card originator that replaced the bank.

Here's another situation. Mogul Finance securitizes many of the commercial loans it makes. When a loan defaults, it might want to repurchase the loan to give it maximum workout flexibility and to protect the credit standing of the securitization vehicle.

At issue is whether a ROAP gives the transferor the ability to unilaterally cause the holder to return specific assets. Here's the rundown: [86 and 87]

TYPE OF ROAP	CAN YOU HAVE THIS TYPE OF ROAP IN A SALE?
Unconditional ROAP or repurchase agreement that allows the transferor to specify the assets that may be removed	No. 🚫
A ROAP conditioned on a transferor's decision to exit some portion of its business	No. 🚫 Examples include transferor cancellation of an affinity relationship, spinning off a business segment or accepting a 3rd party bid for a specified portion of its business (all within the transferor's control).
A ROAP for random removal of excess assets	Yes, if the ROAP is sufficiently limited so that the transferor cannot remove specific assets (e.g., the ROAP is limited to the amount of the transferor's retained interest and to one removal per month)
A ROAP for defaulted receivables	Yes. 👍
A ROAP conditioned on third-party cancellation or expiration without renewal of an affinity or private-label arrangement	Yes. 👍

EXAMPLE. *Diversified Corp. has sold all of its worldwide trade receivables to a QSPE. Under the terms of the deal, it will remove receivables related to any subsidiary it sells. The ROAP provision precludes the transfer from being accounted for as a sale. It gives Diversified Corp. the unilateral right to remove specific transferred assets.*

ROAPs that might violate FASB 140 but which were allowed under current GAAP will be grandfathered in those situations in which the QSPE does not issue new beneficial interests after March 31, 2001 and does not receive new assets after that date except pursuant to the commitments made before that date.

CAN I HAVE MY CAKE AND EAT IT TOO WITH DEBT-FOR-TAX AND A SALE FOR GAAP?

We find that the securitization term “debt-for-tax” means different things to different people. In its most advanced state, the securitizer seeks to meet all of the following objectives, not simply the first one:

- 1] The securities being issued are characterized as debt of the Issuer rather than equity in an entity, in order to avoid “double taxation.”
- 2] The transaction is treated as a financing by the transferor for tax purposes. This is accomplished by including the assets and debt of the Issuer in a consolidated tax return of the transferor, which results in deferring an up-front tax on any economic gain realized in the securitization. Note that in the case of mortgage loans, REMIC transactions are, by definition, a sale for tax purposes to the extent the sponsor disposes of the regular and/or residual interests.
- 3] Notes or Bonds rather than Pass-Through Certificates are issued so as to invite easier participation and eligibility for certain categories of investors.
- 4] The transaction is treated as an “off-balance sheet” sale for accounting purposes with recognition of any attendant gain and without consolidation of the Issuer into the financial statements of the transferor.

To meet that accounting objective, we suggest you follow these guidelines:

- 1] The issuer needs to be a QSPE (see page 10). Note that in a two-tier structure (see page 8), the entity that issues the debt (e.g., the owner trust) needs to be the QSPE.
- 2] The legal form of the QSPE does not matter for accounting purposes so long as it is a legal entity and cannot be unilaterally dissolved by the transferor. It can be an owner trust, partnership, LLC, etc.
- 3] There is no minimum size requirement for the equity of the QSPE for accounting purposes, but check with your tax advisors.
- 4] The equity of the QSPE can be wholly owned by the transferor.
- 5] The transfer of assets to the QSPE must meet the sale accounting requirements of FASB 140.
- 6] Put options may be okay if the bankruptcy lawyers say they are okay.
- 7] Call options are problematic. Generally, the Issuer and the tax lawyers want substantive call provisions and the accountants and underwriters do not. Call options on the bonds are viewed the same way as call options on the transferred assets; that is, the use of such call options would usually be considered inconsistent with the sale accounting requirements of FASB 140, but only as to the classes of bonds subject to the call. Also see discussion on page 18 of the accounting for certain call options in the draft Q&A. Cleanup calls are okay. In practice, a “safe harbor” has emerged at the 10 percent of transferred assets level to qualify as a cleanup call provided the transferor or an affiliate is the servicer and holds the cleanup call.

The fact that QSPEs are not consolidated for GAAP has somewhat reduced the tension that often existed between accountants and tax professionals when trying to structure a “debt-for-tax/sale-for-GAAP” deal. It has also allowed for the issuance of collateralized debt securities by QSPEs rather than some form of hybrid debt/participation certificate. Tax practitioners generally take into consideration the following factors in determining whether a transaction should be treated as a financing, and some of the factors are given greater weight than others (it’s interesting to compare these factors to the ones cited by the SEC staff (page 14) and the ones relevant to the definition of a debt security under FASB 115 (page 53)):

- 1] Nomenclature used in the transaction (i.e., labeling the securities as bonds or notes secured under an indenture rather than pass-through certificates); Where the instrument is in the form of debt and has a decent credit rating, there is a presumption that it is debt. Where the same security is in the form of a pass-through certificate, there is a presumption that it is equity that has to be overcome.
- 2] A revolving period or a partial reinvestment of principal collections in newly originated collateral;
- 3] The level of credit risk embodied in the security and whether the security is senior to other classes in the structure;
- 4] Payment mismatch (e.g., monthly pay collateral vs. quarterly pay debt);
- 5] Use of excess spread to pay principal on debt so that the debt can be retired before the collateral is repaid;
- 6] Existence and the size of the present value of the equity in the issuing entity;
- 7] Cap on the interest rate of a variable rate security at a debt-like objective rate vs. an equity-like cap at the weighted average rate of the loans;
- 8] A right of the Issuer to call the debt at a point significantly earlier than a typical cleanup call (see previous warning for GAAP sale treatment);
- 9] Use of a floating rate index for interest on the debt different than the index on the underlying loans (see previous GAAP warning on page 12 on use of derivatives within a QSPE);
- 10] Retaining control of and responsibilities for servicing the loans; and
- 11] Separateness rather than overlap in the ownership of the debt and the equity.

CAN WAREHOUSE FUNDING ARRANGEMENTS BE OFF-BALANCE SHEET?

One ingredient for a successful securitization is adequate deal size – securitizing a pool of assets that has reached critical mass. If the deal is sufficiently large, the costs of developing the structure and paying advisors, underwriters, ongoing administrators and trustees are typically more economical in relation to the amount of capital raised. Also, large deals attract a larger pool of investors and enhance the “name recognition” of the securitizer.

Traditionally, a securitizer of longer-term assets accumulates (or warehouses) these assets on its balance sheet. When the pool reaches critical mass, the loans are sold in a typical term securitization. During the accumulation phase, the securitizer finances the cost of carrying the assets with prearranged lines of credit, known as warehouse or repo lines. Typically, the securitizer hedges the price risk of loans in the warehouse as they await sale. The loans are often securitized near quarter-end to assure that the on-balance sheet short-term funding can be retired, so as not to violate debt covenants that might exist.

There are disadvantages to the traditional warehouse approach. Because so many securitizers sell assets close to quarter-end, the supply concentration could widen securitization spreads. Also, market participants fear that an unexpected, large disruption in the capital markets could temporarily preclude securitizers from timely access to needed funds. Finally, if a securitizer is unable to execute a securitization on schedule, equity analysts would likely demand explanations for the delay and for the absence of securitization income that quarter.

An off-balance sheet warehouse securitization offers a partial solution to these problems. But these structures—offered in a variety of flavors—need careful accounting scrutiny to comply with the off-balance sheet criteria of FASB 140 while typically seeking to preserve debt treatment for tax.

In an off-balance sheet warehouse, a commercial or investment bank typically purchases a class of beneficial interest issued by a securitization vehicle created by the seller. Using the proceeds from the sale of the beneficial interest, the vehicle acquires loans from the securitizer as they are originated. The beneficial interest takes the form of a variable funding note, whose principal adjusts upward, to a ceiling, as the securitizer transfers additional loans to the vehicle. The seller retains a beneficial interest that entitles it to all cash flows on the loans not needed to service or credit enhance the variable funding note.

When the transferred assets have reached critical mass and market conditions are judged appropriate, the holder of the variable funding note puts it back to the vehicle, forcing the entity to dispose of the assets (to the permanent securitization vehicle) to raise cash to redeem the note.

Properly structured, puts such as these comply with the sale criteria of FASB 140 and do not disqualify the entity from being a QSPE. In a significant change from FASB 125, FASB 140 does not allow the transferor to bid on the assets in an auction.

What triggers the investment bank's desire to put its interest? Most investment banks do not have the appetite for long-term investments with the characteristics of the variable funding note and they also seek the additional fees associated with underwriting the term deal. The fact remains that there cannot be a contractual obligation or a direct or indirect financial compulsion or relationship as an agent that effectively forces the investment bank to exercise the put.

Bottom line – the securitizer places significant trust in its investment banker in order to achieve off-balance sheet accounting.

If the warehouse securitization structure complies with all of the off-balance sheet sale conditions of FASB 140, the securitizer recognizes a book gain or loss on the transfer but typically not a tax gain or loss. Gain or loss is calculated conventionally, but without anticipating any of the benefits that might arise in a subsequent term securitization of the assets, and based solely on the terms of the warehouse arrangement.

One should be skeptical of any gain calculation that produces a gain in excess of the gain that could have been obtained had the securitizer sold the loans outright in a whole loan sale without any continuing involvement beyond conventional servicing. Why? Fundamentally, the life of a warehouse securitization is much shorter compared to a term transaction, but its actual duration is difficult to predict. This complicates the estimate of the relative fair value of the retained interests. Also, a term securitization often takes advantage of arbitrage opportunities, typically by using a multi-class structure designed to satisfy the narrow appetites of different investor classes. Because the securitizer cannot record this benefit until a term securitization takes place, any gain on a warehouse deal would be relatively smaller.

CAN I METAPHYSICALLY CONVERT LOANS TO SECURITIES ON MY BALANCE SHEET?

For liquidity purposes, state tax planning, capital requirements or other reasons, financial institutions might wish to convert whole loans to one or more classes of securities. The accounting for loans differs from the accounting for securities in several respects:

- Loans which are held for sale (or for a securitization to be accounted for as a sale), are carried at the lower of cost or market in the aggregate. Thus, temporary declines in market value due to rising interest rates might require a charge in the income statement.
- Loans held for investment require allowances for losses under FASB 5 and are subject to the impairment accounting provisions of FASB 114.
- Securities are accounted for under FASB 115 and are not written down via a charge to the income statement unless there is an “other-than-temporary impairment” or the trading classification is elected.

To accomplish the goal of converting loans to securities on the balance sheet and accounting for them under FASB 115, a QSPE is generally used as the transferee. The QSPE may be a grantor trust issuing a single class of pass-through certificates or it may involve a more complex structure with multiple classes of senior and subordinated interests. In a significant change from FASB 125, FASB 140 requires that at least 10 percent of the fair value of the beneficial interests in the QSPE be acquired by independent third parties, otherwise the entity will have to be consolidated and the transferor is back to where it started—with loans on the balance sheet.

[36] An exception has been granted for mortgage loans in a guaranteed mortgage securitization, which requires a substantive guarantee by a third party (one that adds value or liquidity to the security). No part of the beneficial interests needs to be sold to outsiders because the guarantor provides legitimacy to the transaction. This exception cannot be extended to any other types of loans. Because no proceeds are raised, these securitizations are neither a sale nor a financing under FASB 140. In a guaranteed mortgage securitization, the historical carrying value of the loans, net of any unamortized fees, costs, discounts, premiums and loss allowances plus any accrued interest, is allocated to the sold interests, if any, and the retained interests (including servicing) in proportion to their relative fair values. However, if the transferor retains all of the resulting securities and classifies them as debt securities held-to-maturity, then FASB 140 does not require a servicing asset or a servicing liability to be established. [13]

DO BANKS HAVE TO ISOLATE THEIR ASSETS IN A TWO-TIER STRUCTURE TO GET SALE TREATMENT?

Banks are not subject to the U.S. Bankruptcy Code. Nonetheless, FASB 140 requires that securitizations to be accounted for as sales by banks provide reasonable assurance that the transferred assets will be beyond the reach of a receiver in the event that a bank is placed in receivership. In August 2000, the FDIC issued a rule designed to help banks meet the GAAP requirements for a sale. The rule states:

The FDIC shall not, by exercise of its authority to disaffirm or repudiate contracts, reclaim, recover or recharacterize as property of the institution or the receivership any financial assets transferred by an insured depository institution in connection with a securitization [issued by a special purpose entity demonstrably distinct from the insured depository institution], provided that such transfer meets all conditions for sale accounting under generally accepted accounting treatment, other than the “legal isolation” condition as it applies to institutions for which the FDIC may be appointed conservator or receiver...12 C.F.R. § 360.6 (August 11, 2000).

We anticipate that attorneys will be able to conclude that the FDIC’s final rule places them in a position to issue an acceptable opinion on whether the securitized assets would be beyond the reach of the FDIC and the banks’ other creditors, even in the event that the bank was placed in receivership. See next section on lawyer’s letters.

Banks may still retain one advantage, but it is not entirely clear at the time of this writing. Under the FDIC’s rule, although the securitization must be issued by an SPE, a two-tier structure (with an intermediate bankruptcy remote entity) is not a requirement. However, this will eventually depend on the strength of lawyers’ letters covering a single-tier structure.

DO I ALWAYS NEED TO BOTHER MY LAWYER FOR AN OPINION LETTER?

In 1997, the American Institute of Certified Public Accountants (AICPA) issued an auditing interpretation called *The Use of Legal Interpretations as Evidential Matter to Support Management's Assertion That a Transfer of Financial Assets Has Met the Isolation Criteria in Paragraph 9 (a) of Statement of Financial Accounting Standards No. 125*. [AICPA § AU9336.01-.20.]

The interpretation contains an extract of a legal opinion (for an entity that is subject to the U.S. Bankruptcy Code), which provides persuasive evidence (in the absence of contradictory evidence) to support management's assertion that the transferred assets have been isolated. In short, it is a true sale "would" opinion vs. a "should" or "more likely than not" opinion. This represents the highest level of assurance counsel is able to provide on the question of isolation. The example follows:

We believe [or it is our opinion] that in a properly presented and argued case, as a legal matter, in the event the Seller were to become a Debtor, the transfer of the Financial Assets from the Seller to the Purchaser **would** be considered to be a sale [or a true sale] of the Financial Assets from the Seller to the Purchaser and not a loan and, accordingly, the Financial Assets and the proceeds thereof transferred to the Purchaser by the Seller in accordance with the Purchase Agreement **would not** be deemed to be property of the Seller's estate for purposes of [the relevant sections] of the U.S. Bankruptcy Code.

...Based upon the assumptions of fact and the discussion set forth above, and on a reasoned analysis of analogous case law, we are of the opinion that in a properly presented and argued case, as a legal matter, in a proceeding under the U.S. Bankruptcy Code, in which the Seller is a Debtor, a court **would not** grant an order consolidating the assets and liabilities of the Purchaser with those of the Seller in a case involving the insolvency of the Seller under the doctrine of substantive consolidation. [If an affiliate of the Seller has also entered into transactions with the Purchaser, the opinion should address that.]

The previous example deals with a one-step transfer of financial assets. In a two-step transfer, a lawyer's opinion should also address the second transfer (from the wholly owned bankruptcy remote subsidiary to the securitization vehicle that issues beneficial interests to investors). In most securitizations that feature credit enhancement (for example, the wholly owned bankruptcy remote subsidiary or an affiliate retains a subordinated interest in the securitization vehicle), the lawyer's letter usually cannot conclude that the second transfer is a true sale. Instead, the attorney usually concludes that this transfer would either be a true sale or a secured financing and that is acceptable.

Other issues covered in the auditing interpretation:

QUESTIONS	KEY POINTS
What should the auditor consider in determining whether to use a lawyer to obtain persuasive evidence to support management's assertion that a transfer of assets meets the isolation criterion?	<div>→ Use of a lawyer may not be necessary when there is a routine transfer of financial assets without continuing involvement by the seller like full or limited recourse, servicing, other retained interests in the transferred assets or an equity interest in the transferee.</div> <div>→ Use of a lawyer usually is necessary if, in the auditor's judgment, the transfer involves complex legal structures, continuing seller involvement or other legal issues that make it difficult to determine whether the isolation criterion is met.</div> <div>→ The auditor should evaluate the need for updates to a legal opinion if transfers occur over an extended period of time or if management asserts that a new transaction is the same as a prior structure.</div>
If the auditor determines that the use of a lawyer is required, what should the auditor consider in assessing the adequacy of the legal opinion?	<div>→ The auditor should consider whether the lawyer has experience with relevant matters, such as knowledge of the U.S. Bankruptcy Code and other applicable foreign or domestic laws and knowledge of the transaction. The lawyer may be a client's internal or external attorney who is knowledgeable about relevant sections of the law.</div> <div>→ A lawyer's conclusion about hypothetical transactions generally would not provide persuasive evidence because it may be neither relevant to the actual transaction nor contemplate all of the facts and circumstances or the provisions in the agreements of the actual transaction.</div> <div>→ The auditor should obtain an understanding of the assumptions that are used by the lawyer, and make appropriate tests of any information that management provides to the lawyer and upon which the lawyer indicates it relied.</div>
Are legal opinions that restrict the use of the opinion to the client or to third parties other than the auditor acceptable audit evidence?	<div>→ The auditor should request that the client obtain the lawyer's written permission for the auditor to use the opinion. Language to the effect that the auditors are authorized to use but not rely on the lawyer's letter is not acceptable audit evidence.</div>
If the auditor determines that it is appropriate to use the work of a lawyer, and either the resulting legal response does not provide persuasive evidence...or the lawyer does not grant permission for the auditor to use a legal opinion that is restricted..., what other steps might an auditor consider?	<div>→ Because isolation is assessed primarily from a legal perspective, the auditor usually will not be able to obtain persuasive evidence in a form other than a legal opinion.</div> <div>→ In the absence of persuasive evidence, accounting for the transfer as a sale would not be in conformity with GAAP, and the auditor should consider the need to modify the auditor's report on the financial statements.</div>

Originally, this auditing interpretation did not apply to securitizations by FDIC-insured banks. At the time of this writing, the AICPA is working on a revision to the interpretation to provide guidance based on the recently issued FDIC rule described above. STAY TUNED FOR FURTHER DEVELOPMENTS. 📢

SHOULD I JOIN THE PACK THAT IS ABANDONING GAIN ON SALE ACCOUNTING?

Gain (or loss) on sale accounting is not elective in a securitization accounted for as a sale. In other words, prepayment, loss or discount rate assumptions used to value a retained interest may not be tailored so as to force a zero gain.

More and more, securitizers are announcing that they will discontinue the use of “gain on sale” accounting.⁶ This is in reaction to the:

- unwanted volatility in earnings that goes hand in hand with the timing and current spreads of securitization transactions
- vocal criticism (from equity analysts, in particular) that characterizes this accounting as “front-ending” income
- rating agencies adding the securitization back to the balance sheet when considering capital adequacy.

The following discussion covers some of the accounting issues that a company should consider before making a switch:

- 1]** In order to report zero up-front gain, the securitization must be structured as a financing rather than a sale in virtually every case. (One technical exception exists when it is not practicable to estimate the fair value of a liability—see page 40.) Debt for GAAP seems to be the only practical structure to avoid recognizing the gain or loss that results from sale accounting. Typically, though, management strongly objects to ballooning the balance sheet due to the negative implications that has on debt/equity ratios, return on assets, debt covenant compliance, etc. Bear in mind, however, that the liability side of the balance sheet will not balloon further if all cash securitization proceeds are used to repay on balance sheet warehouse funding or other debt. On the other hand, the typical pattern of a frequent securitizer is to minimize on-balance sheet warehouse funding on quarterly balance sheet dates by using sale accounting as the means to shrink the balance sheet debt.
- 2]** The FASB considered, but rejected, the United Kingdom accounting approach of a “linked presentation,” in which the pledged assets remain on the balance sheet, but the sales proceeds (treated as nonrecourse collateralized debt) are reported as a deduction from the pledged assets rather than as a liability. No gain or loss is recognized. We continue to recommend that the FASB consider adopting the UK approach as a means to resolve many of the thorny conceptual dilemmas and real-world issues that they and their constituents are struggling with.
- 3]** The most common way of intentionally achieving debt-for-GAAP has been by inserting a call option at the 20 percent level, which is considered more than just a cleanup call. However, in a preliminary draft of a FASB Special Report on Implementation Guidance for FASB 140, the

6. Securitizers who have made these announcements include Consec Finance, Centex, First Union, Ocwen Financial, Provident Bank, Westcorp and Ugly Duckling.

FASB staff took the following position:

If a transferor holds a call option to repurchase the individual loans that remain, from an entire portfolio of prepayable loans that were transferred in a securitization transaction, once prepayments have reduced the portfolio balance to some specified amount, then sale accounting is precluded only for the transfer of the remaining principal balance subject to the call, not the whole portfolio of loans. In this case, the specific asset over which the transferor retains control is the remaining principal balance once the asset amortizes to the specific threshold. The transferor has no effective control over the portion of the financial asset that will be collected before then, so the transfer of that portion of the asset should be accounted for as a sale, assuming the other provisions of paragraph 9 are met.

[draft Q&A 48]

STAY TUNED FOR FURTHER DEVELOPMENTS. 

- 4] Assuming this part-sale, part-financing treatment prevails for the 20 percent call scenarios, securitizers will have to go back to the drawing board to intentionally defeat sale accounting after March 31, 2001. Consolidation of the vehicle might be the technique adopted. If the securitization vehicle fails to meet the stringent QSPE criteria and there is insufficient outside equity, then the transferor needs to consolidate the vehicle. The transaction taken as a whole will effectively be a financing in the consolidated financial statements.
- 5] There is some question as to whether the pledged assets in a securitization accounted for as a financing should be classified as loans or as securities, which is due to what appears to us to be contradictory guidance in FASB 140. Paragraph 10 of FASB 140 says: "Upon completion of any transfer of financial assets," [whether or not it satisfies the conditions to be accounted for as a sale] [58] "the transferor shall: (a) continue to carry in its statement of financial position any retained interest in the transferred assets, including, if applicable, servicing assets, beneficial interests in assets transferred to a QSPE in a securitization, and retained undivided interests and (b) allocate the previous carrying amount between the assets sold, if any, and the retained interests, if any, based on their relative fair values at the date of transfer." The term "transfer" is defined to include "putting it into a securitization trust" or "posting it as collateral." [364] On the other hand, paragraph 12 simply states, "If a transfer of financial assets in exchange for cash...does not meet the criteria for a sale...the transferor and transferee shall account for the transfer as a secured borrowing with pledge of collateral."
 - If the pledged assets are treated as loans (their previous treatment), then they would likely be considered loans held for long-term investment and not loans held for sale. Thus, for mortgages, there would be no FASB 65 (lower of cost or market) requirement, although valuation allowances for credit losses would be required.
 - If the pledged assets are treated as securities, then FASB 115 applies, and a decision as to held-to-maturity (HTM), trading, or available-for-sale (AFS) is required.
 - If classified as AFS, the assets would be marked to market (affecting equity and comprehensive income), but GAAP precludes marking the corresponding liability.

- The risk-based capital requirement for financial institutions might be different if the assets are classified as securities rather than loans.
- There should be some other balance sheet caption to distinguish these pledged assets from the loan or investment portfolio—for instance, “Restricted assets included in securitization structure” or “Securitized assets restricted for repayment of non-recourse borrowing.”

6] Accounting for a securitization as a financing does not eliminate the need to make many subjective judgments and estimates and could still result in volatility in earnings due to the usual factors of prepayments and credit losses. After all, the company still effectively owns a residual even though it cannot be found on the balance sheet. It is the excess of the securitized assets over the associated debt, albeit at their original amounts and not “repriced” as a result of the securitization structure. Different accounting treatments will affect reported income from origination through securitization and continue through maturity (when the reported income tally finally evens out). Some of these differences are listed below:

- a]** In the financing accounting scenario, the amounts of origination costs, points, purchase premiums and deal expenses take on less significance in the first-year income statement. In a financing, these items are deferred (amortized over the life of the loan or the bonds) rather than expensed in a gain on sale calculation. The rate of amortization will be affected by actual prepayments and prepayment estimates.
- b]** When mortgage loans are originated or acquired with the intent to securitize as a financing, then the loans generally will be classified as held for long-term investment and will not be subject to a FASB 65 LOCOM adjustment (e.g., from rising interest rates) during the accumulation period. A securitizer adopting financing treatment might want to reconsider its hedging policies during that period because the “income statement risk” of a LOCOM adjustment or a lower gain on sale (e.g., if spreads widen) is mitigated. But before revising hedging strategies, remember that the economic risk associated with volatile interest rates preceding a term securitization is present regardless of the accounting treatment.
- c]** If loans are securitized in a financing transaction, [we think—see item 5] the securitizer does not have to recognize a separate servicing asset. That is, the servicing asset can remain embodied in the carrying value of the loans. If a servicing asset is created, it will be subject to LOCOM accounting under FASB 140.
- d]** Underwriting fees and deal costs of issuance will be deferred and amortized over the life of the bonds, and the pace of amortization will be affected by prepayments.
- e]** Provisions for credit losses will be made periodically under FASB 5. In a sale, the securitizer estimates all credit losses over the entire life of the loans transferred and accounts for them in the gain on sale calculation.
- f]** Original Issue Discount (OID) on bond classes will be amortized as additional interest expense and the pace of amortization will be affected by prepayments. Also, in a deal

with maturity tranching, especially in a steep yield curve, significant amounts of “phantom” GAAP income could result.

Assume, for instance, that four sequential pay tranches are issued at yields of 7%, 8%, 9%, and 10%, respectively and backed by a pool of newly originated 10% loans. An overall yield to maturity on the assets is calculated and used for FASB 91 purposes, but interest expense on the bonds is calculated based on the yield to maturity of each outstanding bond. The result is that the net interest margin reported in the earlier years will exceed the net interest margin reported in the later years. Observe that, in this example, there would be no income reported during the years in which only the last class is outstanding. A more conservative answer would result if the four bond classes were treated as a single large bond class, with a single weighted average yield to maturity used to record the interest cost.

- 7] In Real Estate Mortgage Investment Conduit (REMIC) deals accounted for as financings, (REMICs by definition are a sale for tax purposes to the extent that the regular and/or residual interests are disposed of) taxes will still have to be paid on any up-front tax gain, and a deferred tax asset created for taxable income recognized before book income. When a company is willing to account for its transactions as on-balance sheet financings, it can take advantage of certain features of the FASIT legislation that would have been in conflict with sale accounting treatment. In particular, FASIT provides for liberal asset substitution and permits withdrawals of assets when the deal is overcollateralized, and gives the securitizer the ability to liquidate a class of securities and to hedge certain risks without regard to QSPE limitations on derivatives. These provisions can be used to give an Issuer significantly more flexibility than is available with REMIC structures. Nothing, however, mitigates the show-stopper in FASITs – the up front “toll charge” tax on an artificially calculated gain.
- 8] In comparing *pro forma* projected results of weaning off of gain-on-sale accounting, don’t omit the income from the accretion of yield (at the discount rate) on the residual interests retained in the sale accounting scenario.
- 9] In what hardly would seem like a deal-breaker, the classification of transactions as financing or investing and amounts from operations within the statement of cash flows differ in the financing scenario from the sale scenario.
- 10] The FASB’s extensive new disclosures relating to securitizations, including the cash inflows (outflows) between the securitizer and the securitization vehicles, disclosure of assumptions used to estimate fair value, static pool losses and stress tests of the value of the retained interests, do not apply to securitizations accounted for as financings. Some companies provide supplemental information showing key financial statement components on a *pro forma* basis as if their off-balance sheet securitizations were on-balance sheet. The FASB considered, but rejected, this type of presentation as being a required part of the new disclosures.

QUESTIONS

RELATING TO DETERMINING GAIN

or

LOSS

on

SALES

HOW DO I CALCULATE GAIN OR LOSS WHEN I RETAIN SOME BOND CLASSES OR A RESIDUAL?

Very carefully. **The FASB has cautioned that those responsible for financial statements need to exercise care in applying the Statement and need to be able to identify the reasons for gains on securitizations. Otherwise, FASB says that it is likely that the impact of the retained interest being subordinate to a senior interest has not been adequately taken into account in the determination of the fair value of the retained interest. [59]**

If the transfer qualifies as a sale, then:

- 1] Allocate the previous book carrying amount (net of loss allowances, if any) between the classes sold and the retained interests (including servicing assets) in proportion to their relative fair values on the date of transfer.
- 2] Record on the balance sheet the fair value of any guarantees, recourse obligations or derivatives such as put options written, forward commitments, interest rate or foreign currency swaps.
- 3] Recognize gain or loss only on the assets sold by comparing the net cash proceeds (after transaction costs and after liabilities created as determined in step 2) to the allocated book value of the sold classes. The allocation in step 1 effectively defers a portion of the profit or loss—the amount attributable to the portion(s) of the financial assets retained.
- 4] Continue to carry on the balance sheet (initially at its allocated book value [see step 1]) any retained interest in the transferred assets, which may include a separate servicing asset and debt or equity instruments in the SPE. [11]
- 5] For retained securities classified as available-for-sale, increase or decrease the allocated book value to fair value on the balance sheet with the amount of the adjustment, net of taxes, being charged or credited to the other comprehensive income portion of stockholders' equity. For retained securities classified as trading, increase or decrease the allocated book value to fair value on the balance sheet with the amount of the adjustment being charged or credited to current earnings.

There is no provision that the amount of gain recognized on a securitization with retained interests cannot exceed the gain that would be recognized if the entire asset had been sold. The FASB indicated that imposing such a limitation would have, among other things, (1) presumed that a market price always exists for the sale of the whole loans and (2) resulted in ignoring the added value (i.e., arbitrage) that many maintain is created when assets are divided into their several parts. However, as indicated above, the FASB cautions that securitizers need to be able to identify the reasons for gains on securitizations. [303]

HOW IS GAIN OR LOSS CALCULATED IN A REVOLVING STRUCTURE?

Gain or loss recognition for relatively short-term receivables such as credit card balances, trade receivables or dealer floor plan loans sold to a relatively long-term revolving securitization trust is limited to receivables that exist and have been sold (and not those that will be sold in the future pursuant to the revolving nature of the deal). Recognition of servicing assets is also limited to the servicing for the receivables that exist and have been sold. [78] FASB 140 requires an allocation of the carrying amount of the receivables transferred to the SPE, between the sold interests and the retained interests (in proportion to their relative fair value) be performed. See credit card example on page 35.

A revolving securitization involves a large initial transfer of balances generally accounted for as a sale. Ongoing, smaller subsequent months' transfers funded with collections of principal from the previously sold balances (we like to call them "transferettes") are each treated as separate sales of new balances with the attendant gain or loss calculation. The recordkeeping burden necessary to comply with these techniques is quite onerous, particularly for master trusts. Paragraph 72 of FASB 140 shows an example where the seller finds it impracticable to estimate the fair value of the servicing contract, although it is confident that servicing revenues will be more than adequate compensation for performing the servicing.

The implicit forward contract to sell new receivables during a revolving period, which may become valuable or onerous as interest rates and other market conditions change, is to be recognized at its fair value at the time of sale. Its value at inception will be zero if entered into at the market rate. FASB 140 does not require securitizers to mark the forward to fair value in accounting periods following the securitization (neither does FASB 133, as these forwards typically do not meet FASB 133's definition of a derivative as they require physical settlement).

Certain revolving structures use what is referred to as a bullet provision as a method of distributing cash to their investors. Under a bullet provision, during a specified period preceding liquidating distributions to investors, cash proceeds from the underlying assets are reinvested in short-term investments (as opposed to continuing to purchase revolving period receivables). These investments mature to make a single bullet payment to certain classes of investors on a predetermined date. In a controlled amortization structure, the investments mature in such a way to make a series of scheduled payments to certain classes of investments on predetermined dates. The bullet or controlled amortization provision should be taken into account, in determining the relative fair values of the portion of transferred assets sold and portions retained by the transferor. [question 118 of the draft Q&A]. No accounting entries need be made to recognize the short-term investments held on behalf of the investors other than to the extent the investments are placed with the seller's financial institution.

Is there a sample gain on sale worksheet that I can use as a template?

Assumptions (all amounts are hypothetical and the relationships between amounts do not purport to be representative of actual transactions):

• Aggregate Principal Amount of Pool			\$ 100,000,000
• Net carrying amount (Principal amount + accrued interest + purchase premium + deferred origination costs - deferred origination fees - purchase discount - loss reserves)			\$ 99,000,000
• Deal Structure:			
	PRINCIPAL AMOUNT	PRICE	FAIR VALUE*
Class A	\$ 96,000,000	100	\$ 96,000,000
Class B	4,000,000	95	3,800,000
Class IO			1,500,000
Class R			1,000,000
TOTAL	\$ 100,000,000		\$ 102,300,000

*Including accrued interest

• Class IO and R are retained by the Seller					
• Servicing Value:				\$ 700,000	
• Up-front Transaction costs (underwriting, legal, accounting, rating agency, printing, etc.)				\$ 1,000,000	
Basis Allocation of Carrying Value:					
COMPONENT	FAIR VALUE	% OF TOTAL FAIR VALUE	(\$99MM X%) ALLOCATED CARRYING AMOUNT	SOLD	RETAINED
Servicing	\$ 700,000	.68%	\$ 673,200		\$ 673,200
Class A	96,000,000	93.20	\$ 92,268,000	\$ 92,268,000	
Class B	3,800,000	3.69	3,653,100	3,653,100	
Class IO	1,500,000	1.46	1,445,400		1,445,400
Class R	1,000,000	.97	960,300		960,300
TOTAL	\$ 103,000,000	100.00%	\$ 99,000,000	\$ 95,921,100	\$ 3,078,900

Net proceeds (with accrued interest, after \$1 million transaction costs)	98,800,000
Pre-Tax Gain	\$ 2,878,900

Journal Entries:		DEBIT	CREDIT
(1) Cash	\$ 98,800,000		
Servicing Asset		673,200	
Class IO		1,445,400	
Class R		960,300	
Net carrying value of Loans			\$ 99,000,000
Pre-tax gain on sale			2,878,900
(2) Class IO	\$ 54,600		
Class R	39,700		
Equity (Earnings, if trading)			\$ 94,300

In the second journal entry, the allocated carrying amount of Class IO and Class R are adjusted upward to their fair values because they are required to be classified as either an available for sale or trading security. [14] Note the following: 1) a similar adjustment is not made for the servicing asset; and 2) a “haircut” on the amount of gain recognized results when the Class IO and Class R are classified as available for sale and not trading.

How about a credit card example

Assumptions (all amounts are hypothetical and the relationships between amounts do not purport to be representative of actual transactions):

- **Aggregate Principal Amount of Pool** **\$ 650,000,000**
- **Carrying amount, net of specifically allocated loss reserve** **\$ 637,000,000**
- **Servicing Value** **\$ 5,000,000**
- **Value of fixed-price forward contract for future sales** **0**
- **Up-front transaction costs** **\$ 4,000,000**
- **Losses are reimbursed from excess interest spread account**
- **Deal Structure:**

	PRINCIPAL AMOUNT	PRICE	FAIR VALUE*
Class A	\$ 500,000,000	100	\$ 500,000,000
Class B	25,000,000	100	25,000,000
Seller's Certificate	125,000,000		125,000,000
IO Strip*			10,000,000
Servicing			5,000,000
TOTAL	\$ 650,000,000		\$ 665,000,000

Basis Allocation of Carrying Value:

COMPONENT	FAIR VALUE	% OF TOTAL FAIR VALUE	(\$637 MM X%) ALLOCATED CARRYING AMOUNT	SOLD	RETAINED
Class A	\$ 500,000,000	75.19%	\$ 478,960,300	\$ 478,960,300	
Class B	25,000,000	3.76	\$ 23,951,200	\$ 23,951,200	
Seller's Certificate	125,000,000	18.80	119,756,000		\$ 119,756,000
IO Strip*	10,000,000	1.50	9,555,000		9,555,000
Servicing	5,000,000	.75	4,777,500		4,777,500
TOTAL	\$ 665,000,000	100.00	\$ 637,000,000	\$ 502,911,500	\$ 134,088,500

Proceeds net of \$ 1 million allocated transaction costs (assumes 25% allocation to the initial sale) **\$ 524,000,000**

Pre-Tax Gain **\$ 21,088,500**

Journal Entries:

	DEBIT	CREDIT
(1) Cash	\$ 521,000,000	
IO Strip	9,555,000	
Servicing Asset	4,777,500	
Seller's Certificate	119,756,000**	
Deferred Transaction costs	3,000,000	
Net carrying value of Loans		\$ 637,000,000
Pre-tax gain on sale		21,088,500
(2) IO Strip	\$ 445,000	
Equity (other comprehensive income)		\$ 445,000

* In determining the fair value of the IO Strip, the seller would consider the yield on the receivables, charge-off rates, average life of the transferred balances and the subordination of the IO flows in a spread account.

** Note that in the above example, the allocated carrying amount of the seller's certificate is less than its principal balance. FASB 140 does not provide any guidance on how such difference should be amortized. Presumably, it should be amortized as additional yield over the average life of the retained balances.

Each month during the revolving period, the investor's share of principal collections would be used to purchase new receivable balances ("transferettes"), and an analysis similar to the above would be made with a new gain or loss recorded. The record keeping burden to comply with these techniques is onerous, particularly for master trusts.

And a lease example

Assumptions (all amounts are hypothetical and the relationships between amounts do not purport to be representative of actual transactions):

Carrying Amount of Transferred Finance Lease:

• Rentals Receivable (\$492.75 per month for 36 months)	\$	17,739
• Estimated Residual Value (\$15,000 guaranteed*)		18,000
• Unearned Income	(5,739)
• Net Investment in Lease		<u>30,000</u>

Allocation of net investment in lease to unguaranteed residual
\$3,000 future value discounted at 8% implicit lease rate = **\$2,362**

Securitization of guaranteed cash flows:
Advance Rate = **90%** of guaranteed cash flows discounted at **6%**
Subordinated interest valued at **12%** discount rate
Servicing fee rate = adequate compensation

	FAIR VALUE	% OF TOTAL	ALLOCATED COST
Senior Interest Sold at Par	\$ 25,932	91.057	\$ 25,166
Subordinated Interest	2,547	8.943	2,472
TOTAL	\$ 28,479	100.000	\$ 27,638
Dr. Cash	\$ 25,932		
Dr. Subordinated Interest	2,472		
Dr. Residual Value	2,362		
Cr. Net investment in lease		\$ 30,000	
Cr. Pre-tax gain on sale		766	
Comparison of Sale vs. Financing accounting treatment			
		SALE	FINANCING
At Inception:			
Gain on Sale	\$ 766		—
During the Life:			
Earned Lease Income		—	\$ 5,739
Interest Expense			(3,533)
Yield on Retained Interest		802	—
At Termination:			
Gain on Residual Value Realization**		638	—
TOTAL	\$ 2,206	\$ 2,206	

* Only guarantees from the lessee or a credit-worthy third party obtained at lease inception can qualify a lease residual as a financial asset subject to FASB 140 [264].

** FASB Technical Bulletin 86-2, Accounting for an Interest in the Residual Value of a Leased Asset, requires lessors that sell “substantially all” of the minimum lease rental payments to allocate book basis to the remaining interest in the residual value and carry it at that value until it is realized through a subsequent sale. The retained residual interest also needs to be written down if there is an impairment loss based on an other than temporary decline in fair value below carrying amount.

IS FAIR VALUE IN THE EYES OF THE “B-HOLDER”?

In recent years, several public companies announced losses resulting from downward adjustments to previously recorded residual interests in securitizations. The adjustments often stemmed from securitized mortgage assets that prepaid more quickly than the sellers’ original estimates. The losses also led equity analysts to increasingly question the “quality of earnings” of many securitizers. The analysts pointed out that these gains are, for the most part, noncash; instead, the gains usually result from recording assets that represent an estimate of the present value of *anticipated* cash flows.

In response, some securitizers indicated that they would utilize more conservative assumptions when calculating the gain on securitizations. More conservative assumptions mitigate or eliminate subsequent downward adjustments if adverse market developments occur. In at least one well-publicized case, it appeared that the securitizer might use more conservative assumptions for newly securitized assets but would not use similar assumptions when estimating the fair value of retained interests in previously securitized assets. Different assumptions should be used only when warranted by the facts and circumstances of the specific assets securitized. For example, a securitizer is justified in making different estimates for loans with substantively different terms or economic characteristics.

FASB 140 does not introduce any new accounting definition of fair value. The fair value of an asset is defined as the amount at which it could be bought or sold, in a current transaction between willing parties, other than in a forced or liquidation sale. If quoted market prices are not available, the estimate of fair value should be based on the best information available. The estimate of fair value should consider prices for similar instruments and the results of valuation techniques, such as the present value of the estimated future cash flows, option-pricing models, matrix pricing, OAS models and fundamental analysis. The objective when measuring financial liabilities at fair value is to estimate the value of the assets required currently to (a) settle the liability or (b) transfer the liability to an entity of comparable credit standing. [69]

It would be unusual for a securitizer to find quoted market prices for most financial components arising in a securitization—complicating the measurement process and requiring estimation techniques. FASB 140 discusses these situations as follows:

- The underlying assumptions about interest rates, default rates, prepayment rates and volatility should reflect what market participants would use.
- Estimates of expected future cash flows should be based on reasonable and supportable assumptions and projections.
- All available evidence should be considered, and the weight given to the evidence should be commensurate with the extent to which the evidence can be verified objectively.
- If a range is estimated for either the amount or timing of possible cash flows, the likeli-

hood of all possible outcomes should be considered either directly, if applying an expected cash flow approach, or indirectly through the risk-adjusted discount rate, if determining the best estimate of future cash flows. [70]

The FASB has expressed a preference for a multi-scenario probability analysis using an expected present value technique instead of a more traditional “best estimate” technique of the single most-likely cash flow. The expected present value technique considers and weights the likelihood of many possible outcomes. For example, a cash flow might be \$100, \$200, or \$300 with probabilities of 10 percent, 60 percent, and 30 percent, respectively. The expected cash flow is \$220. See question 75A of the FASB draft Q&A for an illustration of the approach.

WHAT ARE THE AUDITORS’ RESPONSIBILITIES FOR FAIR VALUE?

Auditors do not function as appraisers and are not expected to substitute their judgment for that of the entity’s management. In September 2000, the AICPA issued Statement on Auditing Standards No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (SAS 92), effective for financial statement audits for fiscal years ended on or after June 30, 2001. Under SAS 92, if management uses a valuation model of the present value of expected future cash flows to determine fair value, the auditor should obtain evidence supporting management’s assertions about fair value by performing procedures such as:

- Determining whether the valuation model is appropriate for the security to which it is applied and whether the assumptions used are reasonable and appropriately supported. The evaluation of the appropriateness of valuation models and each of the assumptions used in the models may require considerable judgment and knowledge of valuation techniques, market factors that affect fair value, and actual and expected market conditions. Accordingly, the auditor may consider it necessary to involve a specialist in assessing the model.
- Calculating the value, for example, using a model developed by the auditor or by a specialist engaged by the auditor, to develop an independent expectation to corroborate the reasonableness of the value calculated by the entity.

Auditors should consider the size of the entity, the entity’s organization structure, the nature of its operations, the types, frequency and complexity of its securities, and the controls over those securities in designing audit procedures for assertions about the fair value of securities. Auditors may be able to reduce the substantive procedures for valuation assertions by gathering evidential matter about the controls over the design and use of the models (including the significant assumptions) and evaluating their operating effectiveness.

SAS 92 also provides that if the estimates of fair values were obtained from broker-dealers or other third-party sources based on proprietary valuation models, the auditor needs to understand the work performed or to be performed by the broker-dealer or other third-party sources

in developing the estimate. The auditor may also determine that it is necessary to obtain estimates from more than one source. For example, this may be appropriate if:

- The pricing source has a relationship with the entity that might impair its objectivity, such as an affiliate or counterparty involved in selling or structuring the product; or
- The valuation is based on assumptions that are highly subjective or particularly sensitive to changes in the underlying circumstances.

When a specialist is used, the appropriateness and reasonableness of methods and assumptions are the responsibility of the specialist. SAS No. 73, *Using the Work of a Specialist*, calls for the auditor to:

- 1] Obtain an understanding of the methods and assumptions used.
- 2] Make appropriate tests of data provided to the specialist, taking into account the auditor's assessment of control risk.
- 3] Evaluate whether the specialist's findings support the related assertions in the financial statements.

Ordinarily, the auditor would use the work of the specialist unless the auditor's procedures lead them to believe the findings are unreasonable in the circumstances. If the auditor believes the findings are unreasonable, the auditor should apply additional procedures, which may include obtaining the opinion of another specialist.

The staff of the SEC has cautioned auditors that the sensitivity analysis disclosed in the footnotes to the financial statements must be subjected to robust audit procedures, including testing the reasonableness of the assumptions used, as well as testing the accuracy of the model.

WHAT IF I CAN'T ESTIMATE FAIR VALUE?

The FASB expressed concern that in some cases the best estimate of fair value would not be sufficiently reliable to justify current recognition of a gain. Errors in the estimate of asset value or liability value might result in recording a nonexistent gain, and accordingly, the FASB provided guidance for situations in which it might not be practicable to determine fair value. [298] But in the draft Q&A, the staff concluded that in a vast majority of circumstances, it should be practicable to estimate fair values. [question 67 of draft Q&A]

In the event that it is not practicable to estimate the fair value of a retained asset, you must value it at zero. Valuing a retained interest at zero will often result in recognizing a loss on sale (even in a par execution) after considering out-of-pocket transaction costs and any premium the transferor paid to acquire the assets or costs the transferor incurred to originate the asset and capitalized on the balance sheet.

In the event that it is not practicable to estimate the fair value of any liability such as a corporate guarantee on the senior bonds, you will not be able to recognize any gain on sale. The unknown liability has to be recorded as the **greater** of:

1. the sum of the known assets less the fair value of the known liabilities—i.e., “plug” the amount that results in no gain or loss; (Paragraph 72 in FASB 140 illustrates that accounting) or, the FASB 5 liability (which may be zero).
2. You may be required to record a loss if a liability under FASB 5 and FASB Interpretation 14 (*Reasonable Estimation of the Amount of a Loss*) would be recognized. [71]

When a securitizer concludes that it is not practicable to estimate fair values, FASB 140 requires footnote disclosure describing the related items and the reasons why it is not practicable to estimate their fair value. Practicable means that an estimate of fair value cannot be made without incurring excessive costs. It is a dynamic concept. What is practicable for one entity might not be for another; what is not practicable in one year might be in another.

Little guidance exists as to when “it is not practicable to estimate the fair value of assets and liabilities,” and a frequent securitizer would likely resist having to disclose an inability to evaluate the creditworthiness of the pool. Moreover, FASB 140 does not give guidance on the subsequent accounting under this option leaving any number of unresolved questions. For example, is income not to be recognized at all until it becomes practicable to estimate the fair value of the liability? And is income then to be recognized in one lump sum?

CAN I RECORD AN ASSET FOR SERVICING?

Yes, if the benefits of servicing are expected to be more than adequate compensation to service the assets. [62] This would best be evidenced by the ability to receive (as opposed to pay) cash up-front if the rights and obligations under the servicing contract were to be assigned to another servicer.

Servicing is inherent to financial assets; however, it only becomes a distinct asset when contractually separated from the underlying assets via a sale or securitization of the assets, with servicing retained. [61] A servicer of the assets commonly receives the benefits of servicing—revenues from contractually specified servicing fees, late charges and other ancillary revenues, including “float”—and incurs the costs of servicing those assets. Typically in securitizations, the benefits of servicing are not expected to be less than adequate compensation to the servicer. Adequate compensation is the amount of benefits of servicing that would fairly compensate a substitute servicer, should one be required, which includes the profit that would be demanded in the marketplace and is expected to vary based on the nature of the assets being serviced.

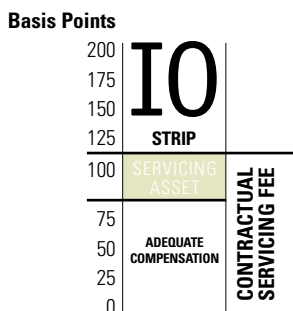
The goal when estimating the value of servicing is to determine fair value; that is, what a suc-

cessor servicer would pay or charge to assume the servicing. Therefore, when estimating the benefits of servicing, the benefits that should be included in the estimation model are those benefits that successor servicers would consider, to the extent that successor servicers would consider them. The entity should estimate the value of the right to benefit from the cash flows of potential future transactions like collecting late charges, not the expected cash flows to be derived from the late charges discounted at some rate selected by the transferor. A potential servicer might be willing to pay more for servicing if the benefits of that servicing included the right to collect late charges than it would pay if the servicing agreement did not include those rights. [questions 76, 79 and 81 of the draft Q&A]

Similarly, when estimating adequate compensation, the estimated costs of servicing should be representative of those costs in the marketplace and should include a profit assumption equal to the profit demanded in the marketplace. Adequate compensation is determined by the marketplace; it does not vary according to the specific servicing costs of the servicer. Therefore, a servicing contract that entitles the servicer to receive benefits of servicing just equal to adequate compensation, regardless of whether the servicer's own servicing costs are higher or lower, does not result in recognizing a servicing asset or servicing liability.

FASB 140 makes no distinction between "normal servicing fees" and "excess servicing fees." The distinction made is between "contractually specified servicing fees" and rights to excess interest ("IO strips"). Contractually specified servicing fees are all amounts that, in the contract, are due the servicer in exchange for servicing the assets. These fees would no longer be received by the original servicer if the beneficial owners of the serviced assets (or their trustees or agents) were to exercise their actual or potential authority under the contract to shift the servicing to another servicer. Depending on the servicing contract, those fees may include: the contractual servicing fee, and some or all of the difference between the interest collected on the asset being serviced and the interest to be paid to the beneficial owners of those assets.

This is what happened to excess servicing:



EXAMPLE Financial assets with a coupon rate of 10 percent are securitized. The pass-through rate to holders of the SPE's beneficial interests is 8 percent. The servicing contract entitles the seller-servicer to 100 basis points as servicing compensation. The seller is entitled to the remaining 100 basis points as excess interest. Adequate compensation to a successor servicer for these assets is assumed to be 75 basis points. The chart graphically depicts the arrangement.

Servicing assets created in a securitization are initially measured at their allocated carrying amount, based upon relative fair values at the date of securitization. Rights to future interest income from the serviced assets in amounts that exceed the contractually specified servicing fees should be accounted for separately from the servicing assets. Those amounts are not servicing assets—they are IO strips to be accounted for as described in the chart on page 43. Servicing assets are amortized in proportion to, and over the period of, estimated net servicing income (the excess of servicing revenues over servicing costs). This is often referred to as the net income forecast or proportional method of amortization. If the estimated net servicing income in Month 1 represents 1 percent of the total (on an undiscounted basis) of the estimated net servicing income over the life of the pool, then 1 percent of the original asset recorded for servicing rights would be amortized as a reduction of servicing fee income in Month 1. This is in contrast to a depletion or liquidation method, which is based on declining principal balances or number of loans. Servicing assets must be subsequently evaluated and measured for impairment as follows:

- 1] Stratify servicing assets based on one or more of the predominant risk characteristics of the underlying financial assets. Those characteristics may include financial asset type, size, interest rate, date of origination, term and geographic location.
- 2] Recognize any impairment through a valuation allowance for an individual stratum. The amount of impairment recognized is the amount by which the carrying amount of servicing assets for a stratum exceeds its fair value. An excess of fair value over carrying amount in one stratum may not be used to offset impairment in another stratum. Also, the fair value of servicing assets that have not been recognized (e.g., those created prior to the adoption of FASB 122) cannot be used to mitigate an impairment loss.
- 3] Adjust the valuation allowance to reflect changes in the measurement of impairment subsequent to the initial measurement. Fair value in excess of the carrying amount for that stratum shall not be recognized. [63]

Servicing is not a “financial asset” under FASB 140. Accordingly, there is a higher threshold analysis of “risks and rewards” to achieve sale accounting when mortgage servicing rights are transferred. See EITF Issues No. 90-21 and 95-5.

Comparison of contractual servicing asset vs. IO strip accounting under FASB 140

	SERVICING ASSET	IO STRIP
Definition	The value of amounts that, per the contract, are due to the servicer for servicing, if more than adequate compensation	Entitlements to interest spread beyond the contractually specified servicing rate
Initial Recorded Amount	Allocated cost-relative to fair value	Allocated cost-relative to fair value
Adjusted Initial Recorded Amount	No adjustment	Adjustment up or down to fair value through earnings, if trading, or equity (other comprehensive income), if available for sale
Income Recognition	Amortized in proportion to and over the period of estimated net servicing income	Trading: Marked to market Available for sale: Level yield, prospective adjustment under EITF 99-20, see page 49
Balance Sheet Carrying Value	Allocated cost, less accumulated amortization and valuation allowance	Fair value
Recognition of Impairment	Through valuation allowance for an individual stratum when carrying amount exceeds fair value; change in valuation allowance in earnings	Trading: Marked to market Available for sale: Write-down to fair value under EITF 99-20, if impaired, see page 49

The difference in accounting between servicing fees and IOs could lead seller-servicers to select a stated servicing fee that results in larger servicing assets and lower retained IO interests (or vice versa), with an eye to subsequent accounting. The potential accounting incentives for selecting a higher or lower stated servicing fee may counterbalance each other. On the other hand, because of potential earnings volatility (regardless of treatment), many issuers may look to ways to minimize servicing assets and sell or repackage servicing and IO strips. Note that the transfer of servicing is covered in EITF Issues No. 90-21 and 95-5, not FASB 140.

SHOULD I RECORD A LIABILITY FOR RETAINED CREDIT RISK, OR IS IT PART OF THE RETAINED BENEFICIAL INTEREST IN THE ASSET?

The transferor should focus on the source of cash flows in the event of a loss by the trust. If the trust can only “look to” cash flows from the underlying financial assets, the transferor has retained a portion of the credit risk through its retained interest. It should not record a separate obligation. Possible credit losses from the underlying assets do affect, however, the accounting for and the measurement of the fair value of the transferor’s retained interest. In contrast, if the transferor could be obligated to reimburse the trust beyond losses charged to its retained interest (i.e., it could be required to “write a check” to reimburse the trust or others for credit related losses on the underlying assets) a separate liability should be recorded at fair value on the date of transfer.

HOW ARE CASH RESERVE ACCOUNTS HANDLED? —WHAT IS THE “CASH-OUT” METHOD?

According to question 73 in the FASB Q&A Implementation Guide, a cash reserve account is a retained interest in transferred assets. This is true regardless of whether the account is funded with the transferor’s own cash or cash is withheld from sale proceeds to establish the account. If the transferor’s own cash is used, then for purposes of the gain or loss calculation, the carrying amount of assets transferred is increased by the amount of cash deposited. If the cash deposit is funded with amounts withheld from sale proceeds, then for purposes of the gain or loss calculation, the carrying amount of the assets transferred is also increased by the amount of cash deposited. Thus, the sequence of events does not affect the net gain or loss recognized at the time of securitization. Assuming the securitization is accounted for as a sale, the reserve account is recorded at its allocated basis, based on relative fair value on the transfer date. If the cash reserve account is inside the securitization trust and the seller’s only entitlement to it is through its ownership of some form of residual certificate, then no separate asset is recorded for the account; rather, its fair value characteristics are included when estimating the fair value of the residual interest. The fair value of a cash reserve account will usually have to be estimated since there is no ready market for this type of asset.

Consider the following example:

Company A securitizes \$100 million principal amount of loans, which produce excess interest of 100 basis points per annum after servicing fees and interest paid to investors. At the transfer date, \$1 million in cash is deposited in an interest bearing cash reserve account outside of the securitization trust. In subsequent periods, all cash distributions to which Company A as residual holder would otherwise be entitled are deposited in the cash reserve account and reinvested in eligible short term investments. Any losses incurred on the pool are reimbursed to the Trust with funds transferred from the cash reserve account. When the reserve account balance accumulates to an amount in excess of 5% of the outstanding balance of the securitized assets, the excess is released to Company A. At subsequent dates, additional amounts based on lower percentages are scheduled to be released to the Company.

Company A uses the “cash-out” method in its net present value calculation. Under this method, Company A projects the excess cash flows (increased by anticipated reinvestment income) as of the day they are available to the Company (the dates the amounts are released from the cash reserve account). This is in contrast to the “cash-in” method in which future cash flows are projected to occur earlier (and have a higher net present value); they are projected to occur as of the monthly dates the 100 bp of excess interest are generated on the loans (note that anticipated reinvestment income is excluded from that calculation to avoid double-counting). Separately, an amount of losses to be reimbursed to the Trust would be estimated.

According to question 75 in the FASB draft Q&A Implementation Guide:

...using an expected present value technique or a “best estimate” technique with an appropriate discount rate, the cash-out method estimates the fair value in a manner consistent with paragraph 69 [the fair value requirements of FASB 140] (that is, both the entire period of time that the transferor’s use of the asset is restricted and the potential losses due to uncertainties are considered when estimating the fair value of the credit enhancement).

The SEC staff goes even further. They have announced that the cash-in method could result in a material misstatement of the financial statements. Accordingly, several registrants have been required to file restated financial statements.

DESECURITIZATIONS—WHAT IF WE PUT HUMPTY-DUMPTY BACK TOGETHER AGAIN?

A “deseuritization” is the process by which securities created in a securitization are transformed back into their underlying loans or other financial assets. Since FASB 140 does not allow sale treatment when an asset is exchanged for 100 percent of the beneficial interests in that asset, it seemed logical to the FASB staff that sale treatment should not be allowed for the opposite case of an exchange of all of the beneficial interests in the asset (e.g., IOs and POs or senior and subordinated classes) for the asset itself (e.g., the mortgage loans). See EITF Topic D-51, *The Applicability of FASB Statement No. 115 to Deseuritizations of Financial Assets*.

INVESTOR accounting

HOW DO I ACCOUNT FOR SECURITIES WITH PREPAYMENT AND/OR CREDIT RISK?

IO strips, loans or other receivables that can be contractually prepaid or otherwise settled in such a way that the holder would not recover substantially all of its investment are to be carried at fair value, similar to investments in debt securities classified as available for sale or trading under FASB 115. [14] This is true regardless of whether the assets were purchased or were retained in a securitization and regardless of whether the asset (the entitlement to cash flows) is certificated as a security or uncertificated.

No guidance is given as to the size of a premium that would trigger this provision. However, the FASB staff has said that the probability of prepayment is not relevant in deciding whether this provision should apply. So the potential for the loss of a portion of the investment would not be evaluated differently for a wide-band Planned Amortization Class (PAC) class vs. a support class.

EITF 99-20, *Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets* sets forth the rules (effective in the second quarter of 2001) for (1) recognizing interest income (including amortization of premium or discount) on (a) all credit-sensitive mortgage and asset-backed securities and (b) certain prepayment-sensitive securities including agency IOs and (2) determining when these securities must be written down to fair value because of impairment. Existing GAAP did not provide guidance for securities whose cash flows change as a result of both prepayments and credit losses and, in some cases, interest rate resets.

Consider the following example:

You own a subordinated debt class from a securitization of mortgage loans. It has a principal amount and a variable rate of interest. Losses on the underlying mortgage loans in the pool are charged against this subordinated class before any losses are allocated to the senior classes. Because of this feature, the security's fair value and allocated basis is significantly less than its principal amount. At inception, a certain amount of prepayments and losses is expected. At the end of the first quarter, (a) the actual interest rate on the class changes; (b) the actual prepayments and the estimate of future prepayments differ from the original expectation, and (c) the actual losses and the estimate of future losses differ from the original expectation.

EITF 99-20 adopts the **prospective** method for adjusting the level yield used to recognize interest income when estimates of future cash flows on the security either increase or decrease since the date of the last evaluation (typically quarterly—see next page, Determining Periodic Interest Income).

The impairment provisions of EITF 99-20 bring us much closer to a lower-of-amortized cost or fair value approach than existing GAAP. Effectively, two sets of books are maintained: one at

amortized cost and one at fair value. If (1) fair value is less than amortized cost and (2) the present value of the estimated cash flows have decreased since the last estimate was made (other than as a result of an interest rate reset of a plain-vanilla floater), then you must write-down the security to fair value through earnings.

Securities covered by EITF 99-20 include:

- All ABS, CDOs, CMBS and MBS that are not (1) guaranteed by the government, its agencies or guarantors of similar credit quality or (2) sufficiently collateralized to ensure that the possibility of credit loss is remote. A minimum rating requirement (e.g., investment-grade) to be eligible for exclusion from 99-20 was not specified.
- All IOs, including agency IOs and any other premium securities if prepayments could cause the holder not to recover substantially all of their recorded investment. (Agency POs are excluded.)

The above securities are covered by EITF 99-20 regardless of whether they are:

- Securities purchased by investors or securities (or uncertificated interest strips) retained by securitizers
- Fixed rate or floating rate securities
- Publicly offered or privately offered securities
- Securities classified as held-to-maturity or available-for-sale. If classified as trading, they are already being marked to market, but the interest income recognition portion of 99-20 applies if the holder is required to report interest income separately in their income statement pursuant to industry practice.
- Securities designated as notes, bonds, pass-throughs or participation certificates. Even trust certificates are typically covered because they often possess the characteristics of debt rather than equity securities (see below).

The scope of EITF 99-20 includes the debt host component of a hybrid beneficial interest. A hybrid beneficial interest (for purposes of this discussion) is one that embeds a derivative that requires separate accounting under FASB 133. The issue of when and how a hybrid contract is to be separated into its component parts is a FASB 133 implementation issue and, therefore, not within the scope of EITF 99-20. However, due to a number of technical and conceptual issues, the FASB has suspended the application of FASB 133 to beneficial interests in securitizations until the FASB resolves these issues. Yet another reason to: STAY TUNED FOR FURTHER DEVELOPMENTS. 📺🔊

Determining Periodic Interest Income

As of the purchase date for investors or the securitization settlement date for securitizers, you estimate the timing and amount of all future cash inflows from the security using assumptions that were used in determining fair value. The excess of those future cash flows over the initial investment (or allocated cost under FASB 140 for securitizers) is the accretable yield to be recognized as interest income over the life of the investment using the effective yield method.

You determine the yield by solving for the internal rate of return (IRR) which equates those future cash flows back to the amount of the initial investment (or allocated cost for securitizers). At any balance sheet date, the amortized cost of the investment is equal to (1) the initial investment plus (2) the yield accreted to date less (3) all cash received to date regardless of whether labeled as interest or principal less (4) any writedowns for impairment (see below).

You must update the cash flow estimates throughout the life of the investment taking into account the assumptions that marketplace participants would use in determining fair value. To determine the level yield used to accrete interest income in the following period, you must solve for a new IRR which equates the new estimates of future cash flow back to the amortized cost amount at the latest balance sheet date.

Some residual interests generate relatively small amounts of cash to the holder in the early periods of a securitization (due to the requirement to build up credit enhancement). When applying the effective yield method to these residuals, it is likely that the carrying value of the residual will be higher at the end of the year than at the beginning of the year and that is acceptable provided the estimates of cash flow are appropriate.

Determining Whether an Impairment Charge Is Required

Whenever the current fair value of the security is lower than its current amortized cost, you must test to see if an impairment charge for the deficiency is required to be taken through current earnings. If there has been an adverse change in estimated cash flows (considering both the timing and amount of flows), then you must write the security down to fair value, which becomes the new amortized cost basis for future amortization. This is how you determine if there has been an adverse change:

- 1] Calculate the present value of the newly estimated remaining cash flows discounted at the last rate used to recognize accretable yield on the security. Changes in cash flow resulting from resets on plain-vanilla floating rate securities are not taken into account in this test provided the security is not a super-floater or an inverse floater.
- 2] Compare the present value in step 1 to the present value of the previously estimated remaining cash flows discounted at the last rate used to recognize accretable yield on the security [adjusted for cash receipts during the intervening period].
- 3] If the present value has decreased (i.e., step 1 result is less than step 2 result), then an adverse change and an other-than-temporary impairment has occurred.

Transition



EITF 99-20 must be applied no later than the second quarter of 2001, (regardless of a company's fiscal year-end) to all securities in the portfolio, not just those purchased after 3/31/01. Earlier application is permitted but previously issued financial statements cannot be restated to adopt the provisions of 99-20.

In the quarter of adoption, the level yield to be used to recognize interest income will be based on the amortized cost amount as of the last day of the previous quarter (e.g., 3/31/01 if adopted in the second quarter of 2001) and the estimates of future cash flows made as of the first day of the quarter of adoption (e.g., 4/01/01 if adopted in the second quarter of 2001).

For securities whose fair value is below amortized cost but no impairment charge was required to be recorded under existing GAAP, but would have been required if the company had been applying EITF 99-20, an impairment charge writing the security down to fair value must be recognized in the quarter of adoption (may be recognized earlier) in a manner similar to a cumulative effect of a change in accounting principle.

When do I need to change the yield on an investment covered by EITF 99-20?

When do I have to take a write-down on an investment covered by EITF 99-20?

Has there been a change in the timing or amount of estimated cash flows as measured by a change in the present value of the estimated future cash flows (using the most recent yield to recognize interest income)?	Increased	Increase the yield prospectively (to the IRR of revised estimate of cash flows discounted to the current amortized cost)	
	Stayed the same	Continue to apply the most recent yield to recognize interest income	
	Decreased	Is current Fair Value lower than carrying value (amortized cost)?	
		YES 	NO 
		Write-down the investment to its fair value as a charge to current earnings* Change the yield prospectively (to the current market yield used in the fair value determination)	Decrease the yield prospectively

*A write-down may not be required if the decline in the present value of the cash flows is primarily the result of a change in the contractual interest rate of an investment in a “plain-vanilla” floater (i.e., there would not have been a decline absent the change in interest rate). Leveraged floaters and inverse floaters are not plain-vanilla.

SEC Staff Accounting Bulletin 59, SAS 92 and the FASB Special Report on Statement 115 provide additional guidance when considering whether an other-than-temporary impairment exists. Also, if you intend to sell a specifically identified security classified as available-for-sale at a loss shortly after the balance sheet date, a write-down for other-than-temporary impairment should be recognized in earnings in the period in which the decision to sell is made. [EITF Topic D-44, “Recognition of Other-than-Temporary Impairment upon the Planned Sale of a Security Whose Cost Exceeds Fair Value”]

SAS 92 cites the following additional factors as indicators that an other-than temporary impairment might have occurred:

- The decline is attributable to adverse conditions specifically related to the security.
- The decline has existed for an extended period of time.
- Management does not possess both the intent and the ability to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value.
- The security has been downgraded by a rating agency.

Example of Application of EITF 99-20

- I purchase a B-piece on January 1, 2001 for \$106.08. It has a face amount of \$100 and is also entitled to all of the excess interest from the net coupon on the loans over the interest paid to the senior class, subject to reimbursing the senior class for credit losses.
- The assumed pre-tax yield at the date of purchase is 10.77% per annum based on an assumed prepayment rate of 5 CPR and assumed losses of 100 basis points per annum on the outstanding principal amount of the loans (the "Base Case").
- As of the end of year 1, there are five alternative scenarios presented in the following table. The first is that the base case prepayment, loss and market yield for the B-piece assumptions do not change. The other scenarios involve an increase or decrease in one or more of the assumptions as to prepayments, losses and market yield for the B-piece.

		BASE CASE	Scenarios for Years 2 through 5			
			ONE	TWO	THREE	FOUR
1	Prepayment Assumption	5 CPR	7 CPR	7 CPR	3 CPR	3 CPR
2	Credit Loss Assumption	100 bp	200 bp	200 bp	50 bp	50 bp
3	Market Yield for B-piece	10.77%	12%	8%	12%	8%
4	Cash Flows to B-piece:					
5	Year 1	\$15.70	\$15.70	\$15.70	\$15.70	\$15.70
6	Year 2	13.30	11.19	11.19	14.34	14.34
7	Year 3	28.08	31.70	31.70	24.51	24.51
8	Year 4	52.23	49.24	49.24	54.44	54.44
9	Year 5	42.89	38.52	38.52	46.65	46.65
10	Total Years 1 thru 5	\$152.20	\$146.35	\$146.35	\$155.64	\$155.64
11	Present Value of Yr. 2 thru 5 Cash Flows discounted at accretable yield rate of 10.77%	\$101.80	\$97.75	\$97.75	\$103.96	\$103.96
12	Fair Value at End of Year 1 (PV of lines 6 thru 9 discounted at market yield in line 3)	\$101.80	\$94.79	\$104.94	\$100.74	\$111.80
13	Interest Income-Year 1 (investment of \$106.08 times the base case yield of 10.77%)	\$11.43	\$11.43	\$11.43	\$11.43	\$11.43
14	Amortized Cost-end of Yr. 1 (initial investment plus interest income less year 1 cash flow)	\$101.80	\$101.80	\$101.80	\$101.80	\$101.80
15	Has there been a decrease in the present value of estimated remaining cash flows in line 11?	NA	YES	YES	NO	NO
16	Is Fair Value (line 12) below Amortized Cost (line 14)?	NO	YES	NO	YES	NO
17	Impairment to be Recorded (if line 15 and 16 are YES then line 14 minus line 12)?	NO	\$7.01	NO	NO	NO
18	Adjusted Carrying value at end of Year 1	\$101.80	\$94.79	\$101.80	\$101.80	\$101.80
19	Revised Yield for Year 2 (IRR of lines 6 thru 9 discounted back to line 18)	10.77%	12.00%	9.17%	11.59%	11.59%
20	Interest Income –Year 2 (line 19 times line 18)	\$10.96	\$11.38	\$9.34	\$11.80	\$11.80

⁽¹⁾ For reverse-engineers only: The deal structure used to generate the cash flows going to the B-piece was a pool of five-year loans with a principal amount of \$250 amortizing with five annual payments of \$50. Gross coupon of 12 percent on the outstanding principal (after charge-offs) less servicing fee of 1 percent of the outstanding principal (before charge-offs). The senior class had a principal amount of \$150, an interest rate of 6 percent, and was entitled to 100 percent of all scheduled and unscheduled principal payments and write-offs of principal until retired.

How to Account for Investments in Beneficial Interests Issued in the Form of Equity⁽¹⁾

Does the investment represent more than 50% of voting control?	YES →	Consolidate the SPE	YES →	Equity security to be accounted for under FASB 115 as available for sale or trading
NO ↓				
Is the security entitled to cash flows under preset terms and conditions?	YES →	Debt-like security to be accounted for under EITF 99-20		
NO ↓				
Does the investment represent less than 20% voting interest?	YES →	Does the security have a quoted market price?	YES →	
NO ↓		NO ↓		
Equity security to be accounted for using the equity method under APB 18		Equity security to be accounted for at cost under APB 18		

⁽¹⁾ Some beneficial interests issued in equity form may meet the definition of a debt security in FASB 115. For example, some beneficial interests issued in the form of equity represent solely the purchase of a stream of future cash flows to be collected under preset terms and conditions or, by the terms of the special-purpose entity, must be redeemed by the issuing enterprise or are redeemable at the option of the investor. Consequently, those beneficial interests would be within the scope of EITF 99-20 since they are required to be accounted for as debt securities under FASB 115. However, if the position represents a controlling financial interest, consolidation of the SPE is the likely result even if the securities are a redeemable preference share.

through

the

LOOKING GLASS, THE

FASB'S

new

REQUIRED

disclosures

THROUGH THE LOOKING GLASS, THE FASB'S NEW REQUIRED DISCLOSURES

Appendix C to FASB 140 provides specific examples that illustrate the new disclosures that are required. The particular formats in the illustrations are not required; you are encouraged to use a format that displays the information in the most understandable manner in the specific circumstances. The disclosures about securitizations occurring during the period are not required for periods ending before December 15, 2000 (when income statements are presented for comparative purposes with financial statements for periods after that date). [22]

If securitizations are accounted for as sales (but not if they are accounted for as debt) and retained interests are held at the latest balance sheet date, the securitizer must disclose for each major type (e.g., residential mortgage loans, commercial mortgage loans, auto loans, credit card accounts):

- 1] Its accounting policies for initially and subsequently measuring the retained interests including the methodology used to determine their fair value.
- 2] A description of the continuing involvement with the transferred assets, including servicing, recourse and restrictions on retained interests and the gain or loss on sale.
- 3] Quantitative information on the key assumptions used in measuring fair value of the retained interests including discount rates, expected prepayments including expected weighted average life of the underlying assets, and anticipated credit losses separately (a) at the time of the securitization (see Table 1) and (b) subsequently, at the date of the LATEST balance sheet (see Table 2). Ranges of assumptions can be disclosed if the entity has entered into multiple securitizations of the same major asset type during the year.
- 4] Cash flows between the securitization SPE and the transferor including proceeds from new securitizations, amounts reinvested during revolving periods, purchases of delinquent or foreclosed loans, servicing fees and advances, and cash flows received on retained interests, including releases of overcollateralization amounts. See Table 4.
- 5] Static pool actual and projected losses as a percentage of the original balance securitized (generally for each year of origination). See Table 3.
- 6] A stress test showing the hypothetical effect on the fair value of retained interests which would result from two or more unfavorable variations (e.g., 10 percent and 20 percent increases) from the expected levels for each key assumption, calculated without changing any other assumption. See Table 2.
- 7] For both off-balance sheet assets (i.e., securitized assets) and on-balance sheet assets of the same type that the entity manages:
 - a] delinquencies at the end of the period
 - b] credit losses, net of recoveries, during the period
 - c] principal amounts outstanding of (i) securitized loans accounted for as sales; (ii) on-balance sheet loans held for sale or securitization; and (iii) on-balance sheet loans held in portfolio. See Table 5.

8] In a carryover from FASB 125, for all servicing assets and servicing liabilities:

- a]** The amounts of servicing assets or liabilities recognized and amortized during the period.
- b]** The fair value of recognized servicing assets and liabilities for which it is practicable to estimate that value and the method and significant assumptions used to estimate the fair value.
- c]** The risk characteristics of the underlying financial assets used to stratify recognized servicing assets for purposes of measuring impairment
- d]** The activity in any valuation allowance for impairment of recognized servicing assets—including beginning and ending balances, aggregate additions charged and reductions credited to operations, and aggregate direct write-downs charged against the allowances—for each period for which results of operations are presented. [17]

Additional Considerations about the Disclosures:

- The disclosure requirements do not apply to quarterly financial reports. Some companies include the same disclosures in their quarterly reports as they do in their annual reports; while others have provided minimal disclosure in their quarterly reports.
- The FASB chose to require disclosure by major class of asset because prepayments, credit losses and interest rates vary so widely between major classes that aggregating data across those classes would obscure useful information.
- They chose to require disclosure of the weighted average life of the underlying assets so that disclosures of prepayment assumptions would be more comparable since different companies use different methodologies and terminology. [328]
- They chose to require static pool information so that disclosures of credit loss assumptions would be more comparable since different entities use different calculation methods and terminology. [330]
- They chose to require the impact of two or more adverse variations for each key assumption so that the results would indicate whether the valuation had a linear relationship to the assumptions. They chose not to dictate any particular change in assumptions so that companies could select the changes that best portray the sensitivity of the estimates. [330] Companies are not precluded from voluntarily disclosing the effects of positive variations in the assumptions so long as the required adverse variations are shown. The SEC staff has stated that they believe that the sensitivity disclosures should provide investors with transparent information to determine the *pro forma* effects of a change in market conditions on the registrant's retained interests. For example, they would not likely object to the selection of a hypothetical change in assumptions that: (1) is expected to reflect reasonably possible near-term changes in those assumptions, for example a 10 percent adverse change; and (2) reflects significant deviations from those year-end market assumptions that are possible, but are not expected, to occur, sometimes referred to as "outlier" assumptions.

- The SEC staff has commented to auditors that the sensitivity analysis disclosed in the footnotes to the financial statements must be subjected to robust audit procedures, including testing the reasonableness of the assumptions used, as well as testing the accuracy of the model.
- Although not required, disclosure of average balances of managed assets is encouraged because it provides a useful base for comparison of credit losses for the year. [331]
- They did not require separate disclosure of the amounts in foreclosure, repossession, REO, and bankruptcy (even though this information might be foretellers of future losses) nor did they indicate whether those amounts should be included in the reporting of the delinquent amounts. Different companies apply different approaches (e.g., treatment of modifications, waivers and extensions) when making these disclosures.
- They did not require disclosure of servicing advances receivable in the disclosure of the managed portfolio even though this information also might be a foreteller of future losses. The amounts of servicing advances and reimbursements during the year is a required disclosure.
- The managed portfolio disclosures can exclude securitized assets that an entity services if it has no other continuing involvement. [331]
- Some companies provide supplemental information showing key financial statement components on a *pro forma* basis as if their off-balance sheet securitizations were on-balance sheet. The FASB considered, but rejected, this type of presentation as being a required part of the new disclosures.
- The Statement does not include a quantitative materiality threshold for making the required disclosures. However, that does not imply that the disclosure provisions must be applied to immaterial items. Some entities may determine that some or all of the disclosures about securitization transactions are not material after an evaluation of all the relevant facts and circumstances. [332]

TABLE 1

Key economic assumptions used in measuring the fair value of retained interests at the date of securitization resulting from securitizations completed during the year 2000 (weighted based on principal amounts securitized) were as follows:

	Auto Loans	Credit Card Loans	Residential Mortgage Loans	
			Fixed-Rate	Adjustable
Prepayment speed (annual rate)	1.00%	15.00%	10.00%	8.00%
Weighted-average life (in years)	1.80	0.50	7.80	6.50
Expected credit losses	1.10%-2.40%	6.10%	1.25%	1.30%
Residual cash flows discounted at	13.3%	12.2%	11.6%	10.09%
Interest rates on adjustable loans and bonds	Forward Eurodollar yield curve plus contractual spread over LIBOR ranging from 30 to 80 basis points			

TABLE 2

At December 31, 2000, key economic assumptions and the sensitivity of the current fair value of residual cash flows to immediate 10 percent and 20 percent adverse changes in those assumptions are as follows (\$ in millions):

	Auto Loans	Credit Card Loans	Residential Mortgage Loans Fixed-Rate	Adjustable
Balance Sheet Carrying Value of retained interests-Fair Value	\$15.60	15.00	\$12.00	\$13.30
Weighted-average life (in years)	1.7	0.4	6.5	6.1
Prepayment speed assumption (annual rate)	1.3	15.0	11.5	9.3
Impact on fair value of 10% adverse change	0.3	1.6	3.3	2.6
Impact on fair value of 20% adverse change	0.7	3.0	7.8	6.0
Expected credit losses (annual rate)	3.0%	6.1	0.9	1.8
Impact on fair value of 10% adverse change	4.2	3.2	1.1	1.2
Impact on fair value of 20% adverse change	8.4	6.5	2.2	3.0
Residual cash flows discount rate (annual)	14.0	14.0	12.0	12.0
Impact on fair value of 10% adverse change	1.0	0.1	0.6	0.5
Impact on fair value of 20% adverse change	1.8	0.1	0.9	0.9
Interest rates on variable and adjustable loans and bonds	Forward Eurodollar yield curve plus contracted spread			
Impact on fair value of 10% adverse change	1.5	4.0	0.4	1.5
Impact on fair value of 20% adverse change	2.5	8.1	0.7	3.8

These sensitivities are hypothetical and should be used with caution. As the figures indicate, changes in fair value based on a 10 percent variation in assumptions generally cannot be extrapolated because the relationship of the change in assumption to the change in fair value may not be linear. Also, in this table, the effect of a variation in a particular assumption on the fair value of the retained interest is calculated without changing any other assumption; in reality, changes in one factor may result in changes in another (for example, increases in market interest rates may result in lower prepayments and increased credit losses), which might magnify or counteract the sensitivities.

TABLE 3: Expected Static Pool Credit Losses

Static pool losses are calculated by summing the actual and projected future credit losses and dividing them by the original balance of each pool of assets. The amount shown here for each year is calculated based on all securitizations occurring in that year.

Actual and Projected Credit Losses (%) as of:

	Automobile Loans Securitized in		
	1998	1999	2000
December 31, 2000			
Actual to date	1.45	.93	.21
Projected	.55	1.00	1.75
Total	2.00	1.93	1.96
December 31, 1999			
Actual to date	.85	.18	
Projected	1.10	1.71	
Total	1.95	1.89	
December 31, 1998			
Actual to date	.15		
Projected	1.70		
Total	1.85		

Note: FASB 140 does not require that the actual to-date and the projected amounts be separately disclosed.

TABLE 4:

The table below summarizes the cash flows received from (paid to) securitization trusts during the year ended December 31, 2000 (\$ in millions):

Proceeds from new securitizations	\$1,413
Collections used by the trust to purchase new balances in revolving credit card securitizations	3,150
Servicing fees received	23
Cash flows received on interest-only strips	71
Cash received upon release from reserve accounts	10
Purchases of delinquent or foreclosed assets	(45)
Servicing advances	(102)
Reimbursements of servicing advances	90
Prepayment Interest Shortfalls paid out as compensating interest	(5)

TABLE 5:

Historical Loss and Delinquency Amounts for the Managed Portfolio for the year ended December 31, 2000 (\$ in millions):

	Total Principal Amount of Loans	Delinquent Principal Over 60 Days	Average Balance (Optional)	Credit Losses (net of recoveries)
Type of Loan	At December 31, 2000		Year Ended Dec. 31, 2000	
Auto	\$ 830	\$ 42.3	\$ 720	\$ 21.6
Residential Mortgages:				
Fixed-rate	482	5.8	470	5.6
Adjustable-rate	544	7.1	520	6.2
Credit card balances	300	15.0	350	16.0
Total loans managed	\$ 2,156	\$ 70.2	\$ 2,060	\$ 49.4
Comprised of:				
Loans held in portfolio	\$ 652	25.0		
Loans held for sale or securitization	19	.2		
Loans securitized	1,485	45.0		
Total loans managed	\$ 2,156	\$ 70.2		

what's
SLATED
FOR
2001?

WHAT'S SLATED FOR 2001?

- The FASB has said that they intend to issue an Exposure Draft in the second quarter of 2001 dealing with Consolidations of entities that have significant limits on their permitted activities and powers (a.k.a. SPEs). The scope would not be limited to securitization vehicles but would include other types of entities as well. The FASB has tentatively promised that they will not overturn FASB 140's dictum that a QSPE shall not be consolidated in the financial statements of a transferor or its affiliates. [199] You can look to the FASB's Web site at www.fasb.org for updates on the status of that project.
- Originally, the AICPA auditing interpretation on Lawyers' Letters did not apply to securitizations by FDIC-insured banks. At the time of this writing, the AICPA is working on a revision to the interpretation to provide guidance based on the recently issued FDIC rule described earlier. The revised auditing interpretation, when available, will be posted to www.aicpa.org.
- The FASB staff released a preliminary draft of a FASB Special Report, Implementation Guide on FASB 140 containing the following guidance:

If a transferor holds a call option to repurchase the individual loans that remain, from an entire portfolio of prepayable loans that were transferred in a securitization transaction, once prepayments have reduced the portfolio balance to some specified amount, then sale accounting is precluded only for the transfer of the remaining principal balance subject to the call, not the whole portfolio of loans.

Visit the FASB's Web site to see when a final Implementation Guide is available.

- The issue of when and how a hybrid contract is to be separated into its component parts is an implementation issue of Statement 133 and, therefore, not within the scope of 99-20 (see Derivatives Implementation Group Issue D1). Holders of beneficial interests in securitized financial assets that are not subject to paragraph 14 of Statement 140 are not required to apply Statement 133 to those beneficial interests until further guidance is issued.
- The FASB is concerned about the difficulties associated with hedging servicing assets under FASB 133 and intends to consider adding a limited-scope project to its technical agenda that would require measurement of all servicing assets at fair value, with changes in value recognized currently in earnings. A fair value measurement model for recognized servicing assets would eliminate the need for hedge accounting under FASB 133 because it would provide the same measurement and income recognition for both those assets and the derivative instruments used to hedge them. The Board intends to consider adding that project to its technical agenda at a public Board meeting in the near term.
- The federal banking agencies issued a notice of proposed rule making in October 2000 that would require dollar-for-dollar capital for all retained interests which provide credit enhancement and would limit the maximum amount of these assets a bank could hold as a percentage of Tier 1 capital. Stay tuned for further developments at www.ffiec.gov.

ARE YOU

READY

TO

ACCOUNTANT?

TO PLAY WHO WANTS TO BE

ARE YOU READY TO PLAY *WHO WANTS TO BE AN ACCOUNTANT?*

Buy-It, Sign-It, Drive-It, Inc. (“Buy-It”) purchases retail installment auto contracts from a network of selected dealers in the Southwestern Region of the U.S. It has sustained its market share in the face of increasing competition by intensely focusing on its niche. Buy-It finances predominantly prime paper—the borrowers have solid credit histories and make a significant down payment on the autos they purchase.

Buy-It also leases autos to customers under its “Why Pay?” program. Buy-It acquires title to the cars and leases them to retail customers over 36 months, with a variety of customer choices concerning initial minimum payments, ongoing monthly rentals and buyout provisions.

Buy-It has sold some of its paper to Glorious Asset Trust, a multi-seller commercial paper conduit managed by a regional Bank. The balance of the portfolio is financed on-balance sheet via a combination of the Company’s equity and secured bank loans.

Buy-It is considering its first term auto loan securitization. The growing size of Buy-It’s originations, the Company’s good reputation in the market place, and the strength of its servicing operation all point to a successful securitization.

You envision a classical two-step structure for the securitization.

STEP 1: Buy-It will form a wholly owned bankruptcy remote special purpose entity, Buy-It Financial Corp. (“Financial”). The loans will be transferred to Financial as an equity contribution.

STEP 2: Financial will transfer the loans to a newly formed entity, Buy-It Owner’s Trust (“Trust”), in exchange for (1) cash and (2) a certificate, representing the residual interest in the trust. Trust will finance the cash portion of the purchase price by issuing multiple tranches of debt. Financial will distribute to Buy-It the cash it receives from the Trust.

Other significant terms of the transaction are as follows:

- Buy-It will service the loans for a contractually specified servicing rate of 100 basis points.
- Buy-It will have a call option on the sold loans when their principal is 10 percent or less of the original balance sold; a level at which the cost of continuing to service is considered burdensome.
- Buy-It sells all of the Class A and B tranches. As the residual holder, Buy-It is entitled to the net margin enjoyed by the Trust; i.e., the difference between the yield on the auto loans less the sum of the cost of the Trust debt, servicing, and ongoing administration.
- Cash flow to the Residual Certificate is subordinated—all credit losses on the loans are allocated in their entirety to the Residual Certificate. In the unlikely event that credit losses exceed the Residual’s ability to absorb defaults, losses will be allocated to the debt tranches in ascending order of priority.
- All-in transaction costs will run \$1,375,000.

REQUIRED: WHAT’S THE BOTTOM LINE?

Determine the pretax gain or loss on the proposed sale in accordance with FASB 140, using information presented in the case and in the Fact Sheet below. We suggest that you create a worksheet like the template on page 34.

Fact Sheet

Loan Principal to Be Securitized: \$140 million

Existing Allowance for Losses: \$100 thousand

Expected Tranche Data:

Class	Principal	Rate Type	Rate	Sale Price
A-1	\$65,000,000	Fixed	5.5%	100%
A-2	40,000,000	Fixed	6.0%	100%
A-3	30,000,000	Fixed	6.25%	100%
B	5,000,000	Fixed	6.55%	95%
Residual	0	Net Spread	Net Spread	N/A

Estimated Fair Value of Residual:

Scenario Outcome	Fair Value Amount*	Major Assumptions:
Optimistic	\$4,600,000	Historical trends continue except pool performance data improves in six months due to demonstrated effectiveness of new servicing system, increased training of personnel and improved policies and procedures.
Best Estimate	\$3,750,000	Historical trends continue. Higher discount rate used due to recent industry developments and estimated effect on liquidity of residual asset.
Pessimistic	\$2,450,000	Same as best estimate except prepayments/losses increase due to softening of regional economy.

*These amounts represent a range of estimated fair values (i.e., willing buyer, willing seller) based on reasonable market-based assumptions as to credit losses, prepayment rates and discount rates. The company has not quantified the probabilities associated with each of the scenario outcomes.

Fair Value of Servicing Asset: \$2.5 million

Based on the amount a successor servicer would pay to assume the servicing rights and obligations

Solution

Is the answer to the question: A. \$5,838,869.86; B. \$4,463,869.86; C. Zero; or D. \$4,703,362.48? Do you need a lifeline? You can receive a worksheet showing the details of the correct calculation by e-mail to jamjohnson@dtus.com or mrosenblatt@dtus.com.

TEST YOUR KNOWLEDGE PART 2

The working group has assembled for an all-hands meeting. The objective of the meeting is to nail down some of the gritty issues of the securitization—the following issues surface:

- The bankruptcy lawyers say: No doubt it should be a true sale at law. They’re evaluating whether they can conclude that the transaction would be a true sale at law.
- The auditors ask if accrued interest at the sale date was factored into the gain calculation.
- The rating agency wants more credit enhancement. Suggests company seed a \$2.5 mil-

lion reserve fund to be held by the trust, and allocate excess interest to the reserve fund until it grows to 3.75 percent of the outstanding balance. Amounts in the reserve fund would be invested in short-term, essentially risk-free, interest earning assets. Funds in excess of the required amount would be released to Buy-It from the reserve fund as a Residual Distribution.

- Securitization team proposes alternative credit enhancement. Utilize “Why Pay” program. Transfer title to cars and assign related leases to Trust. Cash flow used only to absorb credit losses; otherwise reverts to Buy-It. Noted gagging reaction from lawyer and accountant.
- The CFO indicates initial calculation doesn’t include amounts related to dealer reserves. Buy-It advanced \$2.5 million to dealers for their portion of finance charges related to certain loans in the pool. Under their arrangement with the dealers, the dealers will refund the premiums if the loans prepay/default any time during the first 120 days that the loans are outstanding.

Required:

Be prepared to discuss the effects of each of these points on the accounting for the securitization. You need not quantify the effects.

Solution

Meeting Point	Effect on Accounting for the Securitization
Uncertainty Over Legal Opinion	Critical for sale accounting. The company's outside accountants will need access to a legal opinion that concludes that the transaction <i>would</i> be a true sale at law. Buy-It's inability to obtain the appropriate opinion may result in the Company accounting for the transaction as an on-balance sheet collateralized borrowing.
Accrued Interest on Sale	The carrying value of the loans is understated and the gain is overstated. To correct the calculation, Buy-It should include accrued interest in the carrying amount of the loan portfolio. Assuming that the waterfall already includes the receipt of all interest payments after the transfer date, there would be no effect on the fair value of the residual interest. Similarly, if the bonds are sold with pre-issue date accrued interest, that amount should be considered as additional sales proceeds.
Reserve Fund	Assets transferred would include the \$2.5 million seed deposit and should be included in the basis allocation at its fair value. The waterfall should be recalculated, including the effects of the additional cash in the trust on a cash-out basis and the residual certificate fair value amount increased by the result.
Using Operating Leased Assets as Credit Enhancement	Neither the autos under lease or the cash flows from an operating lease are financial assets as defined by FASB 125. Thus, FASB 125 does not apply to their transfer (other accounting literature – FASB 13 – is on point). Inclusion of nonfinancial assets in a securitization trust would usually result in Buy-It having to consolidate the accounts of the Trust, (it is not a QSPE nor does it have third party equity) thus defeating off-balance sheet sale treatment. Also, inclusion of these assets might make it more difficult for the attorneys to conclude that a true sale has occurred.
Dealer Reserves	Dealer reserves should be understood carefully – arrangements differ from entity to entity. In this case, the carrying amount of the loans was understated by the advance Buy-It made when it acquired the loans. However, Buy-It is also justified in recording an asset for the allocated fair value of the amount it expects to recover from the dealers, which would offset some of the reduction of the gain.

fasb
140
INDEX

FASB 140 Index

Adequate compensation	41
Agent	10, 11, 22
AICPA Auditing Interpretation on Lawyer's Letters	25
Attached call	16
Auction sales	13
Bullet structure	33
Call reports	5
Cash-out Method	44
Cash Reserve Accounts	44
Cleanup call	16
Consolidation	13
Controlled amortization	33
Credit card example	35
Debt-for-tax	20
Demonstratively distinct	10
Derivatives	11
Desecuritization	45
EITF Issue 99-20	47
Embedded call	16
Excess servicing	42
Fair value	37, 38, 39
FASB 140 Q&A Implementation Guide	17-18
FASB 133 on Derivatives	12, 48, 61
FASIT	5, 30
FDIC	24
Float and ancillary fees	40
Freestanding call	16
Gain on sale worksheet	34
Guaranteed mortgage securitization	10, 11
Hybrid ARMs	16
Impairment	43, 47
Insurance companies	5
International securitization	5
Lawyers' letters	25
Lease example	36
Low-level recourse	5
NAIC	5
Nonfinancial assets	5
Passive financial asset	10, 11
Passive derivative that pertains to...	10, 11, 12

Put options	16, 22
Qualifying special-purpose entity	8, 10, 13
Regulatory accounting principles	5
Removal of accounts provisions (ROAPs)	19
Rent-a-shelf	8
Revolving structures	33, 36
Risk-based capital	5
Rule 144A	5
Statement on Auditing Standards No. 92	38
Servicing	40-43
S.O.S. Speaking of Securitization	3
Sponsor	15
Statutory accounting practices	5
Temporary investments	10, 11
Topic D14 of the EITF Abstracts – Special-Purpose Entities	14
Transferettes	33, 35
True sale at law	7, 25
Two-step transfer	8, 25
Uncertificated interest strips	47, 48
Valuations	37, 38, 39, 40
Warehouse arrangements	22

This booklet is written in general terms for widest possible use. It is intended as a guide only, and the application of its contents to specific situations will depend on the particular circumstances involved, as well as, the status of any future FASB interpretations or EITF issues. Accordingly, it is recommended that readers seek up-to-date information or professional advice regarding any particular problems that they encounter. This guide should not be relied on as a substitute for such advice.



About the Authors

You might be convinced by now that a fundamental disconnect exists among law, economics, bank regulation, tax law, ERISA, the '40 Act, and accounting when it comes to securitization. You, like us, might not think FASB 140 is a perfect solution. But, by nature, no accounting standard is ever perfect for all financial statement preparers and users. Unlike the tax and creditors' rights fields, with FASB 140, accountants at least have a comprehensive statement of standards for testing whether a transfer of financial assets is a sale or financing.

Although we hope you agree that they don't look that age, Marty Rosenblatt (right) and Jim Johnson (left) collectively have over 60 years with the firm, the last 15 for each have been devoted to securitization and other capital-markets transactions.

fasb

140

Securitization Accounting under FASB 140
The Standard Formerly Known as FASB 125

1ST

EDITION

JAN 2001

© 2001 Deloitte & Touche LLP.
All rights reserved.

Deloitte
Touche
Tohmatsu