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Financial Services

Securitization Accounting

The Ins and Outs (And Some Do's and Don'ts) of FASB 140, FIN 46R, IAS 39 and More . . .

By Marty Rosenblatt, Jim Johnson & Jim Mountain

Seventh Edition
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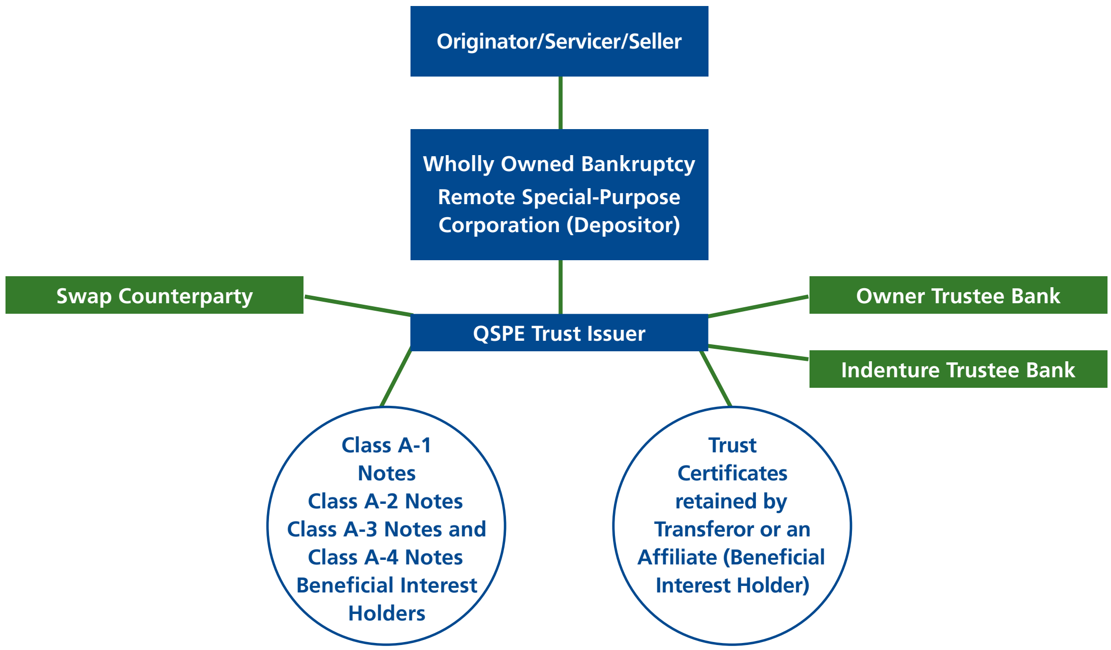
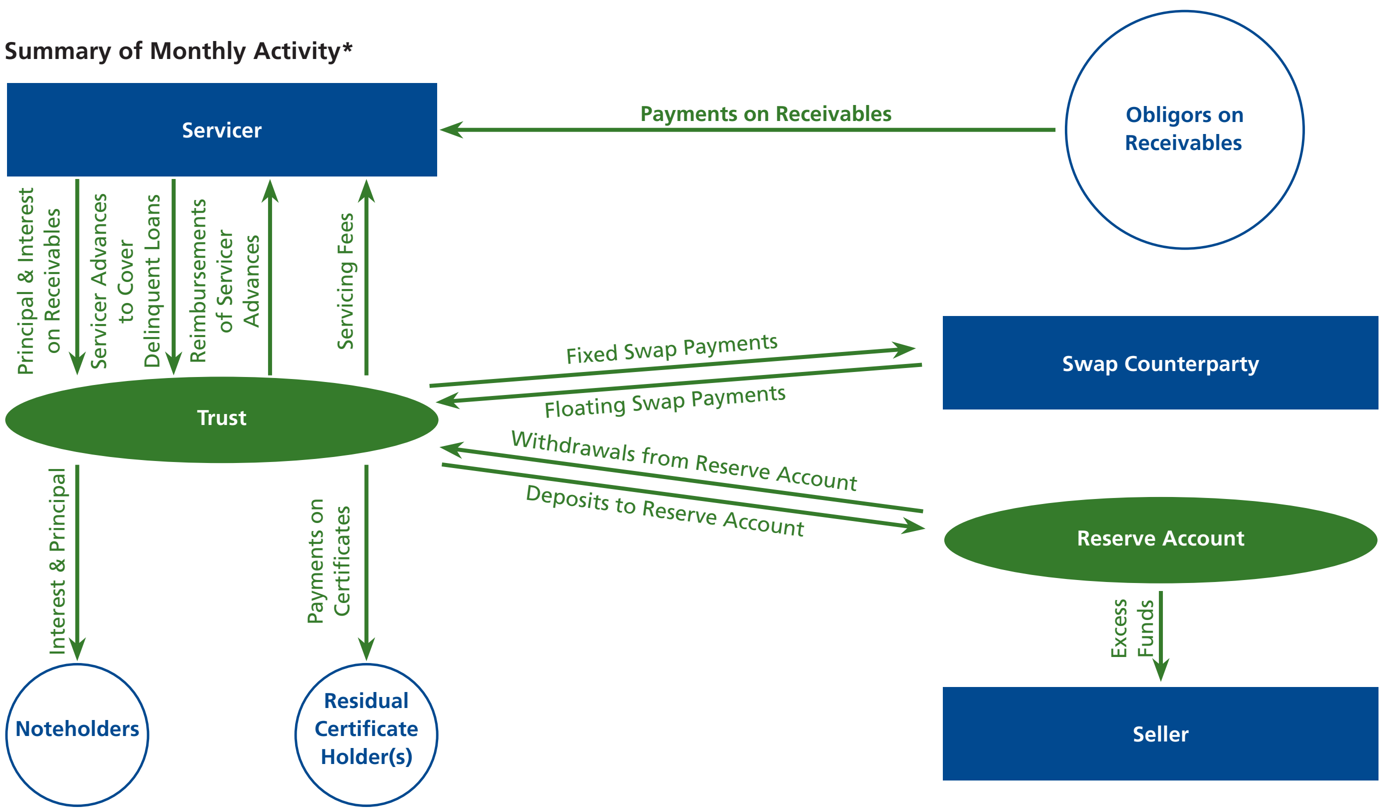
Audit.Tax.Consulting.Financial Advisory.

Key Parties to a Hypothetical Term Securitization Transaction*



Summary of Monthly Activity*



* These charts provide only a simplified overview of the relationships between the key parties to the transaction and the monthly flow of funds. The inspiration for these charts was found in the prospectus for GMAC's *Capital Auto Receivables Asset Trust 2004-1* deal.

On the Cover (left to right):

Marty Rosenblatt is the founding partner of Deloitte & Touche LLP's securitization practice and an Executive Vice President of the American Securitization Forum.

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Table of Contents

What's New in 2005? Is Off-Balance Sheet Treatment Still VIE-able?

This booklet deals with securitizations, mainly those employing term structures and traditional asset types. We made no attempt to deal with the other transaction types 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 potpourri of transactions found in FASB 140 explains why many securitization marketplace participants find it cumbersome to work with the actual statement. (We hope you have a better experience with this booklet!) The other advantage of this booklet is that reference material for all the relevant, but separate, guidance issued by FASB, the EITF, the SEC, the AICPA and the IASB is assembled in one place.

We expect that this booklet will have a shelf life of less than one year. As we go to press, the FASB is considering various significant amendments to FASB 140. If they stick to their timetable, the amendments will go into effect in 2006. See discussion of possible amendments in Chapter 12 (page 82), "*What to expect in 2006 - FASB 140 (R)*."

After reading this booklet, you might be convinced 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 that FASB 140 is a perfect solution. But, by nature, no accounting standard is ever perfect for all financial statement preparers and users. Yet, we find FASB 140 suitable guidance for most securitization transactions.

The FASB and its Emerging Issues Task Force still face the challenge of keeping pace with the continuous innovations in the securitization market and developing additional guidance. This is the seventh edition in this series of booklets. Since our last edition, the FASB has created a new framework for analyzing special-purpose vehicles. While keeping FASB 140's QSPEs, they added a new universe of variable interests, expected losses and primary beneficiaries. The new standard, FIN 46, was initially released in January 2003 and was a bit rough around the edges. By December 2003, the FASB came out with substantial improvements in a revised version, FIN 46R. But even with the improvements, securitizers and their auditors struggle with the new concepts and unfamiliar judgments now required.

The staff of the Securities and Exchange Commission also continues to be keenly interested in structured finance transactions, including securitizations, and regularly questions registrants about their accounting for and disclosure of even seemingly straight-forward deals. The staff expects securitizers to make clear and full financial statement disclosure of their structured transactions. The disclosure should identify key features that drive accounting determinations one way or the other and allow readers to grasp the economic significance of those features. See page 84 for excerpts from the SEC's Off-Balance Sheet Study Report to Congress for further information.

In this ever-changing marketplace, we make a constant effort to stay current and hope that this effort is reflected in the following pages. We recommend that readers seek up-to-date information and advice regarding the application of accounting standards to the particular circumstances involved in any specific transaction. Thank you for your continued interest. We look forward to providing further updates in the months and years ahead.

Sincerely,

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.

Chapter 1

What Is FASB 140 and When Does It Apply?

FASB 140[1] applies to:

- Public and private companies
- Public and private offerings
- All transfers of financial assets
- Resecuritizations of existing ABS, MBS, CMBS and CDO classes
- Net interest margin (NIM) transactions

FASB 140 does not apply to:

- Transfers of nonfinancial assets (or unrecognized financial assets) such as operating lease rents, unguaranteed lease residuals from capital leases, servicing rights, stranded utility costs, or sales of future revenues such as entertainers' royalty receipts or synthetic structures based on reference pools
- Most investor accounting (but, see Chapter 5, "*Investor Accounting Issues*" beginning on page 49)
- Income tax sale vs. borrowing characterizations or tax gain/loss calculations
- 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) and transactions by foreign subsidiaries in consolidated financial statements of U.S. parents

The International Accounting Standards Board (IASB) has issued guidance on accounting for securitizations in the revised *International Accounting Standard 39 Financial Instruments: Recognition and Measurement (IAS 39)*. Guidance provided by the IASB may result in completely different accounting treatment for securitizations than transactions accounted for under FASB 140. Both the FASB and the IASB are actively working to align U.S. and international accounting standards in many areas. When it comes to securitizations however, that convergence will likely be several years in coming. See "*IAS 39*" in Chapter 9, beginning on page 65.

1 FASB Statement 140: "*Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, a replacement of FASB Statement 125* (September 2000)"

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 subject to a "low-level exposure" rule. The federal banking agencies require dollar-for-dollar capital for all retained interests that provide credit enhancement and limit the maximum amount of credit-enhancing interest-only strips a bank may hold as a percentage of Tier 1 capital. See "*Can Banks Get Regulatory Capital Relief Through Securitization?*" on page 60.

3 The National Association of Insurance Commissioners (NAIC) has adopted securitization accounting guidance for statutory reporting purposes in *Statement of Statutory Accounting Principles No. 91, Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities*. See Chapter 8 (page 64) "*Do the Statutory Accounting Principles for Insurance Companies Embrace FASB 140?*"

Chapter 2

Determining Whether a Securitization Meets the Sale Criteria

When is a securitization accounted as a sale?

People often describe a securitization as being either a sale or a financing. Actually, a securitization might be accounted for in one of the following five ways, depending on the deal structure and terms:

- As a sale (for example, 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 received other than interests in the transferred assets, as in transferring additional assets to a credit card master trust or 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 sometimes 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, 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). Merely receiving what FASB 140 calls "beneficial interests"[4] 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: (a) the assets have been legally isolated; (b) the transferee has the ability to pledge or exchange the assets; and (c) the transferor otherwise no longer maintains effective control over the assets. Each of these requirements is discussed further below:

a. **Legal Isolation** - The transferred assets have been isolated - 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 address the possibility of bankruptcy, regardless of how remote insolvency may appear given the transferor's credit standing at the time of securitization. Even a AA-rated issuer of auto paper must take steps to isolate its assets. It is not enough for the transferor merely to assert that it is unthinkable that a bankruptcy situation could develop during the relatively short term of the securitization. The securitization market has witnessed several unexpected bankruptcies of formerly investment-grade companies through the years.

4 Beneficial interests are typically issued either in the form of notes or bonds representing pay-through obligations of a securitization vehicle collateralized by the transferred assets and governed by an indenture, or certificates representing pass-through ownership of interests in the transferred assets and governed by a pooling and servicing agreement.

5 Numbers within brackets represent paragraph references in FASB 140, unless otherwise indicated.

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

STEP 1: The seller/company 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 subordinated 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 first SPC's charter forbids it from undertaking any other business or incurring any liabilities, thus removing concern about its bankruptcy risk. The charter of each SPC must also require that the company be maintained as a separate concern from the parent to avoid the risk that the assets of the SPC would be "substantively consolidated" with the parent's assets in a bankruptcy proceeding involving the parent. [83]

See page 26 and following for the forms of lawyer's letters needed to provide reasonable assurance that the transferred assets would be "beyond the reach of creditors."

b. Ability of Transferee to Pledge or Exchange the Transferred Assets - The transferee (or, in a two-step structure, the second transferee) is a qualifying special-purpose entity (QSPE) and each holder of its beneficial interests has the right to pledge, or the right to exchange, its beneficial 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 transferee's rights to monetize the cash inflows (the primary economic benefits of financial assets) by pledging or selling those assets have to be carefully evaluated to determine whether the restriction precludes sale accounting, particularly if the restriction provides more than a trivial benefit to the transferor, which, according to FASB 140, is a rebuttable presumption. [31]

If the transferor receives cash in return for the assets transferred to a non-QSPE and has no continuing involvement of any kind, (no servicing responsibilities, no participation in future cash flows, no recourse obligations other than standard representations and warranties) the transfer should be accounted for as a sale even though, as in most securitizations, the transferee may be substantially constrained from pledging or exchanging the transferred asset. To fail 9b the transferor must receive more than a trivial benefit as a result of the constraint. [*FASB Special Report: Questions and Answers - Guide to Implementation of Statement 140 (FASB 140 Q & A)*, Question 22A]

Whether or not a securitization vehicle is a QSPE is extremely important because a transferor does not consolidate the assets and liabilities of a QSPE. QSPEs must be designed to operate with limited decision-making authority. A non-qualifying vehicle may need to be consolidated. See Chapter 4 (page 45) "*Are There Any Highlights of FIN 46 (R) - Consolidation of Variable Interest Entities?*"

Note that in a two-step structure (see above), the entity that issues the securities (e.g., the trust) needs to be the QSPE. The "intermediate SPC" (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. 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 that are usually the issuers. Financial statements for these special-purpose corporations are usually not required or requested.

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, assuming that a large number of qualified buyers exist. Neither does the absence of an active market for the securities. [30]

c. Surrender Effective Control - the transferor does not effectively maintain control over the transferred assets either through:
   - An agreement that requires 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
   - The ability to unilaterally cause the SPE or QSPE to return specific assets, other than through a cleanup call. [9c] (See discussion on page 16 of cleanup and other types of calls)

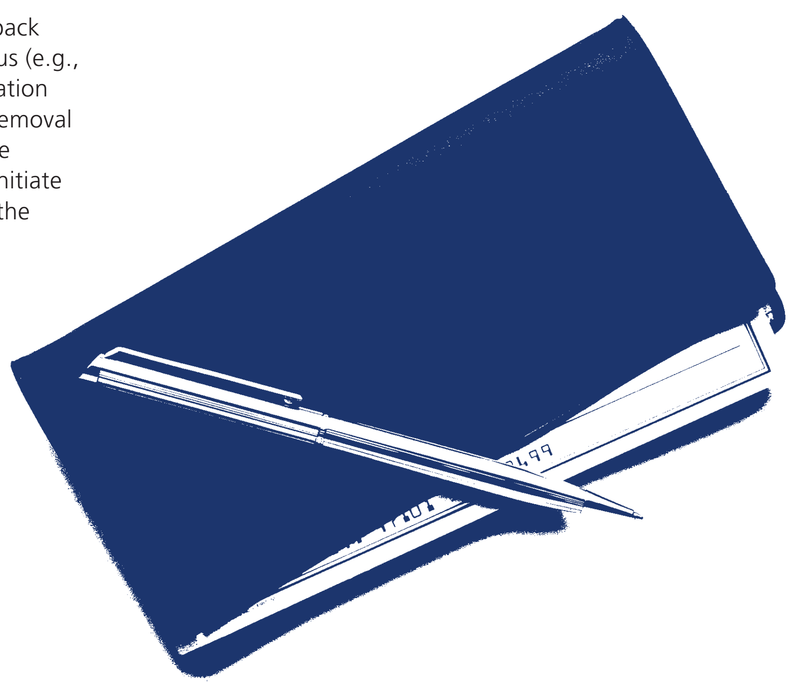
There seems to be some overlap between the second and third tests. They both look at aspects that suggest direct or indirect seller control. The second test focuses on restrictions faced by the transferee. The third test looks to rights of control over the specific assets transferred (which may continue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

The FASB 140 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 since it is able to initiate an action to reclaim specific assets and it knows where the assets are (a QSPE still holds the assets because of the restrictions on dispositions of assets placed on the QSPE). [232]

What if I fail to comply with the sale criteria?

If the securitization does not qualify as a sale, the proceeds raised (as noted before, retained interests are not proceeds) 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. [12] The assets should either be classified separately from other assets not encumbered or the footnotes should disclose the restrictions on the assets for the repayment of the borrowings. The securities that are legally owned by the transferor or any consolidated affiliate (i.e., the securities that are not issued for proceeds to third parties) do not appear on the transferor's consolidated balance sheet - they are economically represented as being the difference between the securitization-related assets and the securitization-related liabilities on the balance sheet.

Ongoing accounting for a securitization, even if treated as a financing, requires many subjective judgments and estimates and could still cause volatility in earnings due to the usual factors of prepayments, credit losses and interest rate movements. After all, the company still effectively owns a residual even though a reader cannot find it on the balance sheet. Securitizations accounted for as financings are often not that much different economically than securitizations that qualify for sale accounting treatment. Therefore, the excess of the securitized assets (which remain on balance sheet) over the related funding (in the form of recorded securitization debt) is closely analogous economically to a retained residual.

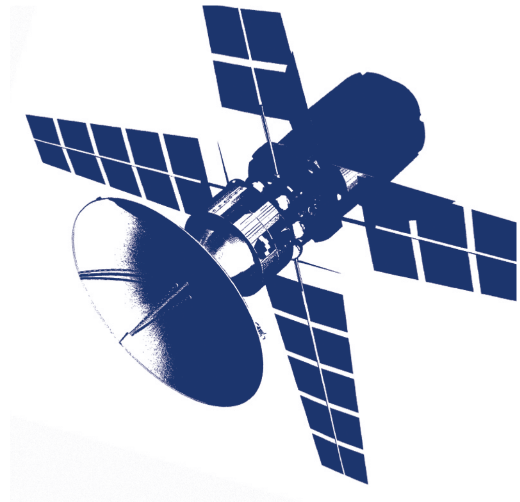


Who is considered to be the transferor in a "rent-a-shelf" transaction?

Often times, a commercial or investment bank will "rent" their SEC shelf registration statement to an unseasoned securitizer who does not have one. The loan originator first sells the loans to a depositor, which is typically a wholly-owned, bankruptcy-remote special-purpose corporation established by the commercial or investment bank. The depositor immediately transfers the loans to a special-purpose trust issuer that issues the securities purchased by the investors. The loan originator often takes back one or more (usually subordinated) tranches. In this situation, even though the Depositor sub of the commercial or investment bank transferred the loans to the trust issuer, it was doing so more as an accommodation to the loan originator and was not taking the typical risk as a principal. If the securitization transaction with outside investors for some reason failed to take place, the depositor would not acquire the loans from the originator. Accordingly, it is the loan originator that would be considered the transferor for purposes of applying the FASB 140 sale criteria to the securitization.

On the other hand, commercial or investment banks often purchase whole loans from one or more loan originators (sometimes servicing retained) and accumulate those loans to be securitized using the dealer's shelf when and how the dealer chooses. In this situation, the commercial or investment bank would be considered the transferor for purposes of applying the FASB 140 sale criteria to the securitization.

It is also possible to have more than one transferor to a single QSPE with commingling of the assets and with each transferor taking back different beneficial interests or portions of the same beneficial interests. [See FASB 140 Q&A, question 60.]



Do I ever have to consolidate a QSPE? How about an SPE?

Transferors do not consolidate the assets and liabilities of QSPEs even if consolidation is the desired outcome. [46] Parties other than the transferor such as investors, service providers and guarantors also do not consolidate the assets and liabilities of a QSPE except if such party has the unilateral right to liquidate the QSPE or to change it to activities in a way that would cause it to qualify no longer as a QSPE. [Paragraph 4d of FIN 46R]

For non-QSPEs, *FASB Interpretation No. 46, Consolidation of Variable Interest Entities, Revised December 2003* (FIN 46R) defines the new concept of a "variable interest entity" (VIE). FIN 46R sets out an elaborate system for evaluating how the economic risks and rewards of the VIE are attributed to various participants in the activities of a VIE. See Chapter 4 (page 45), "*Are There Any Highlights of FIN 46 (R) - Consolidation of Variable Interest Entities?*"

What does it take to be a QSPE?

The words "lobotomy," "brain-dead" or "automatic pilot" are not found in FASB 140. But the FASB 140 does believe that QSPEs should only passively accept financial assets transferred to it, rather than actively purchase them in the marketplace [185]. A QSPE must be a trust or other legal vehicle that meets all four of the following conditions [35].

Condition	Qualifications (Highlighted terms are defined in the chart following this one)
Must be "demonstratively distinct" from the transferor	It cannot be **unilaterally dissolved** by the transferor, its **affiliates** or its **agents** AND either: ▪ At least 10% of the fair value of its beneficial interests is held by **independent third parties** who are not transferors (e.g., cash investors); or ▪ The **transfer** is a **guaranteed mortgage securitization**. [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 no longer qualifying and will likely need to be consolidated by the transferor.
Limits on permitted activities	Its permitted activities: ▪ Are significantly limited ▪ Are entirely specified upfront in the legal documents that created the SPE or its beneficial interests ▪ May be changed only with the approval of the holders of at least a majority of the beneficial interests held by independent third parties [37 and 38]. Some securitization governing documents preclude the transferor (Depositor) and its affiliates from voting, thus ensuring that any amendments to the permitted activities of the QSPE need to be approved by the holders of at least a majority of the third party beneficial interests. 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. See *Special servicer activities* on page 14.
Limits on the assets it can hold	It may hold only: ▪ **Passive** financial assets **transferred** to it [39] ▪ Passive derivative financial instruments that pertain to beneficial interests owned by independent third parties [39 and 40] ▪ 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 ▪ Related servicing rights ▪ Temporarily, nonfinancial assets obtained in the process of foreclosure or repossession. See S*pecial servicer activities* on page 14. ▪ Cash and **temporary investments** pending distribution to security holders
Limits on permitted sales, exchanges, puts or distributions of its assets [189]	It can only dispose of assets in automatic response to one of the following events: ▪ Occurrence of an event that: – Is specified in the applicable legal documents – Is outside the control of the transferor, its **affiliates** and its **agents**; and – 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] ▪ Exercise of a put option by a third-party beneficial interest holder in exchange for: – A full or partial distribution of assets – Cash (which may require that the SPE dispose of assets or issue beneficial interests to generate cash to fund the settlement of the put); or – New beneficial interests in those assets [44] ▪ Exercise of a call option or ROAP by the transferor [51-54 and 85-88] ▪ Termination of the SPE or maturity of the beneficial interests on a fixed or determinable date that is specified at inception [45]

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 all the securities held by independent third parties. [36]
Independent third parties	Parties other than the transferor, its affiliates or its agents.
Affiliates	Affiliates are parties that, directly or indirectly through one or more intermediaries, control, are controlled by, or are under common control with the transferor. [FASB 57, paragraph 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. [FASB 57, paragraph 24(b)]
Agents	Agents are parties that act for and on behalf of another party (e.g., 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.
Temporary investments	Money-market or other relatively risk-free instruments without options and with maturities no later than the expected distribution date. [35]
Transfer	The conveyance of a non-cash financial asset from and to parties that are not the issuer of that financial asset. [364]

While FASB 140 is very specific about the activities of a QSPE, the assets it can hold and the derivatives it can enter into, there is relatively little discussion regarding the issuance or reissuance of its beneficial interests. Many structured finance special-purpose vehicles fund relatively long-term assets with relatively short-term liabilities such as commercial paper, which must be refunded as it matures. The FASB has a project underway that may restrict the discretion allowed to a QSPE in rolling over its beneficial interests. See Chapter 12 (page 82), "*What to Expect in 2006 - FASB 140(R)*."

Limits on the assets a QSPE can hold

A QSPE cannot be a player. The FASB 140 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 140 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, FASB 140 does not allow a QSPE to hold an equity position large enough either by itself or in combination with other investments that enable it (or any related entity such as the transferor or its affiliates) to exercise control or significant influence over an investee. For the same reasons, FASB 140 does not allow a QSPE to hold 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] For example, if an SPE's charter requires that it always vote and must vote in favor of positions recommended by the investee's board, the security is passive. Voting rights are not limited to equity securities. Often debt securities, particularly subordinated ABS found in resecuritizations, have voting rights on certain matters and these need to be considered carefully when evaluating QSPE status. Certain of these votes (protection of creditor rights, etc.) could be analogized to servicing activities that would not necessarily preclude an SPE from being a QSPE. On the other hand, just because a security is issued by a QSPE, it is not necessarily sufficiently passive to be suitable for a second QSPE to hold. The following example deals with restrictions on a QSPE's temporary investments.

EXAMPLE: 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 270-day commercial paper with the intent to sell it in 200 days, the SPE is not qualifying.

Servicing agreements may permit the servicer to keep any "float" generated by temporarily investing collections until they are distributed to the holders of the beneficial interests in the QSPE. As a general matter, this is permissible because "float" is a recognized benefit of servicing. [62] If the cash collections are deposited directly into accounts in the name of the QSPE and temporarily invested through those accounts, the individual investments would need to be money-market or other relatively risk-free instruments that mature before distributions are made. [35c6] If the cash collected on behalf of the QSPE is retained by the servicer for temporary investment (i.e., the servicer keeps the float), the QSPE does not have a need for accounting reasons to limit how the servicer invests those funds. In this case, the servicer is acting as a principal for its own account when it invests the funds, so it is not an agent of the QSPE for that purpose.

Limits on the derivatives a QSPE can hold

A QSPE may only hold passive derivative financial instruments that pertain to beneficial interests sold to independent third parties. The transferor can be 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, corridors and swaps (since they pay off automatically when they are in the money). Forward contracts are passive if they do not allow a choice in the settlement mechanism. [39]

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 is "balanced guaranteed," meaning that it automatically decreases for principal payments and prepayments on the 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. QSPE status is an all or nothing proposition; a vehicle cannot be bifurcated in a QSPE part and a non-QSPE part. If the initial notional amount of the swap was $90 million (and the automatic amortization provision was accordingly modified), the derivative would be permitted. This requirement has been an irritant to some issuers by causing them to delay sale accounting until all securities covered by derivatives have been sold to third parties.

The objective of the following provisions is to effectively prevent transferors from avoiding the accounting requirements of FASB 133[6] by utilizing securitization trusts to package derivatives. [40]

A derivative financial instrument is permitted in a QSPE only if it

▪ Is entered into only: – When the beneficial interests are purchased by independent third parties – 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]
▪ 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]
▪ 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	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] There is little or no additional guidance on how one is to demonstrate compliance with this test.

6 Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activites*, published in June 1998, as amended.

The provision in the second item in the table has been of particular concern to rating agencies. In their view, a seller's unrated retained interest is credit enhancement for the rated securities and nothing more. To the extent this requirement results in a smaller balance derivative, thus exposing the retained interests to unhedged interest or currency risk, it is less effective as a layer of protection as credit enhancement. Alternatives that have been considered include having the seller separately pledge to the QSPE a derivative purchased from a third party that would be available, if needed, to protect investors and that would be accounted for by the seller under FASB 133.

This provision has also been problematic in certain NIM (net interest margin) transactions involving the monetization of residual interests from REMIC transactions that issue LIBOR-based securities. The principal paydown of the NIM bond (the beneficial interest issued in the second securitization) is exposed to a contraction in the amount of excess spread available to the residual (the asset in the second securitization), as a result of the basis risk that exists when increases in LIBOR cause higher interest requirements on the REMIC securities without a corresponding increase in the mortgage interest rate during that period. The principal amount of the NIM bond is generally a very small fraction of the principal amount of the REMIC securities, but the highly leveraged nature of the NIM bond means that it is exposed to basis risk on the entire amount of the REMIC securities.

One solution to the risk of reduced cash flow for principal payments on the NIM bond might be to structure a passive interest rate cap whose notional balance does not initially and is not expected to exceed the outstanding principal amount of the NIM bond. But such a swap would most likely be too small to fully hedge the related cash flow risk. However, if the derivative were to utilize a leveraging factor that takes into account the expected multiple of the ARM collateral balance to the NIM bond balance on each payment date, that risk could be mitigated. A derivative may have leverage features, so long as the derivative has characteristics that relate to, and partly or fully (but not excessively) counteract, some risk associated with the beneficial interests held by outsiders or the related transferred assets.

If the interest on the NIM bond also varies based on LIBOR, a separate interest rate cap is sometimes acquired by the QSPE to protect against interest shortfalls. This type of cap is not problematic so long as the cap notional balance does not initially, and is not expected to, exceed the NIM bond balance subsequently and partly or fully (but not excessively) counteracts the interest rate risk associated with the NIM bond.

Limiting the notional amount of a derivative to the amount of outside beneficial interests and requiring that the derivative not excessively counteract some risk associated with those beneficial interests does not mean that a retained residual interest can never receive any distributions from a QSPE that are attributable to the cash inflows from the derivative. But it is necessary to be satisfied that, under stressed scenarios that are reasonably possible of occurring, the outside beneficial interests would not receive all of the interest and principal payments that they are entitled to, absent the derivative being in place.

When a QSPE holds pre-payable assets, the requirement that the notional amount of any derivative can not be expected to exceed the amount of beneficial interests held by outsiders at any time needs close attention. For example, pre-programmed actions that would avoid becoming overhedged would be okay, but actively managing the derivative position would not.

The limitation on derivatives in QSPEs stems largely from the FASB's concern that people might use QSPEs to avoid FASB 133's accounting requirements to mark derivatives to fair value through earnings. As this booklet is being published, the FASB is working on a project to eliminate the Statement 133 Implementation Issue No. D1, *Application of Statement 133 to Beneficial Interests in Securitized Financial Assets*, (DIG D-1) which provides that beneficial interests in securitized financial assets are not subject to the provisions of FASB133. By eliminating that exception, the FASB may be able to relax the restrictions on having derivatives in QSPEs.

Limits on QSPE sales of assets

A QSPE or its agents cannot have the power to choose whether or when it disposes of specific financial assets. As shown in the table on page 10 and in the following four situations, FASB 140 limits financial asset dispositions to those that are effectively forced on the QSPE or are premeditated:

- The trustee or servicer 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).
- The QSPE is required to dispose of financial assets, if funds are needed, to repurchase beneficial interests upon the exercise of an option held by third-party holders.
- 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, (See page 20 on ROAPs); so merely escaping consolidation via the QSPE status might not get the transaction off-balance sheet.
- The entity is required to liquidate or otherwise dispose of its assets on a determinable date set at its inception such as an auction on a fixed date or on a date when the remaining assets are reduced to some specified percentage of their original balance. A transferor holding the residual interest in a securitization is precluded from participating in a QSPE's auction process of its remaining assets at the scheduled termination of a QSPE's existence. Why? 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. The residual holder 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 therefore would go from its left pocket into its right pocket by means of the QSPE's final distribution of remaining assets to the residual interest holder (after the third-party beneficial interests are redeemed - usually at par). We think that the FASB intended this limitation to apply even in situations where the transferor does not own the entire residual interest. [53, 189 and 235]

Examples of acceptable events triggering automatic disposition of assets (see first item above):

- Servicing failures that jeopardize a third-party guarantee obligor default
- Rating downgrades below a specified minimum rating
- Involuntary insolvency of the transferor
- 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 either to dispose of the financial asset or hold it in a response to a default, a downgrade, a decline in fair value or a servicing failure. FASB 140 does 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 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. [43]
- The SPE must dispose of the asset in response to the technical violation of a contractual provision that lacks real substance. [43]

Special servicer activities

Typically, commercial mortgage loan securitizations involve mortgages with individually large principal balances. If the borrower or property encounters financial or operational difficulties, experienced workout specialists are needed to maximize on-going cash flows from the loan or to prevent further deterioration in value. When commercial mortgage loans are securitized, a special servicer with the relevant expertise and experience is hired to take over from the servicer and perform these functions with respect to each loan that becomes a troubled loan. The special servicer may have a subordinated beneficial interest in the securitized assets and/or a right to call defaulted loans. Sometimes, the special servicer is related to the transferor.

At the heart of the issue is the range of responses available to a special servicer (who is acting on behalf of the QSPE) after a loan defaults. Absent any accounting constraints, the possible responses would fall into the following general categories: the special servicer on behalf of the trust could (1) modify the terms of the existing loan, (2) lend the borrower additional funds, (3) arrange a combination of 1 and 2 (4) commence foreclosure proceedings or (5) sell the loan for cash (either in the markets or in response to a call by the special servicer or a subordinated interest holder).

Special servicers and others believed that FASB 140's requirement that a QSPE must either hold or automatically sell loans upon default (either course of action is consistent with QSPE status; having a choice of holding or selling is not) is unreasonably restrictive and weakens the special servicer's negotiating position with the borrower.

The FASB staff raised and answered several questions that reiterate that a QSPE's decision to sell in response to a delinquency or default must be automatic.[7] The staff also confirmed that another entity (a "hired-gun") may not be engaged to perform activities on behalf of a QSPE that the QSPE itself would not be permitted to perform [FASB 140 Q&A, question 24A]. However, the FASB concluded that a servicer or other beneficial interest holder in a qualifying SPE can have the right (an option) to purchase defaulted loans (that is, through physical settlement - in some cases for a fixed amount and in other cases at fair value). Although market participants may prefer greater flexibility than this answer provides, most believe it is a workable solution.

If the transferor (or its affiliates or agents) is first in line with a call option on a defaulted loan, the transferor would need to recognize the defaulted receivable and the related "obligation" on its balance sheet once the default has occurred, irrespective of its intent to exercise. This treatment does not apply to parties other than the transferor who hold call options, regardless of the priority of exercise.

Other significant conclusions of the FASB 140 staff with respect to servicing activities and servicing discretion are [FASB 140 Q & A, questions 28B, C and D]:

- A servicer or special servicer can have discretion to work out a loan in lieu of foreclosure so long as the discretion is significantly limited and the parameters of the discretion are fully described in the servicing agreement.
- A QSPE may not initiate new lending to the borrower as a result of a workout. Servicer advances are not considered new lending by the QSPE.
- The decision to initiate foreclosure is a servicing activity, not a loan disposal, and the servicer or special servicer may have discretion in determining when to initiate foreclosure so long as the discretion is significantly limited and the parameters of the discretion are fully described in the servicing agreement.
- A servicer or special servicer may have discretion in temporarily managing and disposing of foreclosed real estate owned ("REO") so long as the discretion is significantly limited and the parameters of the discretion are fully described in the servicing agreement.

7 Originally published as EITF Topic D-99, *Questions and Answers Related to Servicing Activities in a Qualifying Special Purpose Entity under FASB Statement No. 140*, and later codified in the FASB 140 Q&A.

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 bankruptcy lawyer's analysis). The FASB's position here is consistent with the theory that the seller has relinquished control over the transferred assets; 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 viewed as the economic equivalent of a repurchase agreement.

Put options have been successfully used in transactions in order to create guaranteed final maturities of short-term tranches to achieve "liquid asset" treatment for thrifts or "money market" treatment for certain other classes of investors but a number of detailed accounting requirements must be considered. Also, hybrid ARMs have been securitized with a put exercisable at the point when the loans turn from a fixed to an 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.

Now for the hard part: Analyzing call options under FASB 140 is probably the area of securitization accounting that is the most conceptual, confusing and prone to misinterpretation. FASB 140 describes six 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 maker 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 an SPE.
- 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 (other than cleanup calls) are not commonly found in securitization transactions.
- Conditional calls are call options that the holder does not have the unilateral right to exercise. The right to exercise is conditioned on the occurrence of some event (not merely the passage of time) that is outside the control of the transferor, its affiliates and agents.
- Cleanup calls in FASB 140-speak 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 regardless of who holds it and are surprised that neither the amount 10 percent nor any party other than the servicer or its affiliates appears anywhere in the FASB 140's definition of a cleanup call.)
- In-substance call options are deemed to exist when the transferor has the right to cause the transferee to sell the assets and (1) has a right such as a right of first refusal to obtain the assets or (2) has some economic advantage providing it, in-substance, with the practical right to obtain the asset because it is not penalized by paying more than the fair value of the asset. Examples of such advantages are ownership of the residual interest or an arrangement such as a total return swap with the transferee.

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. does not know about the restrictions and therefore cannot benefit from it.

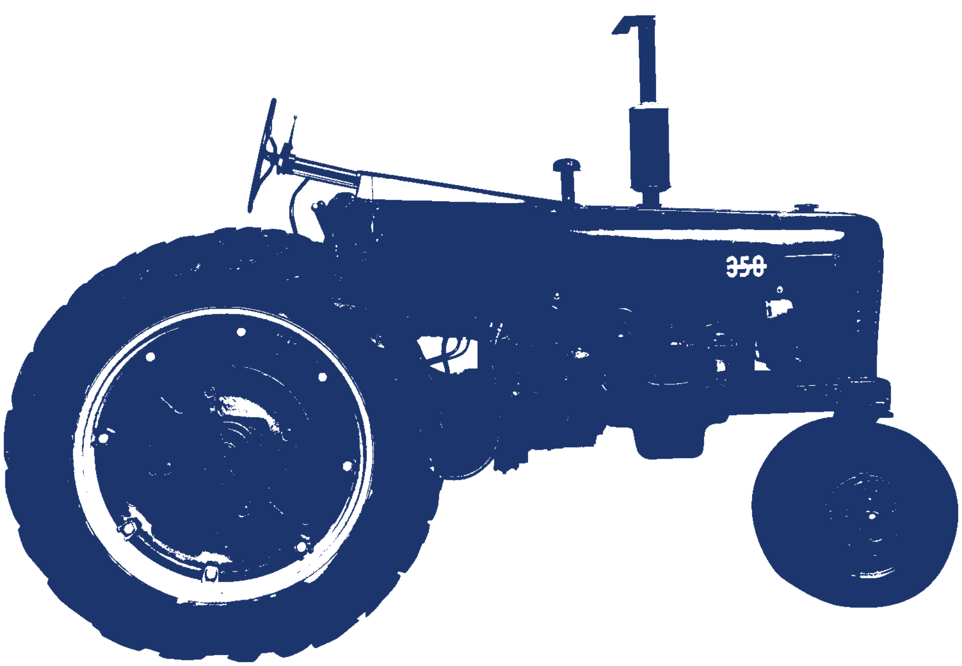
Rights or obligations to reacquire specific transferred assets or beneficial interests, which both constrain the transferee and provide more than a trivial benefit to the transferor, preclude sale accounting. Consider, for example, a transaction where the beneficial interest holders agree to sell their interests back to the transferor at the transferor's request for a price equal to the holders' initial cost plus a stated return. Any such arrangement would be viewed as providing more than a trivial benefit to the transferor. [29] On the other hand, if the call option's strike price was set at fair market value, it is unlikely that the transferor would be viewed as retaining more than a trivial benefit. Similarly, a call held by the transferor that was so deeply-out-of-the-money when written that its exercise is unlikely would 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 beneficial interests subject to a put option, which is exercisable only in the event that holders of at least 75 percent of the securities put their interests. Once the condition is met, the assets under option are to be brought back on balance sheet, regardless of the transferor's intent, until the option expires. [55] When the assets under option are brought back on balance sheet, the transferor treats them as if they were newly purchased. [EITF Issue 02-9]

A transferor call option may result in a part sale, part financing treatment. The specific fact pattern in the FASB 140 Q&A involves a portfolio of prepayable loans. The transferor holds a call option to repurchase the individual loans that remain unpaid once principal prepayments have reduced the portfolio balance to 30 percent of its original balance. The FASB staff's answer is that sale accounting is precluded only for the transfer of the remaining 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. [FASB 140 Q&A, question 50]

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, assuming all loans in the pool are smaller than such limit), because the transferor can unilaterally remove specific assets so control has not been transferred. [FASB 140 Q&A, question 49)

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] In some cases, we have seen parties other than the servicer (like financial guarantors) holding conditional call options to purchase the remaining assets, if the servicer does not first exercise its option.



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 for that portion of the assets. [FASB 140 Q&A, question 56]

	Call Option and Sale Accounting is:	
Transferor Holds a Call Option	**Okay**	**Not Okay**
At a fixed price on all transferred assets		◆ a
At a fixed price on a portion of the assets and:		
Transferor can choose which assets		◆ b
Transferor cannot choose which assets [c]	◆ d	◆ d
At a fixed price on a portion of the beneficial interests issued by the securitization vehicle		◆ a,e
At a fixed price on readily obtainable assets transferred to a non-QSPE	◆ f	
At fair value and the transferor:		
Owns the residual interest		◆ g
Does not own the residual interest	◆	
At a fixed price and the exercise of the call is conditional on the occurrence of some event outside of the control of the transferor, its affiliates and its agents such as a borrower default	◆ h	
And the option is a servicer cleanup call	◆ i	

a Unless the call is so far out of the money or for other reasons it is probable when the option is written that the transferor will not exercise it.

b No sale with respect to any of the assets the transferor can choose to re-acquire.

c For example, the transferor can exercise the option when the balance of the pool reaches some specified level or at some future specified date.

d Part sale, part financing treatment. In other words, the portion of the transferred assets to be derecognized vs. retained should be based on the relative fair values (present values) of (i) the cash flows expected to be distributed before the option becomes exercisable and (ii) the balance of future cash flows expected to remain when the option becomes exercisable.

e Sale accounting is precluded only with respect to those classes of beneficial interests subject to the call.

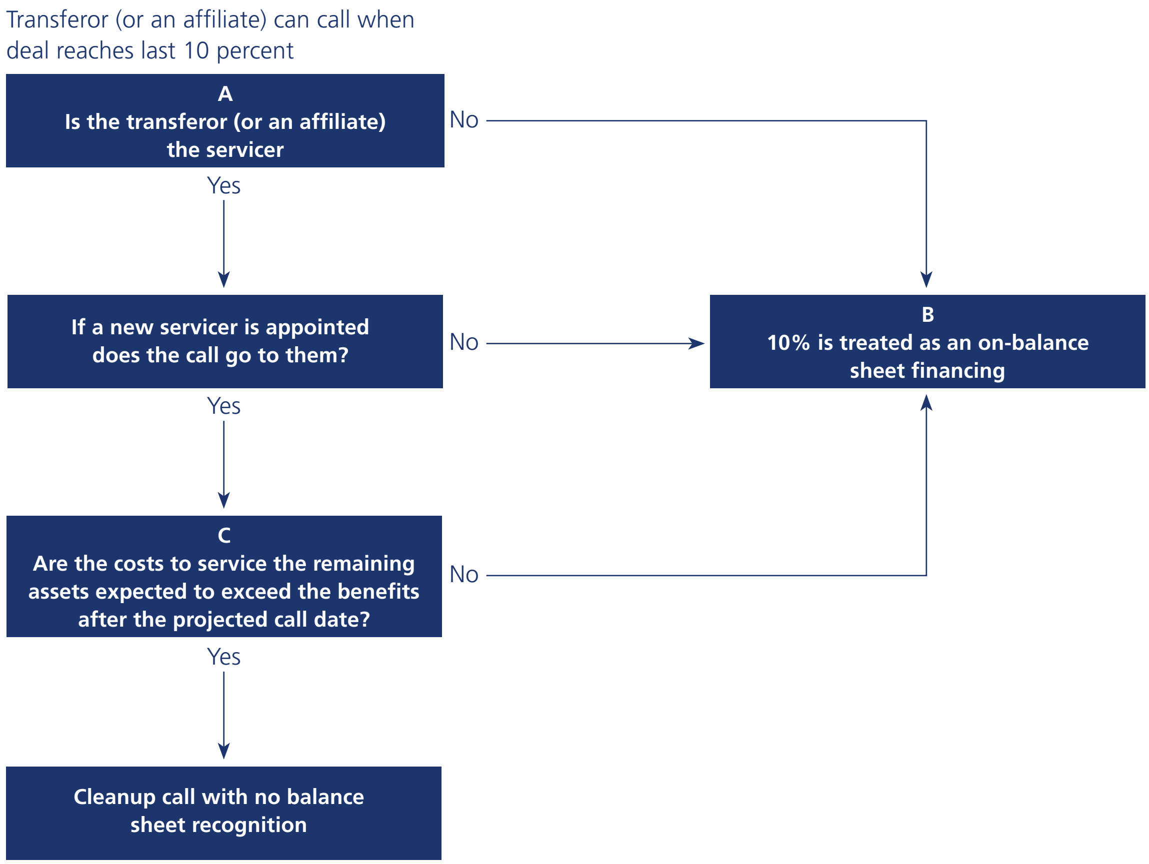
f For example, treasury bonds sold to a non-QSPE. The transferee is not constrained from selling the transferred assets since, if the call is exercised, it could acquire equivalent assets in the open market to deliver. Not applicable to sales to QSPEs, since a QSPE is restricted from purchasing assets in the open market.

g The transferor is deemed to have effective control since it can pay an amount higher than fair value and still realize the excess through their residual holding.

h When the condition occurs, the option must be reanalyzed as an unconditional call. [EITF 02-9]

i Unlike most other call options, in our view, previously sold assets can remain off balance sheet when a cleanup call becomes exercisable but has not been exercised.

Accounting for Cleanup Call and Other Optional Repurchase Provisions



A. Assume that all other sale criteria of FASB 140 are met. The call can be either on the transferred assets or on the securities issued.

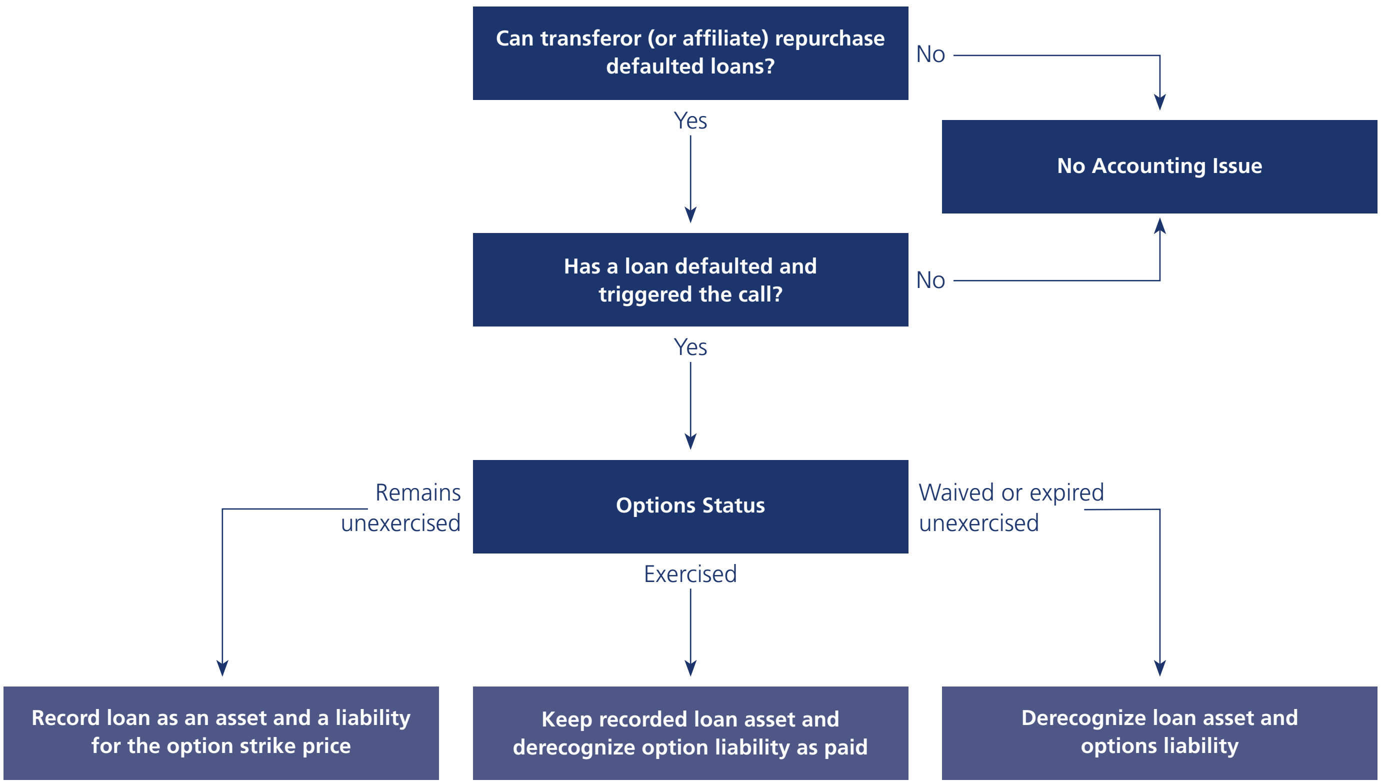
B The actual amount on balance sheet will be less than 10 percent since the allocation of the transferred assets to be derecognized vs. retained is based on the relative fair values (present values) of the estimated cash flows to be distributed to third-party beneficial interest holders before the projected call date vs. the balance of future cash flows expected to remain after the projected call date. Refer to questions 49 and 55 of FASB 140 Q&A. Same kind of estimation pattern would be used if the call was on a certain date rather than when the balances were reduced to a certain percentage of original balances.

C Only a servicer or its affiliate, which may be the transferor, can hold a cleanup call as that term is defined in FASB 140. There is no provision in FASB 140 for a safe harbor at the 10 percent level or any other level. According to FASB 140, paragraph 364, it's a cleanup call if the amount of outstanding assets or beneficial interests falls to a level at which the costs of servicing those assets or beneficial interests becomes burdensome in relation to the benefits of servicing.

How conditional must a conditional call be?

The FASB 140 Q&As recognize the difference between call options that will become exercisable with the passage of time, such as when a loan amortizes to a specific level, and call options that involve significant uncertainty, such as the delinquency of a particular borrower. The FASB 140 Q&As do not directly provide any guidance regarding the impact on sale accounting of a call option that is conditioned upon an event that is outside the transferor's control, but is likely to occur. An extreme example follows: A transferor sells beneficial interests to third parties but retains the right to reacquire those beneficial interests if LIBOR increases at any time during the life of the beneficial interests. Although the transferor has no control over the future level of LIBOR, it is highly likely that the call will become exercisable sometime during the life of the beneficial interests and we believe that sale accounting would not be appropriate. On the other hand, similar to call options whose exercise price is deep out-of-the-money, at certain levels of LIBOR as the strike price, the option could be considered a conditional call.

Accounting for Default Call Options



Can I still hold on to the ROAPs?

Removal-of-accounts provisions (ROAPs) permit the transferor to reclaim assets, subject to certain restrictions. In revolving deals, exercise of a ROAP often does not require 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 ROAPs used? 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 become necessary to remove them from the deal if the bank 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 provide itself 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 third-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 can 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.

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:

- The securities being issued are characterized for tax purposes as debt of the issuer, rather than equity in an entity, in order to avoid "double taxation."
- 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 REMIC interests.
- Notes or bonds rather than pass-through certificates are issued so as to invite easier participation and eligibility for certain categories of investors.
- The transaction is treated as an "off-balance sheet" sale for accounting purposes with recognition of any attendant gain or loss and without consolidation of the issuer into the financial statements of the transferor.

To meet that accounting objective, securitizers often follow these guidelines:

- The transferee/issuer typically needs to be a QSPE (see page 10). Note that in a two-step structure (see page 7); the entity that issues the debt (e.g., the owner trust) needs to be the QSPE.
- 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.
- There is no minimum size requirement for the equity of the QSPE for accounting purposes, but check with your tax advisors.
- The equity of the QSPE can be wholly owned by the transferor.
- The transfer of assets to the QSPE must meet the sale accounting requirements of FASB 140.
- Put options may be okay, but only if qualified bankruptcy lawyers say they are.
- 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 page18 of the accounting for certain call options in the FASB 140 Q&A. Servicer-held cleanup calls are okay.

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:

- 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.
- A revolving period or a partial reinvestment of principal collections in newly originated collateral.
- The level of credit risk embodied in the security and whether the security is senior to other classes in the structure.
- Payment mismatch (e.g., monthly pay collateral vs. quarterly pay debt).
- Use of excess spread to pay principal on debt so that the debt can be retired before the collateral is repaid.
- Existence and the size of the present value of the equity in the issuing entity.
- 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.
- 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).
- 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).
- Retaining control of and responsibilities for servicing the loans.
- 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 and all documentation is complete. 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 proceeds 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 need careful accounting scrutiny to comply with the off-balance sheet criteria of FASB 140 while typically seeking to preserve debt treatment for tax. Prior to the issuance of FIN 46R, there existed a variety of off-balance sheet structures using unconsolidated special-purpose entities with 3 percent outside equity; these have since been consolidated or dissolved.

In an off-balance sheet warehouse using a QSPE, a commercial or investment bank typically purchases a class of beneficial interests issued by a securitization vehicle created by the seller. Using the proceeds from the sale of the beneficial interests, 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 the cash flow 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, put options such as these comply with the sale criteria of FASB 140 and do not disqualify the entity from being a QSPE. FASB 140 does not, however, allow the transferor to bid on the assets in an auction if it holds the residual.

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. No contractual obligation to exercise the put is permitted; neither is 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 is 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 realize this benefit until a term securitization takes place, any gain on a warehouse deal would be relatively smaller.

The investment or commercial bank holding the puttable variable funding note may need to do a FIN 46R analysis because they may have the unilateral right to require the warehouse trust (a QSPE) to liquidate. All of the warehouse provider's contracts with the warehouse trust, including possibly interest rate swaps used to hedge the assets, need to be considered and may complicate the analysis.

Can I metaphysically convert loans to securities on my balance sheet?

For liquidity purposes, state tax planning, risk-based capital requirements (see page 60) or other reasons, financial institutions might wish to transform whole loans to one or more classes of securities. GAAP 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. Other than in a guaranteed mortgage securitization, FASB 140 requires that at least 10 percent of the fair value of the beneficial interests in the QSPE be acquired for cash by independent third parties (i.e., other than any transferor), otherwise the entity will have to be consolidated and the transferor is back to where it started - with loans on the balance sheet. [36] The 10 percent requirement can be met with the sale of any class of security by the SPE, but it must be met at all times. When not met, the SPE may need to be consolidated. An exception has been granted for mortgage loans in a guaranteed mortgage securitization as long as a substantive guarantee has been obtained from a third party (one that adds value or liquidity to the security). Here, no part of the beneficial interests is required to be sold to outsiders because the guarantor provides legitimacy to the transaction. This exception for mortgage loans cannot be extended to any other types of loans. When 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. 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]

Desecuritizations - What if we put Humpty Dumpty back together again?

A "desecuritization" is a transaction in which securities created in an earlier 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 (i.e., income recognition) 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). [EITF Topic D-51, *The Applicability of FASB Statement No. 115 to Desecuritizations of Financial Assets*.] The assets received would be recorded at the carryover basis of the beneficial interests surrendered with no gain or loss recognition instead of being recorded at the fair value of those assets.

Do banks have to isolate their assets in a two-step structure to get sale treatment?

In August 2000, the FDIC issued a rule designed to help banks meet the legal isolation requirement for GAAP sale treatment. 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).

Notwithstanding the FDIC regulation, the equitable right of redemption under U.S. law may still allow a transferor, its creditors or the receiver for a transferor to redeem transferred assets after a default by the vehicle.

In FASB Technical Bulletin No. 01-1, *Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 Related to the Isolation of Transferred Assets* (July 2001), FASB concluded that if the right of redemption is applicable, assets transferred in traditional one-step transfers by an FDIC-insured institution would likely not be judged as being beyond the reach of the transferor and its creditors.

In brief, the equitable right of redemption theoretically might give a bank the ability to recover transferred assets upon default by the vehicle (in a one-step transfer). In the event of a default, the investors (or the trustee on their behalf) might conduct a foreclosure sale of the collateral. The foreclosure sale triggers the equitable right of redemption - the bank can repurchase the collateral by paying the investors principal plus accrued interest.

The FDIC rule does not solve the problem. Why? The FDIC rule only deals with the powers of the FDIC as a receiver for a failed bank, while a default under the securitization (and the resulting right of redemption) might occur prior to the FDIC being appointed as a receiver. We understand the problem would be solved, however, by the bank entering into a two-step transfer, where the first transfer is a "true sale."

Do I always need to bother my lawyer for an opinion letter?

The American Institute of Certified Public Accountants (AICPA) has issued guidance on lawyer's letters in 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.140.* [AICPA § AU9336.01-.21]

In order for an auditor to be satisfied that legal isolation has occurred in connection with a transfer of assets, lawyers must conclude (1) that a "true sale" of the assets has occurred (as opposed to merely a secured lending); and (2) the assets of the transferee would not be "substantively consolidated" with the assets of the transferor in a bankruptcy proceeding involving the transferor. The opinions are generally referred to as True Sale and Non-Consolidation Opinions.

The AICPA interpretation contains extracts of legal opinions, which provide persuasive evidence (in the absence of contradictory evidence) to support management's assertion that the transferred assets have been isolated. For an entity that is subject to the U.S. Bankruptcy Code, a "would" opinion, not a "should" or "more likely than not" opinion must be obtained. 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 transferor also participates in some way in the overall transaction, the opinion should address the effect of that involvement on the opinion. An auditor is not required to obtain a legal opinion with respect to the second or any subsequent transfers in a two-step (or more than two-step) securitization provided that (1) the first step achieves isolation as evidenced by the satisfactory legal opinion and (2) each entity that receives either transferred assets or beneficial interests therein in the series of transfers is either (a) not affiliated with the transferor; (b) a QSPE; or (c) a bankruptcy-remote special-purpose entity included in the same set of consolidated financial statements as the transferor. Where the second transfer or a subsequent transfer is made to a consolidated affiliate of the transferor that is not a bankruptcy remote special-purpose entity (e.g., an operating company), the legal opinions should extend to such transfers. Although not required by the auditing interpretation, the lawyer may also be providing an opinion on the second step of a two-step structure involving a bankruptcy remote SPE, if requested by his client or the rating agencies. The auditor need not be alarmed if the opinion on the second step says something to the effect that such transfer would either be a sale or a grant of a perfected security interest.

2

Chapter

Other issues covered in the auditing interpretation on lawyer's letters are addressed below:

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?	■ Use of a lawyer may not be necessary when there is a routine transfer of financial assets without continuing involvement by the transferor (no servicing responsibilities, no participation in future cash flows and no recourse obligations other than standard reps and warranties.) ■ 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. ■ 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.
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?	■ 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. ■ 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. ■ 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 he relied.
Are legal opinions that restrict the use of the opinion to the client or to third parties other than the auditor acceptable audit evidence?	■ 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.
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?	■ 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. 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.

The auditor also needs to consider the effect of any unusual limitations or disclaimers that might be expressed in the legal opinion in assessing whether the legal letter is adequate audit evidence.

For example, we would find the limitation highlighted below to be troublesome because it essentially negates an otherwise satisfactory opinion by instructing the reader to perform additional legal analysis of the factors mentioned, thereby implying that those factors have not been considered by the lawyers in forming their opinion:

> "We note that legal opinions on bankruptcy law matters unavoidably have inherent limitations that generally do not exist in respect of other legal issues on which opinions to third parties are typically given. These inherent limitations exist primarily because of the pervasive powers of bankruptcy courts, the overriding goal of reorganization to which other legal rights and policies may be subordinated, the potential relevance to the exercise of judicial discretion of future arising facts and circumstances and the nature of the bankruptcy process. **The recipients of this opinion should take these limitations into account in analyzing the bankruptcy risks associated with the transactions as contemplated by the Agreements**."
> (Emphasis added.)

We would not find troublesome a sentence that simply told the reader that they should be mindful of these limitations as opposed to suggesting that the reader is being instructed to perform additional analysis of the bankruptcy risks beyond the legal opinion.

Are there special legal opinions for banks and thrifts?

If the transferor is not subject to the U.S. Bankruptcy Code, but is subject to receivership or conservatorship under provisions of the Federal Deposit Insurance Act, there are two alternate forms of legal opinions that would be acceptable. A lawyer might choose to give a "true sale" opinion of the type illustrated above[8] or the lawyer might choose to give an opinion addressing isolation both prior to the appointment of the FDIC as a receiver and following the appointment of the FDIC as receiver (see following example). In either case, the opinion or a separate opinion must still address the doctrine of "substantive consolidation" as discussed above.

"Based on and subject to the discussion, assumptions and qualifications herein, it is our opinion that:"

1. Following the appointment of the FDIC as the conservator or receiver for the Bank:
   a. The FDIC Rule will apply to the Transfers,
   b. Under the Rule, the FDIC acting as conservator or receiver for the Bank could not, by exercise of its authority to disaffirm or repudiate contracts under 12 U.S.C. §1821(e), reclaim or recover the Transferred Assets from the Issuer or recharacterize the Transferred Assets as property of the Bank or of the conservatorship or receivership for the Bank,
   c. Neither the FDIC (acting for itself as a creditor or as representative of the Bank or its shareholders or creditors) nor any creditor of the Bank would have the right, under any bankruptcy or insolvency law applicable in the conservatorship or receivership of the Bank, to avoid the Transfers, to recover the Transferred Assets or to require the Transferred Assets to be turned over to the FDIC or such creditor, and
   d. There is no other power exercisable by the FDIC as conservator or receiver for the Bank that would permit the FDIC as such conservator or receiver to reclaim or recover the Transferred Assets from the Issuer, or to recharacterize the Transferred Assets as property of the Bank or of the conservatorship or receivership for the Bank;
   e. Provided, however, that we offer no opinion as to whether, in receivership, the FDIC or any creditor of the Bank [but not the bank itself] may take any such actions if the Holders of beneficial interests in the transferred assets receive payment of the principal amount of their Interests and the interest earned thereon (at the contractual yield) through the date the Holders are so paid; and
2. Prior to the appointment of the FDIC as conservator or receiver for the Bank, the Bank and its other creditors would not have the right to reclaim or recover the Transferred Assets from the Issuer, except by the exercise of a contractual provision [insert reference to applicable provision, such as a ROAP] to require the transfer, or return, of the Transferred Assets that exists solely as a result of the contract between the Bank and the Issuer."

"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 receivership, conservatorship, or liquidation proceeding in respect of the Seller, a court would not grant an order consolidating the assets and liabilities of the Purchaser with those of the Seller."

8 The illustrative opinion shown on page 26 would be revised to (i) change "a Debtor" in the third line to "subject to receivership or conservatorship" and (ii) change "the Seller's estate for purposes of [the relevant sections] of the U.S. Bankruptcy Code" in the last three lines to "subject to repudiation, reclamation, recovery, or recharacterization by, the receiver or conservator appointed with respect to the Seller."

Can I structure my securitizations to avoid gain on sale accounting?

Recognition of a gain (or loss) 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 have abandoned "gain on sale" accounting. This is in reaction to the:

- Unwanted volatility in earnings that goes hand in hand with the timing and the then-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.
- Mortgage REITs wanting to build up earning assets on the balance sheet and meeting the exemption from Investment Company Act of 1940 (the '40 Act) status.[9]

The SEC staff expects securitizers to make clear and full financial statement disclosure of their structured transactions. The disclosure should identify key features that drive accounting determinations one way or the other and allow readers to grasp the economic significance of those features. See page 84 for further discussion of SEC views.

The following discussion covers some of the accounting issues that a company should consider in evaluating sale vs. financing structures:

- 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, which is expected to be rare - see "*What if I can't estimate fair value?*" on page 39.) Debt for GAAP seems to be the only practical structure to avoid recognizing the gain or loss that results from sale accounting. Often, 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, a 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.
- The FASB considered, but rejected, the 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 on the left hand side of the balance sheet rather than as a liability. No gain or loss is recognized. We continue to believe that "a linked presentation" approach would have resolved many of the thorny conceptual dilemmas and real-world issues that FASB struggled with while deliberating FIN46. However, the linked presentation is not permitted under U.S. GAAP.
- The most common features of securitizations being reported as debt-for-GAAP are:
  - Failing QSPE status by giving the servicer or special servicer the discretion either to work out or foreclose defaulted loans or dispose of them by sales to third parties.
  - Failing QSPE status by giving the issuer SPE the ability to acquire passive derivatives from time to time at its discretion or to acquire non-passive derivatives at any time.
  - Failing QSPE status by transferring a substantive amount of non-passive financial assets or non-financial assets to the issuing SPE.
  - Failing QSPE status by allowing the issuer to temporarily invest some funds in non-risk-free investments.
  - Allowing the transferor to repurchase or replace ANY transferred loan it chooses, subject to some overall limit on the total dollar amount or number of loans that can be repurchased.

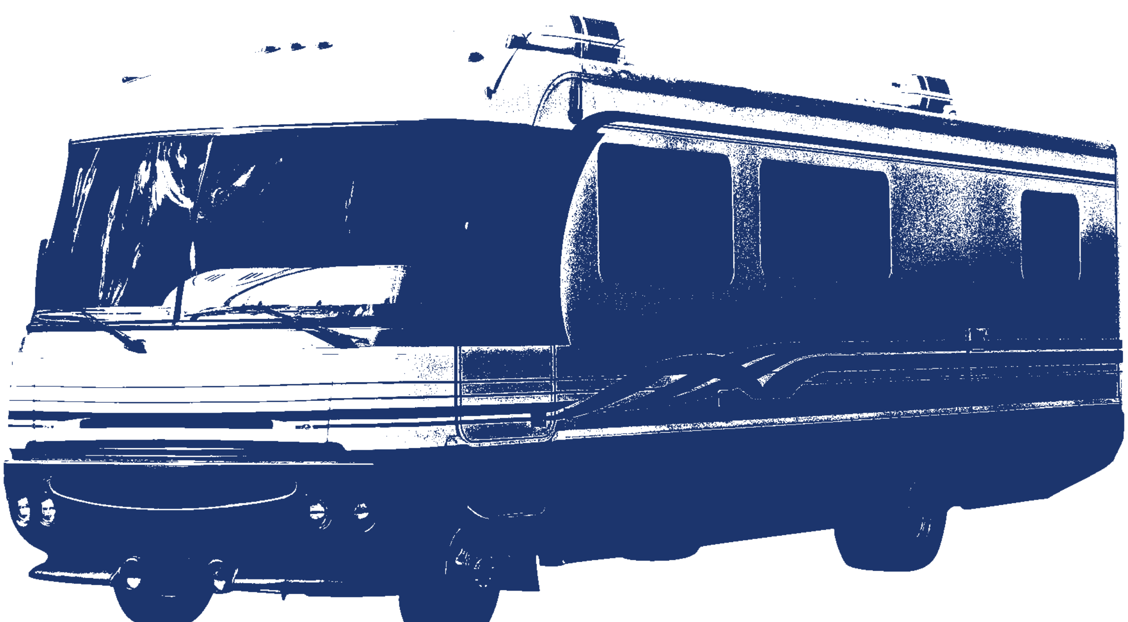
9 To qualify for an exemption under the '40 Act, the REIT needs to be "primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on and interests in real estate," by investing at least 55 percent of its assets in mortgage loans or mortgage-backed securities that represent the entire ownership in a pool of mortgage loans and at least an additional 25 percent of its assets in mortgages, mortgage-backed securities, securities of REITs and other real estate-related assets.

- 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 (beneficial interests). The uncertainty stems from 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: (1) 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 (2) 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 the financial asset 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." In our view, if the transferor must consolidate the assets and liabilities, including derivatives of a non-QSPE issuer under FIN 46R, then we think those classifications would override the paragraph 10 guidance described above.
- 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 requirement to carry them at the lower of cost or market value (LOCOM) 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.
- The balance sheet and/or footnote disclosures should identify the assets. Balance sheet captions such as "Restricted assets included in securitization structure" or "Securitized assets restricted for repayment of non-recourse borrowing" could be used.

Accounting for a securitization as a financing does not eliminate the need to make subjective judgments and estimates and could still result in volatility in earnings due to the usual factors of prepayments, credit losses and interest rate movements. 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:

- In the financing accounting scenario, origination costs, points, purchase premiums and deal expenses are capitalized and 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.
- When mortgage loans are originated or acquired with the intent to securitize as a financing, the loans generally will be classified as held for long-term investment and will not be subject to a 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 less relevant. 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.
- Underwriting fees and direct deal costs of issuance will be capitalized and amortized over the life of the bonds, and the pace of amortization will be affected by prepayments.
- Provisions for credit losses will be made periodically under FASB 5 or FAS 114. 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. Typically, the timing pattern of credit losses is low in the early periods following securitization followed by a ramp-up in subsequent periods.
- Derivatives inside a non-QSPE securitization trust will be consolidated and accounted for under FAS 133.

- 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. Current GAAP does not seem to support this more conservative treatment for a consolidated non-QSPE.
- In Real Estate Mortgage Investment Conduit (REMIC) deals accounted for as GAAP financings, 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. That tax asset should be evaluated for recoverability and, if it seems partially or fully unrecoverable, a valuation reserve would be required. For tax purposes, REMICs by definition are a sale, to the extent that the REMIC interests are sold.
- In comparing pro forma projected results of weaning off of gain-on-sale accounting, don't forget the income from the accretion of yield (at the discount rate) on the residual interests retained in the sale accounting scenario.
- 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. The SEC staff has been active recently in challenging cash flow classifications to make sure that registrants are properly identifying operating, investing and financing cash flows.
- FASB 140's extensive disclosures relating to securitizations do not apply to securitizations accounted for as financings. These include 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. 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 disclosures.



Chapter 3

Determining Gain or Loss on Sale

How do I calculate gain or loss when I retain some bond classes or 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]

First, accumulate all of the elements of carrying value of the pool of assets securitized, including any premiums and discounts, capitalized fees or costs and allowances for losses. Next, identify any assets received or retained and any liabilities incurred as part of the securitization. Finally, carefully estimate the fair values of every element received, retained or incurred based on current market conditions. Use realistic assumptions and appropriate valuation models and only consider existing assets actually transferred (without anticipating future transfers). Then if the transfer qualifies as a sale:

- 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.
- Record on the balance sheet the fair value of any new liabilities issued including guarantees, recourse obligations or derivatives such as put options written, forward commitments, interest rate or foreign currency swaps.
- Recognize gain or loss only on the assets sold by comparing the net sale proceeds (after transaction costs and after liabilities incurred) to the allocated book value of the sold classes.
- Continue to carry on the balance sheet (initially at its allocated book value) any retained interest in the transferred assets, which may include a separate servicing asset and debt or equity instruments in the SPE. [11]
- For retained interests classified as available-for-sale securities under FASB 115, 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 interests 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.

Notice that FASB 140's basis allocation methodology results in recognizing only the gain or loss attributable to the portion of the securitized assets sold. The proportion of gain or loss related to interests retained is not immediately recognized in the P&L, at least not under FASB 140. That deferred gain or loss will either be recognized immediately after the securitization accounting is done as part of the initial FASB 115 mark-to-market of retained securities classified as trading or it will be recognized over time as a higher yield, if assumptions materialize.

There is no rule 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]

Financial modeling of securitization transactions is an integral part of the accounting process both at the date of the transaction and on an ongoing basis. Reasonable financial modeling requires using quantitative processes that appropriately reflect the nature of the assets securitized, the structural features and terms of the securitization transaction and the applicable accounting theory. It also requires accurate data about current amounts and balances. Finally, it requires current market valuation information (such as yield curves, credit spreads and derivative prices) and supportable assumptions about future events (such as customer prepayment behavior, default probability and loss severity). Securitization transactions are too complex to be able to analyze intuitively at the level of precision required for financial reporting.

How is gain or loss calculated in a revolving structure?

Gain or loss recognition for relatively short-term receivables such as credit card balances, draws on home equity lines of credit, 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 the 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 record keeping 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.

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. [FASB 140 Q&A, Question 123].

FASB Staff Position (FSP) FASB 140-1 (April 2003), *Accounting for accrued interest receivable related to securitized and sold receivables under Statement 140*, concludes that it is inappropriate to report the receivables for accrued fee and finance charge income on the investor's portion of the transferred credit card receivables, commonly referred to as accrued interest receivable (AIR), as "loans receivable" or other terminology implying that it has not been subordinated to the senior interests in the securitization. The AIR asset should be accounted for as a retained beneficial interest. *The Interagency Advisory on the Accounting Treatment of Accrued Interest Receivable Related to Credit Card Securitizations* (December 4, 2002) provides additional guidance.

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

A term securitization 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 — $ 100,000,000
- Net carrying amount (Principal amount + accrued interest (if it has to be remitted to the trust) + 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
TOTAL	**$100,000,000**		**$ 99,800,000**

* Including accrued interest

- Class IO (fair value of $1,500,000) and Class R (fair value of $1,000,000) 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	($99 MM X%) Allocated Carrying Amount	Sold	Retained
Servicing	$ 700,000	.68%	$ 673,200		$ 673,200
Class A & B	99,800,000	96.89	95,921,100	$ 95,921,100	
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 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 Loans		$ 99,000,000
Pre-tax Gain on Sale		2,878,900
2. Class IO	$ 54,600	
Class R	39,700	
Equity - other comprehensive income (Earnings, if trading)		$ 94,300

A credit card example

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 one below 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. This example illustrates the gain calculation at the inception of a revolving credit card securitization.

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
■ Cash Collateral Account fair value (cash out method)	$ 5,000,000
■ Value of fixed-price forward contract for future sales	0
■ Up-front transaction costs	$ 4,000,000
■ Offered Deal Structure:	

	Principal Amount	**Price**	**Proceeds**
Class A	$ 500,000,000	100	$ 500,000,000
Class B	25,000,000	100	25,000,000
Initial Funding of Cash Collateral Account			(7,000,000)
TOTAL	$ 525,000,000		$ 518,000,000

Basis Allocation of Carrying Value

Component	**Fair Value**	**% of Total Fair Value**	**($637 MM X%) Allocated Carrying Amount**	**Sold**	**Retained**
Classes A & B	$ 518,000,000*	78.72%	$ 501,468,100	$ 501,468,100	
Seller's Interest	125,000,000	19.00	121,010,600		$121,010,600
IO Strip**	10,000,000	1.52	9,680,900		9,680,900
Cash Collateral Account	5,000,000	.76	4,840,400		4,840,400
TOTAL	**$ 658,000,000**	**100.00%**	**$ 637,000,000**	**501,468,100**	**$135,531,900**

Net proceeds after transaction costs (assumes 25% allocation to the initial sale)	517,000,000
Pre-Tax Gain	$ 15,531,900

Journal Entries	**Debit**	**Credit**
1. Cash	$ 518,000,000	
IO Strip	9,680,900	
Cash Collateral Account	4,840,400	
Seller's Interest	121,010,600***	
Deferred Transaction costs	3,000,000	
Pre-tax gain on sale		$ 15,531,900
Net carrying value of Loans		637,000,000
2. IO S	$ 319,100	
Equity - other comprehensive income		$ 319,100

* Although the aggregate fair value of Classes A and B to the investors is $525 million, the fair value to the Seller was only $518 million since $7 million was retained to establish a Cash Collateral Account (which is reflected at its cash-out fair value of $5 million in the Basis Allocation of Carrying Value). There are other ways that the up-front deposit could be taken into account. For example, as the transfer of an additional asset rather than a reduction of proceeds. Only one way is illustrated here.

** 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.

***Note that in the above example, the allocated carrying amount of the seller's interest 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.

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, in advance for 36 months)	$17,739
■ Estimated Residual Value ($15,000 guaranteed*)	18,000
■ Less Unearned Income	(5,739)
■ Net Investment in Lease (computes to 8% interest rate implicit in the lease)	30,000
■ Less: Present value of unguaranteed residual	(2,362)
$3,000 future value discounted at 8% implicit lease rate	
Net carrying amount of financial assets securitized	$27,638

Securitization of guaranteed cash flows:

Advance Rate = 90% of guaranteed cash flows discounted at 6%

Subordinated interest valued at 12% discount rate

Servicing fees were not considered in this analysis

Basis Allocation of Carrying Value

	Fair Value	% of Total Fair Value	Allocated Carrying Amount
Senior Interest Sold at Par	$ 25,932	91.057%	$ 25,166
Subordinated Retained Interest	2,547	8.943	2,472
TOTAL	**$ 28,479**	**100.000%**	**$ 27,638**

Journal Entry

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 S	$ 766	
During the Life:		
Earned Lease Income	N/A	$ 5,739
Interest Expense	N/A	(3,533)
Yield on Retained Interest	802	N/A
At Termination:		
Gain on Residual Value Realization**	638	N/A
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 eye of the "B-Holder"?

Over the years, several public companies have announced significant losses resulting from downward adjustments to previously recorded residual interests in securitizations. The adjustments often stemmed from securitized 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, non-cash; instead, the gains usually result from recording assets that represent an estimate of the present value of anticipated cash flows.

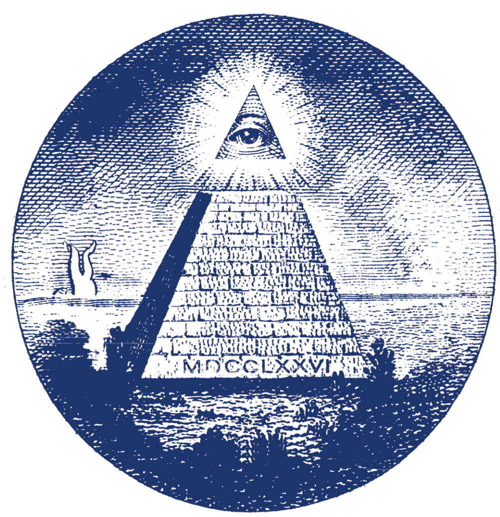
In response, some securitizers indicated that they would utilize more conservative assumptions when calculating the gain on securitizations. More conservative assumptions mitigate or eliminate subsequent downward adjustments if adverse market developments occur. In at least one well-publicized case, 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, option-adjusted spread models and fundamental analysis. The objective when measuring financial liabilities at fair value is to estimate the value of the assets required currently to (1) settle the liability or (2) 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 likelihood 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. [FASB 140 Q&A, question 77].



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). 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.

For those public companies subject to the provisions of Section 404 of the Sarbanes-Oxley Act of 2002, the internal controls over fair value estimates become even more critical. When fair value estimates are a significant component of the company's financial reporting, management will need to make an assessment of the effectiveness of the related internal control structure and the auditors will need to audit and opine on both managements' descriptions of the controls and their assessment as well as giving their own opinion directly on control effectiveness.

SAS 92 also provides that if the client obtained its estimates of fair value 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:

- Obtain an understanding of the methods and assumptions used.
- Make appropriate tests of data provided to the specialist, taking into account the auditor's assessment of control risk.
- 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 to a belief that 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 retained interests' 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. See also the discussion in Chapter 6, "*Through the Looking Glass, FASB 140's Required Disclosures*" beginning on page 56.

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 FASB 140 Q&A, the staff concluded that in a vast majority of circumstances, it should be practicable to estimate fair values. [FASB 140 Q&A, question 69]

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, which were 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:

- 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 - a loss on sale would be recognized if a liability under FASB 5 and FASB Interpretation 14 (*Reasonable Estimation of the Amount of a Loss*) would be recognized in an amount greater than the "plug." The FASB 5 liability could be zero. [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 market factors such as the creditworthiness of the pool. Moreover, FASB 115 does not have a practicability exception. The FASB has said if a retained interest is initially valued at zero (because it was not practicable to estimate fair value), but the instrument is required to be classified as available for a sale or trading, then a fair value would have to be computed for purposes of preparing the first balance sheet after the securitization. [FASB 140 Q&A, question 71]

Do 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.

When do I record an asset for servicing?

If the benefits of servicing are expected to be more than adequate compensation to service the assets, a servicing asset must be created. [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 sold to another servicer.

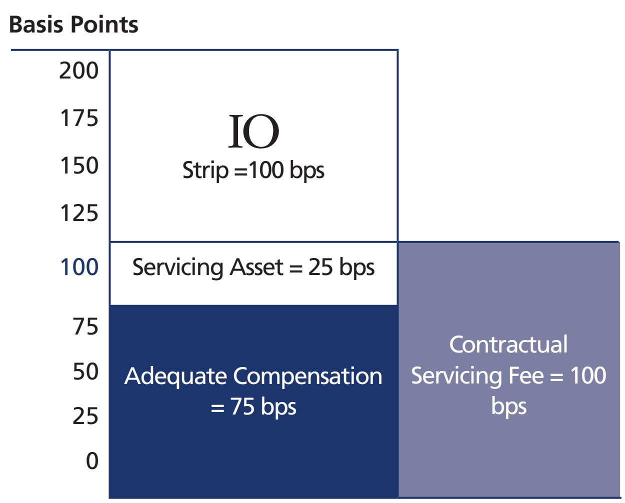
Servicing is inherent to financial assets; however, it only becomes a distinct asset when contractually separated from the underlying assets via a sale or securitization of the assets, with servicing retained. [61] A servicer of the assets commonly receives the benefits of servicing - revenues from contractually 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 expected to equal or exceed 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. Adequate compensation 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 successor 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, such as collecting late charges. [FASB 140 Q&A , questions 78 through 91]

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. Therefore, it stands to reason that any asset value that a particular servicing arrangement has is attributable to the excess of the contractual servicing fee over the level of adequate compensation. Likewise, the amount of a servicing liability would be determined by how far short the contractual servicing fee fell below the adequate compensation level.

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.

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 the next page. 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:

- 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.
- 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 as assets (e.g., those created prior to the adoption of FASB 122) cannot be used to mitigate an impairment loss.
- 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 cannot 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.

FASB recognized that 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. Again, note that the transfer of servicing is covered in EITF Issues No. 90-21 and 95-5, not FASB 140.

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

	Servicing Asset	IO Strip
Definition	The value of amounts above adequate compensation that, per the contract, are due to the servicer for servicing.	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 [14]
Income Recognition	Amortized in proportion to and over the period of estimated net servicing income	Trading: Marked to market (if interest income is required to be shown separately, use level yield prospective adjustment under EITF 99-20, see page 53) Available for sale: Level yield, prospective adjustment under EITF 99-20
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 53

How are cash reserve accounts handled? What is the "cash-out" method?

According to question 74 in the FASB 140 Q&A, 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.

There are several different ways to think about cash reserve accounts. One internally consistent way is to reduce the fair value of any interests sold to third parties by the amount of cash initially deposited in the cash reserve account, whether that cash was withheld from the amount paid by the third parties or contributed by the transferor with separate funds. The size of the cash reserve account does not affect the total historical cost basis to be allocated. Assuming the securitization is accounted for as a sale, the cash reserve account is recorded at its allocated basis, based on relative fair value on the transfer date. Gain or loss is calculated based on the net proceeds after any initial reserve account funding requirements are met. This method is illustrated in the credit card example on page 35.

Another way is to increase the total historical cost basis to be allocated by the initial amount of the cash reserve account, regardless of how it is funded mechanically. Net proceeds are increased to reflect any cash paid by the third-party investors that was trapped to initially fund the cash reserve account. These two methods will give slightly different gain or loss results, because the differences in allocation percentages and the basis to be allocated do not exactly offset the difference in the proceeds recognized.

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.

EXAMPLE: Company A securitizes $100 million principal amount of 8 percent 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 percent 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 whereby 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 basis points 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 76 in the FASB 140 Q&A:

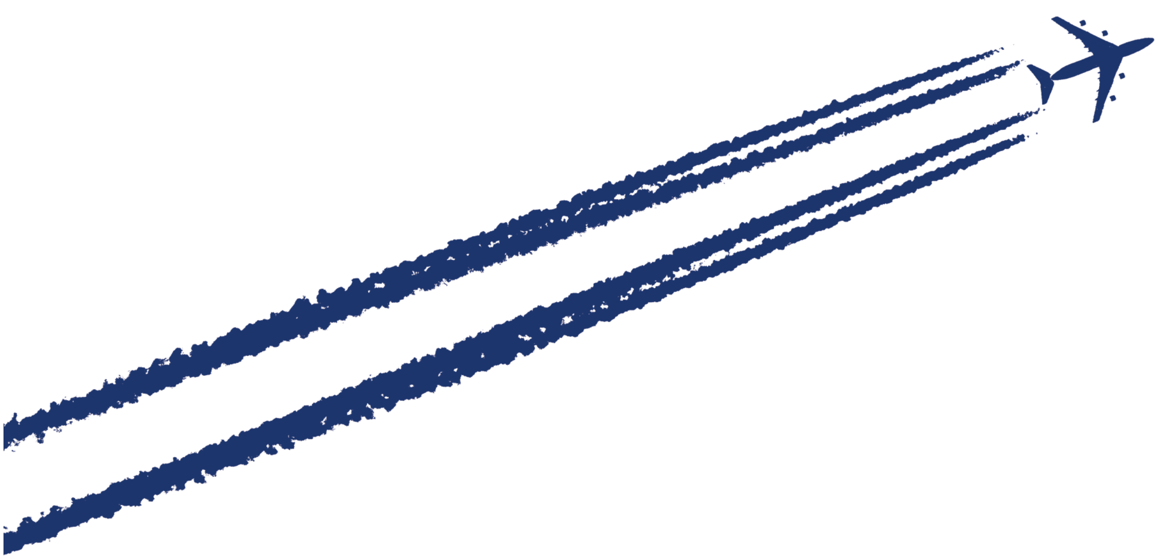
> ...using an expected present value technique or a "best estimate" technique with an appropriate discount rate, the cash-out method estimates the fair value in a manner consistent with paragraph 69 [the fair value requirements of FASB 140] (that is, both the entire period of time that the transferor's 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 believe that the cash-in method could result in a material misstatement of the financial statements and, accordingly, forced several registrants to restate their financial statements.

How are prefunding accounts handled?

Securitizations often contain a prefunding feature wherein the principal amount of beneficial interests that are issued is greater than the principal amount of the financial assets that are initially transferred to the trust. These additional proceeds are deposited in a prefunding account and reinvested awaiting use as payment to the transferor as additional eligible financial assets are subsequently transferred to the trust (there is a 90-day maximum period for additional transfers for REMICs). The transferor also funds at the initial closing a capitalized interest account to make up for the negative carry. If the trust is a QSPE, neither of these accounts appears on the transferor's balance sheet. If the transferor is unable to deliver additional eligible financial assets, the amounts in the prefunding account are paid out to beneficial interest holders according to the waterfall.

Prefunding features complicate the gain on sale analysis because it is more difficult to estimate the value of a retained, residual interest given the uncertain period that the "excess" beneficial interests will be outstanding. FASB 140 does not permit gain recognition on assets that have not yet been transferred, particularly assets that might not even have been originated yet. Accordingly, we think the appropriate assumption at the initial closing is that there will be no additional assets transferred and that the prefunding account will be paid out to the beneficial interest holders according to the waterfall at the earliest possible date. With this assumption in place, the estimation of the residual value can proceed. As the transferor makes additional transfers to the trust, additional gains (or losses) will be recorded taking into account the cash proceeds and any additional estimated residual value.



Chapter 4

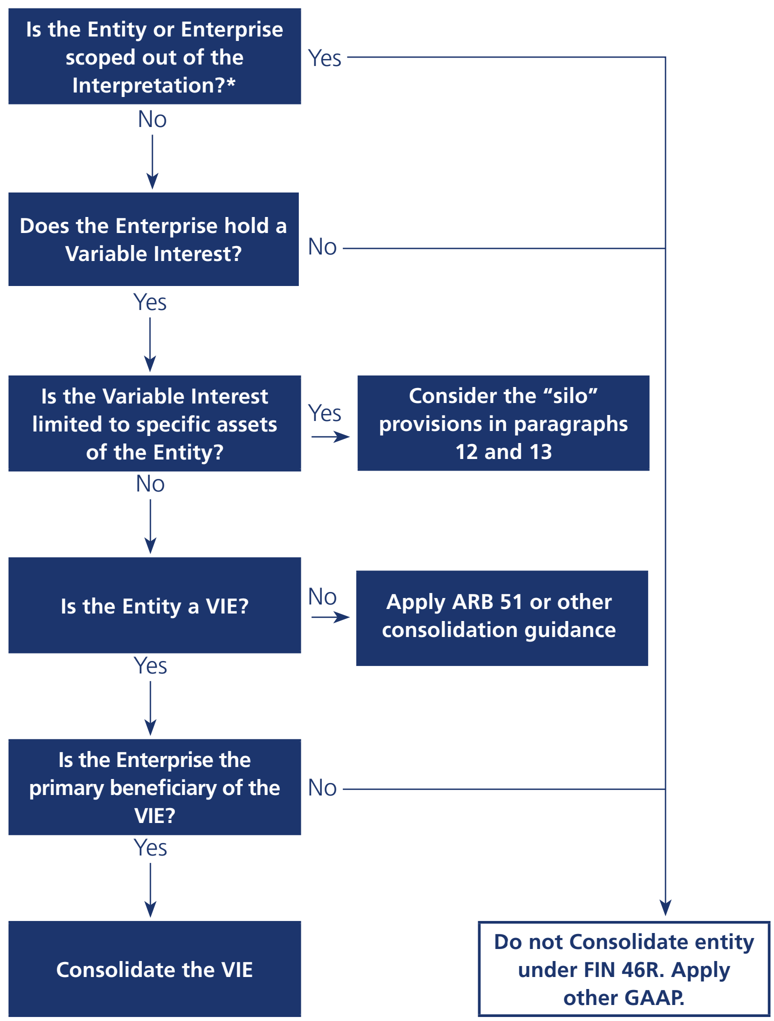
Are there any Highlights of FIN 46(R) – Consolidation of Variable Interest Entities?

For non-QSPEs, FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, Revised December 2003 ("FIN 46R") defines the new concept of a "variable interest entity" (VIE). FIN 46R sets out an elaborate system for evaluating how the economic risks and rewards of the VIE are attributed to various participants in the activities of a VIE.

Under FIN 46R, if an entity is to consolidate a VIE, it is called the "primary beneficiary." An entity that is judged to have a majority of the economic risks of the VIE, as evidenced by holding "variable interests" that absorb a majority of the "expected losses," is the primary beneficiary. Otherwise, the primary beneficiary is the entity that has a majority of the economic rewards, because its variable interests receive a majority of the "expected residual returns." Not every VIE will have a primary beneficiary, because a majority of the FIN 46R-defined risks and rewards may not be concentrated with any one holder. The FASB's theory was that a requisite level of control for consolidation is implied in an economic relationship that absorbs a majority of the risks or rewards.

The remainder of this section contains more general observations about FIN 46R, rather than detailed implementation guidance. A basic FIN 46R flowchart and glossary of terms also appear. Many of the detailed implementation questions remain unresolved, particularly when it comes to issues of importance to securitization. For example, in EITF Issue No. 04-7, *Determining Whether an Interest Is a Variable Interest in a Variable Interest Entity*, the EITF was deliberating the question of how to recognize which types of relationships with a VIE should even go into the measurement. After spending months and making little headway on this fundamental question, the EITF suspended its deliberations and the FASB has announced that it would take up the question and consider issuing a FASB staff position.

Basic FIN 46R Flowchart



* For the most part, not-for-profit organizations, employee benefit plans, QSPEs, mutual funds, separate accounts of life insurance companies and governmental organizations are not subject to FIN 46R.

Glossary of FIN 46R Terms

Variable Interest Entity (VIE) - An entity subject to the FIN 46R consolidation rules. VIE is broader than the old special purpose entity or SPE concept.

Variable Interests - Contractual, ownership or other commercial interests in an entity that change with changes in the fair value of the entity's net assets (excluding variable interests).

Subordinated Financial Support - Variable interests that will absorb some or all of an entity's expected losses.

Primary Beneficiary - An enterprise that consolidates a VIE because it holds variable interests that absorb more than half of the expected losses or half of the expected residual returns of the entity.

Enterprise - The company evaluating whether it should consolidate another entity.

Entity - The entity that is the subject of the consolidation analysis.

Expected Losses - A new statistical measure of variability of possible future outcomes for those scenarios **below** the average outcome. The term is used when determining whether an entity is a VIE and to identify the enterprise, if any, that is the primary beneficiary. The calculated amount of expected losses will generally be less than one half the amount of the standard deviation of future cash flows (on a present value basis) calculated across all of the scenarios.

Expected Residual Returns - The mirror image of expected losses representing variability of possible future outcomes for those scenarios **above** the average outcome. If no enterprise holds variable interests absorbing a majority of the expected losses, the enterprise, if any, that holds variable interests absorbing a majority of expected residual returns is the primary beneficiary.

Silos - Smaller, "virtual" VIEs that are analyzed separately for consolidation. Silos can only be split from an entity that is a VIE to begin with.

The main points of FIN 46R most interesting to securitization outside the realm of QSPEs include:

- Investment companies, both registered and unregistered, do not need to follow FIN 46R in accounting for their investments.
- Most non-QSPE securitization vehicles will likely be VIEs, making FIN 46R applicable. Either qualitative or quantitative analyses of whether a particular variable interest holder is the primary beneficiary that must consolidate may be acceptable. In public meetings, some FASB board members seemed to lean towards qualitative analyses, perhaps because quantitative methods seem difficult to prescribe precisely. In any event, significant judgment will be required to come to appropriate accounting conclusions.
- Consolidation does not just increase the size of the parent's balance sheet. It also changes the size and potentially the nature of line items reported on the income statement and statement of cash flows, even when net income overall remains unchanged. For example, the net fees earned by a collateral manager of a consolidated entity would be eliminated in consolidation and gross interest income and interest expense would be recognized instead.
- The consolidation question is not necessarily finally settled when the deal closes. Each participant needs to make its own assessment when it becomes involved with the transaction. That means that two different participants that become involved at different times may come to different, and contradictory, consolidation conclusions. The amounts of profits and losses experienced by the entity will generally not require any participant to reconsider its original conclusions about whether the entity is a VIE or who is the primary beneficiary. But some events, such as distributing capital or accepting new capital investments, changing the governing legal documents or increasing or decreasing the activity level (or activity type) may necessitate reconsideration. Of course, a participant would also need to reconsider their own status as the primary beneficiary, if they increased or decreased the amount of their interests in the VIE.
- A participant that has only a position similar to a variable interest, but that runs solely to specific assets of a VIE, will generally be excluded from consideration entirely if those assets represent less than a majority of the VIE's total assets as measured by fair value. Any variability attributable to those variable interests will also be excluded from the analysis.
- The previous point notwithstanding, a VIE may need to be broken up for purposes of accounting analysis into two or more "silos," or deemed separate accounting variable interest entities, if there are segregated groups of assets within a VIE where "essentially all of the assets, liabilities and equity of the silo are separate from the overall entity and specifically identifiable. In other words, essentially none

of the returns of the assets of the silos can by used by the remaining VIE, and essentially none of the liabilities of the deemed entity are payable from the assets of the remaining VIE."[10] "Essentially all" and "essentially none" represents a very high threshold, so siloing VIEs should be relatively rare.

How might FIN 46R apply in a QSPE mortgage deal?

EXAMPLE: MBanker is an originator and seller/servicer of non-conforming mortgage loans. MBanker securitizes those mortgage loans using a QSPE trust. That's-a-Wrap, is a monoline financial guarantor that provides the substantial guarantee to the QSPE of timely payment of principal and interest on the mortgages. Mbanker sells the resulting senior mortgage-backed securities to Nvestor. MBanker keeps a residual class interest in the pool. Under the terms of the securitization, NVestor can exercise an option to put back its mortgage-backed securities to the trust and trigger an auction of the underlying loans in order to pay off NVestor. The three parties evaluate whether or not they need to consolidate the trust under FIN 46R as follows:

- MBanker is the transferor to a QSPE and cannot consolidate, regardless of its risk and reward profile.
- That's-a-Wrap is also precluded from consolidating the trust because of its QSPE status, regardless of its risk and reward profile.
- NVestor must evaluate the trust under FIN 46R. NVestor cannot claim the QSPE exemption from FIN 46R because it can unilaterally cause the trust to liquidate by electing to put back its mortgage-backed securities.

How might FIN 46R apply in a non-QSPE mortgage deal? (With IOs and Sub Pieces)

EXAMPLE: MBanker is an originator and seller/servicer of fixed rate subprime mortgage loans. MBanker securitizes those mortgage loans using a trust that fails to qualify as a QSPE since MBanker has the discretion to sell, workout or foreclose defaulted loans. The trust sells the senior mortgage-backed securities, which bear interest based on LIBOR plus a margin, and also sells to a single investor a senior interest-only security which absorbs most of the difference between the fixed rate on the mortgage loans and the variable rate on the senior certificates. MBanker retains a subordinated class which is the first class to absorb credit losses. MBanker and the investor in the senior inverse floating rate IO must both perform a FIN 46R expected loss analysis so as to determine whether the variability in credit performance vs. the variability in prepayments and interest rates would absorb a majority of the expected losses of the VIE.

When would FIN 46R require a collateral manager to consolidate a CDO?

Assume that a collateral manager creates a CDO and retains 20 percent of the unrated equity securities. The senior and mezzanine securities are distributed to several investors. The equity class provides credit support to the higher tranches and was sized to absorb a majority (but not all) of the expected losses of the CDO. Therefore, each investor in the unrated equity securities will need to consider whether its position absorbs a majority of the expected losses or expected residual returns. The collateral manager will need to include the effects of variability in its management fees because the collateral manager is a "decision maker" for the CDO. The collateral manager is not simply a "service provider" because it also holds another significant variable interest in the form of one-fifth of the unrated equity securities. If the collateral manager has only a 20 percent holding in the unrated equity securities, it is fairly unlikely that the collateral manager's total holding represents a majority of the CDO's expected losses or expected residual returns, unless its management fees absorb a significant amount of the entity's variability. Therefore, each other investor in the unrated equity securities will also need to perform a similar analysis. Other interests, such as the mezzanine securities, will also absorb a smaller portion of the expected losses of the CDO, so those will need to be included in the calculations. Depending on the particular facts and circumstances, a holder of the majority of the unrated equity securities might conclude it has the majority of the CDO's overall expected losses and/or expected residual returns. If so, it would be the primary beneficiary and need to consolidate the CDO under U.S. GAAP. On the other hand, a holder of slightly less than a majority of the equity who also holds a substantial portion of the mezzanine securities might come to that conclusion instead. Frequently, the holdings of these classes of interest are purposefully distributed widely enough so that no holder has a majority and no holder consolidates the CDO.

10 See FSP FIN 46R-1, *Reporting Variable Interests in Specified Assets of Variable Interest Entities as Separate Variable Interest Entities.*

How about an example applying FIN 46R to ABCP conduits?

EXAMPLE: Just Conduit is a multi-seller asset-backed commercial paper conduit sponsored by Big Bank. Each seller retains credit exposure on the trade receivables or other assets it sold to Just Conduit. No seller represents more than 5 percent of the total assets of Just Conduit and the sellers are not exposed to the credit performance of another seller's assets. All of the conduit's assets are available for payment of its commercial paper. Big Bank provides liquidity and program-wide credit support. A third-party investor, Private I owns a junior interest in Just Conduit in the form of a note that bears a relatively high rate of interest and is the first to absorb any credit losses incurred by the conduit, before Big Bank does. Because of the substantial over-collateralization provided by each seller, the residual credit risk of Just Conduit's assets is extremely low.

Because each seller has variable interests in specific assets representing less than a majority of Just Conduit's assets, no seller has a variable interest in Just Conduit taken as a whole and all assets are available to pay the commercial paper and junior interest, no silo exists and variability attributable to those interests in specific assets gets excluded from the FIN 46R analysis. [¶12 of FIN 46R] So, for their purposes, the FIN 46R analysis is done.

If the Private I junior securities are sized to be sufficient to absorb a majority of Just Conduit's expected losses as defined by FIN 46R, Private I would be the primary beneficiary of Just Conduit and will consolidate it unless Private I meets the investment company scope exception in FIN 46R.

Chapter 5

Investor Accounting Issues

How do I account for plain-vanilla MBS and ABS?

Most interests in securitization transactions, whether purchased or retained, will probably meet the FASB 115[11] definition of a "security." When the transferor retains FASB 115 securities, they must make an election at the securitization date to classify the securities as either trading, available-for-sale or held-to-maturity. The ongoing accounting treatment for FASB 115 securities will be generally the same for transferors and third-party investors and is described below.

Occasionally, retained interests are purposefully structured so as not to meet the definition of a FASB 115 security. Typically, this is done by leaving the transferor's retained interests represented by contractual rights under the pooling and servicing agreement or other operative document and not having them embodied in any book entry security or other instrument (i.e., leaving them "uncertificated"). Nonetheless, interest only strips and other interests that can be prepaid or otherwise contractually settled in such a way that the holder (e.g., transferor) would not recover substantially all of its recorded investment must be accounted for like a FASB 115 debt security classified either as trading or available for sale. [14] Some transferors treat other uncertificated interests as still being a part of their loan portfolio.

FASB 65[12] covers the ongoing accounting for mortgage loans, and has been followed by analogy for other types of loans. Under FASB 65, loans may be classified as "held for sale" and carried at the lower of cost or fair value (LOCOM) in the aggregate. Premiums and discounts related to loans held for sale are not amortized and no separate allowance for credit losses is provided - it all just rolls up in the LOCOM valuation. Loans not classified as held for sale are classified as long-term investments and carried at amortized carrying value, subject to allowances for credit losses and evaluation for other than temporary impairment. Loans may not be classified as long-term investments unless the holder has both the ability and intent to hold them for the foreseeable future or until maturity. [¶6 of FASB 65] Loans held for investment are not subject to the same virtually absolute prohibition on sales that relates to securities held to maturity, as described below. While a regular pattern of sales would raise questions, occasional well-intentioned sales would probably not be fatal to the accounting. Originations of and principal collections on loans held for investment are reported as investing activities in the statement of cash flows, as are the proceeds of any sale.

How does a transferor or investor apply FASB 115?

Each security must be classified at its acquisition date as either trading, available-for-sale, or held-to-maturity. For the most part, this initial classification cannot be changed so long as the holder retains the security. Only transfers from the available-for-sale category to the held-to-maturity category are generally permitted. Interest income is accrued based on the amortized cost accounting principles of FASB 91 or EITF 99-20, as applicable.

Trading Securities are carried at fair value on the balance sheet. Changes in fair value are reflected in earnings as they occur. Securities that are held principally for the purpose of selling them in the near term (thus held for only a short period of time) must be classified as trading securities. [¶12a of FASB 115] However, the holder may also elect to classify any other FASB 115 security as a trading security, even if they intend to hold it for an extended or indefinite period. [FASB 115 Q&A, question 34] If transferors elect trading treatment for their retained securities, they will likely recognize additional gains as a result of their securitization transaction. The gain or loss calculations described in Chapter 3 show how the original historical cost basis of the transferred assets is allocated to retained interests resulting in no gain or loss being recognized on them. By electing trading classification for its retained securities, the difference between that allocated cost basis and fair value will be recognized in earnings when the transferor marks the securities to fair value for the first time. Of course, the transferor will also have the ongoing earnings volatility that comes with holding any trading security.

11 Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, published in May 1993, as amended.

12 Statement of Financial Accounting Standards No. 65, *Accounting for Certain Mortgage Banking Activities*, published in September 1982, as amended.

Available-for-Sale Securities are also carried at fair value on the balance sheet. However, changes in fair value are recognized on the balance sheet, net of tax effects, in a separate component of equity known as "other comprehensive income" (or OCI) rather than in current earnings. If an individual security's fair value declines below its amortized historical cost basis and that decline is considered to be "other than temporary," the security is impaired and the unrealized loss in other comprehensive income is recognized as a current loss in the income statement. This establishes a new historical cost basis for the security, which means that any subsequent increase in fair value will not offset losses previously recognized.

In their Staff Accounting Bulleting No. 59,[13] the SEC staff observes that the phrase "other than temporary" does not mean "permanent" and that management should act on the premise that a write-down may be required whenever carrying value exceeds the fair value of a security. Recognizing that there are numerous factors to consider and that all available evidence should be evaluated, the staff did offer examples of factors which, individually or in combination, indicate that a decline is other than temporary and that a write-down of the carrying value is required. Those factors are:

- The length of the time and the extent to which the market value has been less than cost;
- The financial condition and near-term prospects of the issuer, including any specific events which may influence the operations of the issuer such as changes in technology that may impair the earnings potential of the investment or the discontinuance of a segment of the business that may affect the future earnings potential; or
- The intent and ability of the holder to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in market value.

Unless evidence exists to support a realizable value equal to or greater than the carrying value of the investment, a write-down to fair value accounted for as a realized loss should be recognized in the determination of net income of the period in which it occurs and the written down value of the security becomes the holder's new cost basis of the investment.

Some high-quality securitization tranches may be underwater simply due to rising interest rates. This situation will require careful evaluation and judgment by the holder's management. If the holder intends to sell the security before its price recovers, then the holder would need to record an impairment loss in the period in which the decision to sell was made. However, in the absence of any reduction in expected future cash flows, the holder would need to start accreting interest yield on the position at a higher rate in order to recognize the extra market value discount arising from the recorded impairment over the life of the security. If the actual sale occurs quickly, that may not be much of an issue. If the sale is delayed, some people might be troubled by the idea of taking a charge in one period only to "recycle" the write-off as higher interest earnings over time.

Held-to-Maturity (HTM) Securities are carried at amortized historical cost basis, subject to write-downs for other than temporary impairments in a manner similar to that described above. The EITF 03-1 disclosure requirements also apply to HTM securities. In order to classify a security as HTM, the holder must have the positive intent and ability to hold the security until its maturity. [¶7 of FASB 115] FASB 115 strictly limits the ability of a holder to sell HTM securities without impugning management's ability to claim the intent to hold other securities until they mature. The permissible reasons to sell or reclassify HTM securities that are most frequently applicable to holders of ABS or MBS securities are:

- Evidence of a significant deterioration in the issuer's creditworthiness
- A significant increase in the holder's regulatory capital requirement causing it to downsize its portfolio
- A significant increase in the risk weights associated with the particular securities
- A sale near enough to contractual maturity so that interest rate risk is no longer a pricing factor (e.g., within three months of contractual maturity)
- Collecting a substantial portion (e.g., at least 85 percent) of the principal balance outstanding at the date the security was acquired, either due to prepayments or scheduled payments to that level.

13 Codified as Staff Accounting Bulletin Topic 5M, *Other Than Temporary Impairment of Certain Investments In Debt and Equity Securities.*

In contrast, sales or reclassifications due to changes in interest rates, prepayment rates, liquidity needs, alternative investment opportunities, funding or foreign currency fluctuations are not permissible reasons to sell a security classified as HTM. The SEC staff has expressed the view that selling even one HTM security for an impermissible reason would call into question management's ability to make a credible assertion about the intent to hold other securities to maturity. Therefore, the staff would expect all other HTM securities would be reclassified as available-for-sale and no new securities be classified as HTM for a period of up to two years.

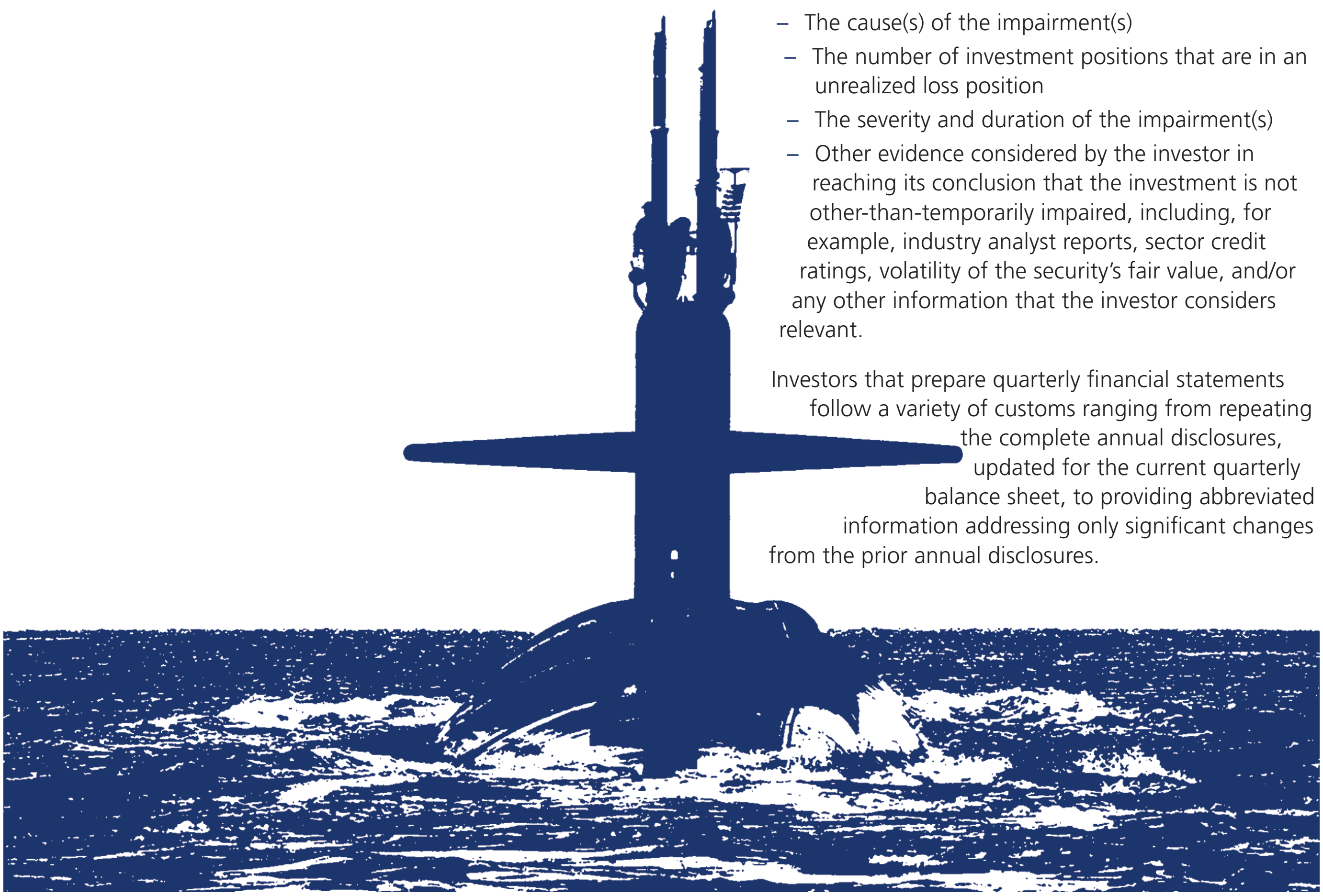
Securities that can be prepaid or otherwise contractually settled in such a way that the holder would not recover substantially all of its recorded investment may not be classified as HTM (i.e., they must be classified either as trading or AFS). Hedge accounting is not available for interest rate hedges of HTM securities. On the other hand, hedge accounting is permitted for interest rate hedges of the liabilities used to fund HTM securities. Also, HTM securities may be pledged as collateral in a financing transaction, including a securitization, which does not qualify for sale treatment.

What disclosures do I need to make when I haven't written down my underwater positions?

Paragraph 21 of EITF 03-1, *The Meaning of Other Than Temporary Impairment and Its Application to Certain Investments*, requires the following disclosures in an investor's annual financial statements:

- As of each balance sheet date, by category-of-investment, a table showing investments that have been continuously in an unrealized loss position for a year or more separately from those with unrealized losses for less than a year:
  - The aggregate amount by which cost or amortized cost exceeds fair value
  - The aggregate related fair value of investments with unrealized losses
- As of the most recent balance sheet date, a narrative discussion of the quantitative disclosures and the information that the investor considered (both positive and negative) to provide insight into the investor's rationale for concluding that the impairments are temporary. This discussion could include:
  - The nature of the investment(s)
  - The cause(s) of the impairment(s)
  - The number of investment positions that are in an unrealized loss position
  - The severity and duration of the impairment(s)
  - Other evidence considered by the investor in reaching its conclusion that the investment is not other-than-temporarily impaired, including, for example, industry analyst reports, sector credit ratings, volatility of the security's fair value, and/or any other information that the investor considers relevant.

Investors that prepare quarterly financial statements follow a variety of customs ranging from repeating the complete annual disclosures, updated for the current quarterly balance sheet, to providing abbreviated information addressing only significant changes from the prior annual disclosures.



How are discounts and premiums amortized?

For securities and non-certificated interests that are of high credit quality and do not have substantial prepayment risk, FASB 91[14] offers two different approaches to recognize fixed-rate interest income on the "level yield method." Only very rarely will the carrying value of an interest in a securitization be exactly par. Whether the difference is caused by basis allocation calculations, market purchase premiums or discounts, preissue date interest or the deferral of fees or costs, investors need to use a rational and systematic method to recognize that difference in earnings relatively smoothly over time. One method is to simply amortize any premium or discount over the maximum contractual life of the position held. If actual prepayments cause the principal balance to decay more quickly than expected, a portion of the unamortized amount would be recognized in earnings in order to catch up with actual prepayments.

FASB 91's second method is to begin amortizing any premium or discount based on an initial estimate of prepayments. That estimate is periodically revised as actual prepayments run faster or slower. In order to estimate prepayments, the underlying pool of assets needs to be large and composed of similar loans for which prepayments are probable and their amount and timing are subject to reasonable estimation.

Adjustable interest rates add an additional level of complexity. In addition to dealing with prepayments, the investor needs to deal with changes in the coupon interest rate over time. For interest rates indexed to LIBOR or some other market index or rate, the amortization schedule for the premium or discount can be established based either on the index or rate in effect at inception or it can be recalculated periodically as that index or rate changes over the life of the security. If there is an artificially high or low rate in effect during the early periods, that would be leveled out over the life so long as the accreted balance does not rise to exceed the amount that would be immediately recognizable if the borrower elected to prepay (considering any prepayment or similar penalties).

FASB 91's level yield method does not cover securities and non-certificated interests that are of lower credit quality or could be contractually repaid in a way that the holder would recover less than substantially all of its initial investment. Read on to the next question and answer for those types of positions.

14 Statement of Financial Accounting Standards No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, published in December 1986, as amended.

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 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. Previous 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.

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).

The impairment provisions of EITF 99-20 bring us much closer to a lower-of-amortized cost or fair value approach than previous 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 (whether of principal or interest) is remote. A minimum rating requirement (e.g., investment-grade) to be eligible for exclusion from 99-20 was not specified; however, the SEC staff has set that threshold at AA.
- All IOs, including agency IOs and any other premium securities (regardless of rating) 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
- Securities acquired at a discount, at par or at a premium
- 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 reports interest income separately in its income statement.
- Securities designated as notes, bonds, pass-through or participation certificates. Even trust certificates are typically covered because they often possess the characteristics of debt rather than equity securities.

The application of FASB 133 to retained or purchased beneficial interests in securitized financial assets has been effectively suspended by Derivatives Implementation Group (DIG) Issue D1. However, that suspension will be lifted concurrent with the effective dates of FASB's anticipated amendments to FASB 140 and FASB 133. This might result in some beneficial interests being accounted for as two separate instruments: one would be the host instrument, usually accounted for as a debt security under FASB 115, and the second would be accounted for as a derivative under FASB 133. The derivative would generate more income statement volatility when compared to today's accounting. See Chapter 12 (page 82), "*What to Expect in 2006 - FASB 140 (R)*".

Investments potentially subject to this accounting are those where the returns have the potential to fluctuate in a derivative-like manner for risks that are not clearly and closely related to risks typical of the host instrument. Indicators are returns that fluctuate based on factors unrelated to interest rates or the direct credit performance of the vehicle's assets or returns that are linked to interest rates but result in excessive leverage or put at risk the ability of the investor to recover substantially all of its initial investment.

How do I compute periodic interest income under EITF 99-20?

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.

The yield is determined 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 write-down for impairment.

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 that 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.

When does EITF 99-20 tell me that I have an impairment loss?

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 to determine if there has been an adverse change:

Step One: 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 floating rate securities are not taken into account in this test provided the security is plain-vanilla, e.g., not a super-floater or an inverse floater.

Step Two: 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].

- 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.

The EITF 99-20 impairment analysis must be done on a security-by-security basis, not on an overall portfolio basis. This can cause unfortunate income statement results if certain securities are deemed to be impaired, while other securities are appreciating in value. For this reason, certain financial institutions have decided to pool one or more groups of securities into a single new security so as to possibly mitigate this mismatch. To be able to give accounting recognition to this new security rather than the underlying instruments, the new vehicle must be a QSPE. See page 10 for requirements to be "demonstrably distinct."

Is there an example of how to apply EITF 99-20?

You purchase a B-piece at the beginning of the year 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.

			Scenarios for Years Two Through Five			
Line		**I - Base Case**	**II**	**III**	**IV**	**V**
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?	N/A	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

* 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 liquidations until retired.

Chapter 6

Through the Looking Glass, FASB 140's Required Disclosures

Appendix C to FASB 140 provides specific examples that illustrate the disclosures that are required and they are repeated (with some enhancements) in the tables on the following pages. 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 for your specific circumstances. [22]

If securitizations are accounted for as sales (but not if they are accounted for as debt) and the transferor has continuing involvement, the securitizer must disclose for each major type (e.g., residential mortgage loans, commercial mortgage loans, auto loans, credit card accounts):

- Its accounting policies for initially and subsequently measuring the retained interests including the methodology used to determine their fair value.
- 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.
- 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 at the time of the securitization (see Table 1) and 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. Retained interests include servicing assets.
- A stress test showing the hypothetical effect on the fair value of retained interests (including servicing assets) 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.
- Static pool actual and projected losses (not necessarily separately) as a percentage of the original balance securitized (generally for each year of origination). See Table 3.
- 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 over collateralization amounts. See Table 4.
- For both off-balance sheet assets (i.e., securitized assets) and on-balance sheet assets of the same type that the entity manages:
  - Delinquencies at the end of the period
  - Credit losses, net of recoveries, during the period
  - Principal amounts outstanding of securitized loans accounted for as sales; on-balance sheet loans held for sale or securitization; and on-balance sheet loans held in portfolio. See Table 5.
- For all servicing assets and servicing liabilities:
  - The amounts of servicing assets or liabilities recognized and amortized during the period
  - 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
  - The risk characteristics of the underlying financial assets used to stratify recognized servicing assets for purposes of measuring impairment
  - 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]

The FASB staff studied compliance with the FASB 140 disclosure requirements among Fortune 1000 companies for the year 2000 reporting season; the first year that the new requirements were in effect. They cited the following improvements that companies should consider:

- Aggregation of dissimilar loan types for purposes of the key assumption information makes the disclosures difficult to interpret.
- Disclosing the cash flows between the transferor and special-purpose entity by major asset type is required.
- Disclosing a sensitivity analysis for valuation of servicing rights that are retained interests is required.
- Disclosing information about managed assets in the MD&A section is insufficient to comply with FASB 140. Managed asset disclosures must be incorporated in the audited financial statements.
- Classification of gain (loss) on sale as interest income (expense) and investing activities, respectively, is inconsistent with the requirements of FASB Statements 95 and 102.

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 provide 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.
- FASB 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]
- FASB 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]
- FASB 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 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: is expected to reflect reasonably possible near-term changes in those assumptions (e.g., a 10 percent adverse change) and 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 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.
- 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] FASB did not require separate disclosure of the amounts in foreclosure, repossession, REO and bankruptcy (even though this information might foretell 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. FASB did not require disclosure of servicing advances receivable in the disclosure of the managed portfolio even though this information also might foretell 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 disclosure.
- FASB 140 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]

The illustrative disclosures in each of the following tables are independent of each other. In other words, they do not purport to present information from the same entity (or the same securitization).

Table 1: Key economic assumptions used in measuring the fair value of retained interests at the date of securitization resulting from securitizations completed during 2005 and 2004 (weighted based on principal amounts securitized) were as follows [for simplicity, disclosures for 2004 are not included below]:

	Auto Loans	Credit Card Loans	Residential Mortgage Loans Fixed-Rate	Residential Mortgage Loans 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 flow discount rates	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, 2005, 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	Residential Mortgage Loans 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 contract 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:**		
December 31, 2005	**2003**	**2004**	**2005**
Actual to date	1.45	.93	.21
Projected	.55	1.00	1.75
Total	**2.00**	**1.93**	**1.96**
December 31, 2004			
Actual to date	.85	.18	
Projected	1.10	1.71	
Total	**1.95**	**1.89**	
December 31, 2003			
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 2005 and 2004 ($ in millions) [for simplicity, disclosures for 2004 not included below]:

	Credit Cards	**Autos**
Proceeds from new securitizations	$1,413	$1,000
Collections used by the trust to purchase new balances in revolving credit card securitizations	3,150	-
Servicing fees received	23	11
Cash flows received on interest-only strips	71	2
Cash received upon release from reserve accounts	10	-
Purchases of delinquent or foreclosed assets	(45)	(2)
Servicing advances	(102)	(60)
Reimbursements of servicing advances	90	40
Prepayment interest shortfalls paid out as compensating interest	-	(5)

Table 5: Historical Loss and Delinquency Amounts for the Managed Portfolio for 2005 ($ 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, 2005		Year ended December 31, 2005	
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		

Chapter 7

Can Banks Get Regulatory Capital Relief Through Securitization?

In November 2001, the FDIC, the Fed, the OCC and the OTS published final rules on Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Securitizations and investments in ABS and MBS for both banks and thrifts in the United States. [66 Fed. Reg 59614]

Generally, a bank must maintain total capital (as defined) of at least 8 percent of its assets (10 percent for those considered well-capitalized banks), adjusted based on prescribed risk levels; and generally 50 percent of that capital is expected to be Tier 1 Capital (as defined).

Dollar-for-dollar capital requirement

A bank must generally maintain risk-based capital equal to the "face amount" (defined below) of the residual interest that is retained on the balance sheet (net of any existing associated deferred tax liabilities) without regard to whether such amount is less than or greater than the full risk-based capital requirement for the assets securitized. Thus, the capital requirement for residual interests is not limited by the 8 percent capital in place under the current risk-based capital regime, but still can be less than the 8 percent of assets whenever the retained residual is less than 8 percent of assets.

Some definitions are in order:

- A **Residual Interest** means any on-balance sheet asset that represents a retained beneficial interest in a securitization accounted for as a sale and that exposes the bank to ANY credit risk directly or indirectly associated with the transferred asset that exceeds a pro rata share of that bank's claim on the asset. Residual interests include "credit-enhancing interest-only strips" (see below), spread accounts, cash collateral accounts, retained subordinated interests and other forms of over-collateralization. Residual interests generally do not include interests purchased from a third party other than purchased credit-enhancing interest-only strips (defined below). A second-dollar or third-dollar loss position would be considered to expose the bank to more than a pro rata share of losses. If any other interests are senior to the retained interest, the regulators would say the retained interest would be a residual interest; however, if rated, it might be eligible for more favorable capital treatment.
- **Face Amount** means the amortized cost of an asset, if not held in a trading account (e.g., accounted for as held-to-maturity [if permitted] or available-for-sale) or the fair value of the asset if held in a trading account. Therefore, although the balance sheet carrying value of an asset carried as available-for-sale might have been increased or decreased for unrealized appreciation or depreciation, it is the amortized cost amount that should be used in the calculation of risk-based capital.

Deferred tax liabilities

In order to reduce the capital requirement for deferred tax liabilities, the liability must be on the balance sheet and specifically identifiable with the residual interest. For example, if a securitization was accounted for as a sale for GAAP but treated as debt-for-tax, and gain on sale was recognized in an amount approximating the present value of a retained I/O strip, then it is likely that deferred taxes would have been provided on that timing difference, which will reverse over the life of the securitization. On the other hand, if the residual interest was represented by a deposit into a cash collateral account, it is unlikely that there would be any associated deferred taxes.

Permitted reductions for rated retained interests

Certain rated retained interests (with the exception of "credit-enhancing interest-only strips") are not subjected to the full dollar-for-dollar capital treatment. The following table presents the manner in which the ratings-based approach would typically be applied, for example, to a "second-dollar" loss position. These same risk weightings and capital requirements apply to a bank or thrift that invests in ABS, CDOs, CMBS and MBS issued by others.

Example Rating	Risk-Weight	Capital Required for Each $1 of Investment
Investment Grade: AAA or AA*	20%	1.6 cents
A*	50%	4 cents
BBB	100%	8 cents
One Category Below: BB	200%	16 cents
B and below, and all Unrated	Not eligible for reduction	100 cents

* IOs and POs, regardless of rating are not eligible for less than 100% weighting.

Keep in mind that a 200 percent risk-weight is a lower capital charge than dollar-for-dollar. The capital requirement for a position is computed by multiplying the face amount of the position by the appropriate risk weight determined from the table. Thus, under the rule, securities rated BB require capital equal to 16 percent which is 200 percent x 8 percent of the face amount whereas, securities B and below or unrated require capital equal to 100 percent of the face amount (dollar-for-dollar capital). Only one rating is required if there is a reasonable expectation that in the near future, either the position may be traded or the position may be used in a secured loan or repo transaction in which a third party relies on the rating. Otherwise, to qualify for the ratings-based approach, the position must be rated by more than one rating agency, the ratings must be the equivalent of BB or better by all rating agencies providing a rating, the ratings must be publicly available, and the ratings must be based on the same criteria used to rate securities that are traded. If the ratings are different, the lowest rating will determine the risk-weight.

If a bank does not retain any residual interests but provides other forms of recourse on the transaction, then a "credit-equivalent amount" for the recourse obligation is computed. This is the full amount of the credit-enhanced assets for which the bank retains or assumes credit risk, subject to a low-level exposure rule. Thus, a bank that extends a partial guarantee of, for example, the first 5 percent of loss on a securitization, must maintain capital equal to 5 percent of the transferred assets. If the guarantee covered the first 10 percent of loss, then the risk-based capital could be limited to 8 percent of the transferred assets. Examples of recourse include credit-enhancing reps and warranties, loan servicing arrangements where the bank is responsible for losses, assets sold under an agreement to repurchase and credit derivative contracts under which the bank retains more than its pro rata share of credit risk on transferred assets.

If a bank securitizes assets in a sale and provides credit enhancement in the form of both the retention of residual interests and retention of other recourse obligations (e.g., writing a limited guarantee regarding the performance of the assets or entering into a credit derivative), then the capital is computed as the greater of the risk-based capital requirement for the residual interests or the full risk-based capital requirement for the transferred assets.

If a bank sells a residual interest to a third party and writes a credit derivative to cover the credit risk associated with that asset, the selling bank must continue to risk weight, and hold capital against, that asset as a residual as if the asset had not been sold. The same holds true if a bank transfers the risk on a residual interest through guarantees or other credit risk mitigation techniques and then reassumes this risk in any form.

Will transforming loans into securities reduce the required capital?

Some banks might consider securitizing pools of whole loans and retaining all or substantially all of the resulting securities. Depending on the risk-weighting of the pool (first-lien one-to-four-family residential mortgage loans originated using prudent underwriting standards are risk-weighted at 50 percent, not 100 percent) and depending on how many A or better rated securities can be created, a bank might be able to reduce the overall capital requirements on the pool and increase liquidity. For the transaction to be respected for accounting purposes and the asset reclassified (which is essential to the capital treatment), either at least 10 percent of the value of the transferred assets must be sold to third parties in the form of beneficial interests or the transaction must be a "guaranteed mortgage securitization" as defined in FASB 140. See page 10.

Concentration limit for certain residual interests

The rule imposes a concentration limit on "credit-enhancing interest-only strips (CEIOs)," whether retained or purchased, to 25 percent of Tier 1 capital (Core Capital for Thrifts) as adjusted for any other disallowed items. For regulatory capital purposes only, any amount of CEIOs that exceeds the 25 percent limit will be deducted from Tier 1 capital. CEIOs that are not deducted from Tier 1 capital, along with all other residual interests, are subject to the dollar-for-dollar requirements, as described above.

Some more definitions are in order:

- **Credit-Enhancing Interest-Only Strip** means an on-balance sheet asset that represents the contractual right to receive some or all of the interest due on transferred assets and exposes the bank to credit risk that exceeds its pro rata claim on the underlying assets. Thus, CEIOs include any balance sheet asset that represents the contractual right to receive some or all of the remaining interest cash flow generated from assets that have been transferred to an SPE, after taking into account trustee and other administrative expenses, interest payments to investors, servicing fees and reimbursements to investors for losses attributable to the beneficial interests they hold. An instrument with these characteristics will still be considered a CEIO even if it is entitled to some principal.
- **Tier 1 (Core) Capital** must equal or exceed 4 percent of risk-weighted assets (total capital must equal or exceed 8 percent) and is comprised of common stockholders' equity, noncumulative perpetual preferred stock, plus minority interest in subsidiaries LESS most intangible assets as well as deductions for the following types of assets when they exceed the relevant capital limitations (e.g., 25 percent of Tier 1 for CEIOs): certain mortgage servicing assets, nonmortgage servicing assets, purchased credit card relationships, CEIOs and deferred tax assets.

EXAMPLE: A bank has $100 in purchased and retained CEIOs on its balance sheet and Tier 1 capital of $320 (before any disallowed servicing assets, purchased credit card relationships and deferred tax assets). The bank would multiply the Tier 1 capital of $320 by 25 percent, which is $80. The amount of CEIOs that exceed the concentration limit, in this case $20, is deducted from Tier 1 capital. The remaining $80 is then subject to the dollar-for-dollar capital charge. The $20 deducted from Tier 1 capital, plus the $80 in total risk-based capital required, equals $100, the balance sheet amount of the CEIOs. Banks may apply a net-of-tax approach on any CEIOs that have been disallowed from Tier 1, as well as to the remaining residual interests subject to the risk-based-capital rule.

Securitizations accounted for as financings

When a securitization is accounted for as a financing, no gain is recognized or capital created from an accounting standpoint, which serves to mitigate some of the regulators' concerns. The agencies, however, have said that they will monitor securitization transactions that are accounted for as financings and will factor into the bank's capital adequacy determination the risk exposures being assumed or retained in connection with the transaction.

Additional regulatory authority

The agencies have said they intend to apply the rule to the substance, rather than the form, of a securitization transaction. The agencies retain the authority to exercise discretion to ensure that banks, as they develop novel financial assets, will be treated appropriately under the regulatory capital standards. Accordingly, they have the right to assign risk positions in securitizations to appropriate risk categories on a case-by-case basis if the credit rating of the risk position is determined to be inappropriate.

Interaction with market risk rule

Some large, sophisticated banks (but not thrifts) are allowed to apply the "market risk rules." For banks that comply with the market risk rules, positions in the trading book arising from securitizations should be treated for risk-based capital purposes in accordance with those rules. However, they are still subject to the 25 percent concentration limit for CEIOs.

Quarterly valuations

The rule requires that the fair value of servicing assets, purchased credit card relationships and CEIOs be updated at least quarterly and include adjustments for any significant changes in assumptions. The FDIC may require independent fair value estimates where they deem it appropriate.

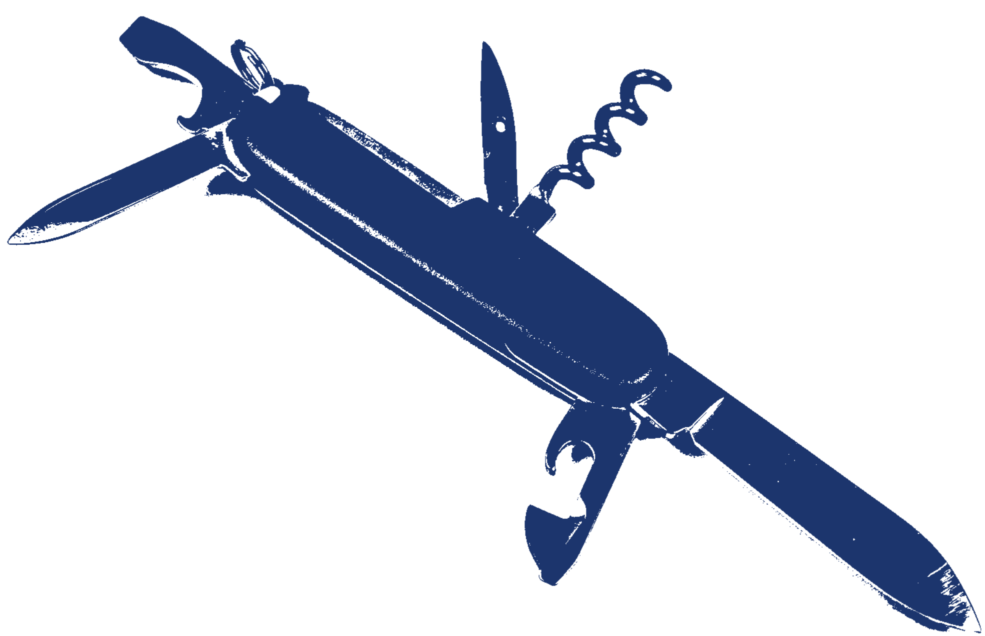
Basel II

As we indicated in the Introduction, we expect this booklet to have a shelf life of less than one year. Accordingly, we have deferred any coverage of the Basel regulatory capital regime to give the rulemaking some additional time to stabilize.

In April 2005, the four federal banking agencies comprising the FFIEC (OCC, Fed, FDIC and OTC) agreed to delay the publication of a notice of proposed rulemaking regarding the U.S. implementation of the Basel II Framework, previously intended to be mid-year 2005, until all relevant issues have been considered.

That announcement followed the results of a recently completed quantitative impact study (QIS4), which "evidence material reductions in the aggregate minimum required capital for the QIS4 participant population and significant dispersion of results across institutions and portfolio types."

While the agencies "remain committed to moving forward with the implementation of Basel II," the press release indicated that the additional work to "determine whether these results reflect differences in risk, reveal limitations of QIS4, identify variations in the stages of bank implementation efforts (particularly related to data availability), and/or suggest the need for adjustments to the Basel II Framework" may cause them to revisit the existing timeline for U.S. implementation of Basel II.



Chapter 8

Do the Statutory Accounting Principles for Insurance Companies Embrace FASB 140?

The National Association of Insurance Commissioners (NAIC) has adopted securitization accounting guidance for statutory reporting purposes in Statement of Statutory Accounting Principles No. 91, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (SSAP No. 91).

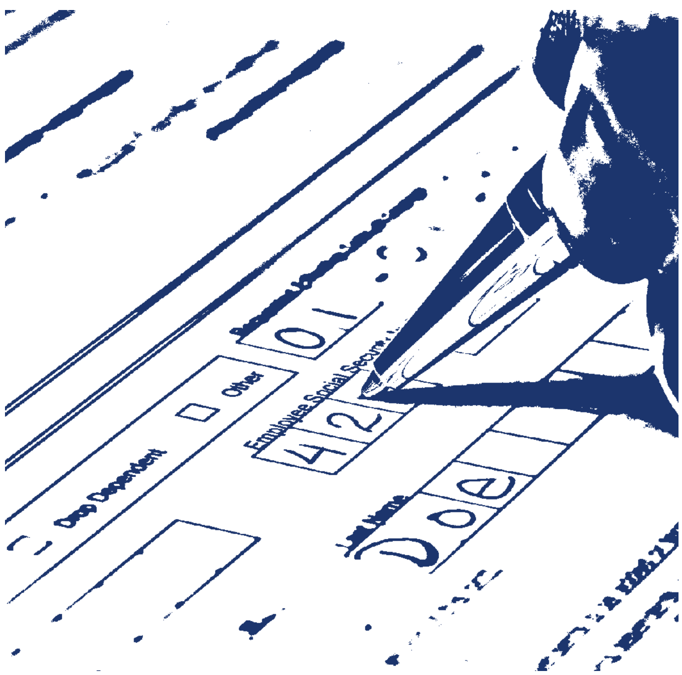
SSAP 91 does not address the securitization of mortality or morbidity risk, but the NAIC is considering developing guidance in that area.

SSAP 91 adopts FASB 140 accounting for securitizations with the following modifications:

- Servicing rights are nonadmitted.
- Sales treatment is not permitted for transactions including recourse provisions or removal-of-accounts provisions.
- Special-purpose entities are not consolidated regardless of whether they are QSPEs or variable interest entities since statutory financial statements are prepared on a legal entity basis.
- Leases are accounted for in accordance with SSAP 22-Leases.
- Reporting entities required to maintain an interest maintenance reserve (IMR) shall account for realized and unrealized capital gains and losses in accordance with *SSAP 7-Asset Valuation Reserve and Interest Maintenance Reserve*. For reporting entities not required to maintain an IMR, realized capital gains and losses shall be reported as net realized capital gains or losses in the statement of income, and unrealized capital gains and losses shall be reported as net unrealized gains and losses in unassigned funds (surplus).
- The concept of revolving-period securitizations is not applicable for statutory accounting purposes.

Subsequent to the transfer of assets, retained beneficial interests shall be accounted for in accordance with the statutory accounting principles for the specific asset type (e.g., bonds in accordance with SSAP 26, loan-backed securities in accordance with SSAP 43, preferred stock in accordance with SSAP 32.)

Reporting entities that have QSPEs as affiliates shall carry their investment in the QSPE at its underlying statutory book value in accordance with SSAP 46. Transactions entered into involving affiliated QSPEs are subject to the provisions of SSAP 25.



Chapter 9

International Securitization Accounting

IAS 39

How has IAS 39 changed the international accounting landscape in the EU and elsewhere?

In the first section of this book, we said that FASB 140 and FIN 46R do not apply to companies that do not follow U.S. GAAP or the parallel Canadian GAAP. The other major securitization accounting framework is IAS 39[15] developed by the International Accounting Standards Board (IASB). At the beginning of 2005, a total of 94 countries either required or permitted the use of IASB's standards for publicly traded companies. This includes the mandatory application of IASB standards by the 25 European Union member countries. Some other jurisdictions, including Australia, Hong Kong, New Zealand, the Philippines and Singapore, have adopted standards that largely mirror the IASB standards.

When and how will IAS 39 become effective?

Most companies in countries moving toward IASB standards will be first-time adopters of IAS 39, applying it for annual periods beginning on or after January 1, 2005. They will apply IAS 39's derecognition criteria to all transactions entered into on or after January 1, 2004 (or an earlier date, if they so choose)[16]. The practical effect of this transition will be to show financial statements for at least two years on a comparable basis. Transfers before the cutoff date that properly resulted in full or partial derecognition under the company's prior GAAP would not come back on balance sheet unless a new transaction qualified them for recognition again. However, transfers after the cut off date into a preexisting securitization would be evaluated under the new rules.

Does IAS 39 use the same concept of "transfer" as FASB 140?

No. Under FASB 140, any conveyance of a noncash financial asset by or to someone other than the issuer is a transfer. So FASB 140 transfers include pledging a bond as collateral for a borrowing. Under IAS 39, in order to meet the definition of a transfer, the "transferor" must either:

- Transfer the contractual rights to receive the cash flows of the financial asset; or
- Retain the contractual rights to receive the cash flows of the financial asset the "original asset" - for example, it retains servicing of the assets - but assumes a contractual obligation to pass-through those cash flows to one or more entities (the "eventual recipients") and all of the following conditions are met: [18][17]
  a. The transferor has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset. Short-term advances by the entity with the right of full recovery of the amount lent plus accrued interest at market rates do not violate this condition.
  b. The transferor is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows.
  c. The transferor is obliged to remit any cash flows it collects on behalf of the eventual recipients without material delay. In addition, the transferor is not entitled to reinvest such cash flows, except for investments in cash or cash equivalents during the short settlement period from the collection date to the date of required remittance to the eventual recipients, and interest earned on such investments is passed to the eventual recipients.[19]

15 International Accounting Standard 39, *Financial Instruments: Recognition and Measurement*, covers many other topics beyond securitization. This chapter deals only with those derecognition aspects of IAS 39 relevant to securitization. The last major revision of IAS 39 was finalized in December 2003 and a provision for macro hedge accounting was added in 2004. In November 2004, the European Commission adopted IAS 39, excluding the option to fair value non-trading financial liabilities and a few of its provisions relating to hedge accounting, which have been criticized in some European Union member countries. The IASB continues to deliberate future possible revisions to address these criticisms and other matters not directly related to securitization.

16 See the IASB's International Financial Reporting Standard 1, *First-time Adoption of International Financial Reporting Standards*, paragraphs 27 and 27A.

17 In this chapter, the numbers in brackets refer to paragraph numbers in IAS 39.

If the arrangement fails to meet any of the conditions above, the transaction is not a "transfer," meaning that the company must continue to recognize the asset in its entirety and record any proceeds received as a liability. The objective of prescribing these conditions to qualify as a transfer to be considered for derecognition is to distinguish pass-through arrangements in which the entity acts more as an agent of the eventual recipients of the cash flows than as an owner of the asset having both an asset and a liability. [BC56] Condition (a) indicates that a transferor has no liability (because there is no present obligation to pay cash), and conditions (b) and (c) indicate that the transferor has no asset (because the transferor does not control the future economic benefits associated with the transferred asset). [BC 60]

Practically no revolving structure will meet criteria (c) above. Although some argue that revolving structures result in the investor's purchasing new assets with collection proceeds, those new assets would not be investments in cash or cash equivalents. Allowing the transferor (perhaps as servicer) to keep the float from temporary reinvestments will also disqualify a transaction as an IAS 39 transfer and therefore preclude any derecognition. Transferring the servicing and any other rights to receive cash flows directly from the assets to a third party might be one way that an originator could meet the criteria for a transfer using a revolving structure. An originator could also continue to service assets in a static pool securitization accounted for as a transfer under IAS 39, although the servicing agreement would need to meet criteria (a), (b) and (c), which is often not the case today.

We sincerely apologize for these roundabout descriptions of accounting for securitizations under IAS 39, but we are convinced that it is not susceptible to any form of straight-forward translation.

What is the basic IAS 39 framework for derecognition following a transfer?

Whether a transfer qualifies for derecognition does not directly depend on whether the transfer is directly to investors in a single step or goes through an SPE that transfers assets or issues beneficial interests to investors. Also, legal isolation is not a requirement. There is no concept analogous to FASB 140's QSPE. Securitizers first consolidate all subsidiaries according to other IASB guidance[18] and then evaluate the transaction in its totality. Whether the transfer qualifies for full, partial or no derecognition will depend on the proportion of risk and rewards transferred to the investors compared to the amount retained by the transferor.

- If substantially all the risks and rewards of ownership of the financial asset are transferred, the transferor derecognizes the financial asset and recognizes separately as assets or liabilities any rights and obligations created or retained in the transfer.
- If substantially all the risks and rewards of ownership of the financial asset are retained (i.e. the transferor continues to absorb most of the likely variability in net cash flows), the transferor continues to recognize the financial asset and an associated liability for the proceeds. [20]
- If neither the transferees taken together nor the transferor have substantially all the risks and rewards of ownership (e.g., a significant amount, but not substantially all, of the risks and rewards have been passed), the transferor either
  - Derecognizes the transferred assets and recognizes separately as assets or liabilities any rights and obligations created or retained in the transfer, if the transferor has not retained control of the financial assets or
  - Continues to recognize the financial assets only to the extent of its continuing involvement in them, if the transferor has retained control of them.[20]

The transferor has retained control of a transferred asset unless the transferee has the practical ability to unilaterally sell it in its entirety to an unrelated third party without imposing additional restrictions on that sale. [23] Most securitization transactions will result in the transferor passing less than substantially all of the risks and rewards and retaining control of the transferred assets, so understanding the continuing involvement concept will be key. See page 69, "*What if I have 'continuing involvement' in the transferred assets?*"

18 See IAS 27, *Consolidated and Separate Financial Statements* and the related interpretation SIC 12, *Consolidation of Special Purpose Entities* . SIC 12 requires companies to consolidate SPEs that they, in substance, control. Examples of when control is deemed to exist in substance include securitization SPEs where the company has a right to a majority of the benefits or is exposed to significant risks of the SPE, even if this is via an "auto-pilot" mechanism. Thus SIC-12 requires most outstanding securitization originators to consolidate the issuing securitization vehicle due to retention of excess spread and first loss pieces.

IAS Accounting for Transfers

<table>
<tr><th colspan="2">Situation</th><th>Accounting</th></tr>
<tr><td colspan="2">Substantially All Risks Transferred</td><td rowspan="2">Derecognize Old Assets
Recognize Any New Assets/Liabilities</td></tr>
<tr><td rowspan="2">Transferred and Retained Risks Are Both Less than Substantially All</td><td>Control Passed - Transferee can unilaterally sell entire asset</td></tr>
<tr><td>Control Retained- Transferee Cannot Unilaterally Sell Entire asset</td><td>Recognize Assets/Liabilities Up to Continuing Involvement Level Plus Any Retained Interest</td></tr>
<tr><td colspan="2">Substantially All Risks Retained</td><td>Recognize All Assets
Proceeds Are Liability</td></tr>
</table>

Do I look at the entire asset or just the transferred portion?

That depends. A part of a financial asset is considered separately for derecognition only if it comprises:

- Only specifically identified cash flows from a financial asset (or a group of similar financial assets)
- Only a fully proportionate (pro rata) share of the cash flows from a financial asset (or a group of similar financial assets); or
- Only a fully proportionate (pro rata) share of specifically identified cash flows from a financial asset (or a group of similar financial assets). [16(a)]

For example, if an entity transferred to a securitization trust all the principal and all but 1 percent of the interest flows from a pool of financial assets, and the interest strip was neither more senior nor subordinated in any way, the transferred interest flows and all of the principal would be the financial asset for which the transfer of risks and rewards would be evaluated. On the other hand, if the 1 percent interest strip was subordinated for purposes of providing credit enhancement to the investors' principal, then the entire asset (e.g., pool of loans) would be the financial asset for which the transfer of risks and rewards would be evaluated. These conclusions are not affected by whether the securitization vehicle issued to outside investors various classes of beneficial interests to provide credit or time tranching.

How do I tell if I have passed or retained substantially all of the risks and rewards?

Compare the transferor's exposure, before and after the transfer, to the variability in the amounts and timing of the net cash flows of the transferred asset. A transferor has retained substantially all the risks and rewards of ownership of a financial asset if its exposure to the variability in the present value of the future net cash flows from the financial asset does not change significantly as a result of the transfer. A transferor has passed substantially all the risks and rewards of ownership of a financial asset if its exposure to such variability is no longer significant in relation to the total variability in the present value of the future net cash flows associated with the financial asset. [21]

Examples of transferring substantially all the risks and rewards of ownership include:

- Unconditionally selling a financial asset
- Selling a financial asset together with an option to repurchase the financial asset at its fair value at the time of repurchase
- Selling a financial asset together with a put or call option that is deeply out of the money (i.e. an option that is so far out of the money it is highly unlikely to go into the money before expiring) [AG39]

Examples of retaining substantially all the risks and rewards of ownership include:

- Selling and agreeing to repurchase the same financial asset where the repurchase price is a fixed price or the sale price plus a lender's return
- Lending securities
- Selling a financial asset together with a total return swap that transfers the market risk exposure back to the seller
- Selling a financial asset together with a deep in-the-money put or call option (i.e., an option that is so far in the money that it is highly unlikely to go out of the money before expiring)
- Selling short-term receivables with a guarantee to compensate the transferee for credit losses that are likely to occur [AG 40]

How do I account for a transfer resulting in the complete derecognition of a financial asset (or part of a larger one)?

If a transfer results in a financial asset being derecognized in its entirety, but the transferor obtains a new financial asset or assumes a new financial liability or a servicing liability, the transferor recognizes those new assets, liabilities or servicing at fair value and any resulting gain or loss is reflected in current earnings. [25] If the asset derecognized was previously part of a larger financial asset, the previous carrying amount of the larger asset is allocated between the part sold and the part retained. [27]

How do I record a servicing asset or liability?

If the transfer qualifies for derecognition of the financial asset in its entirety and the transferor retains the right to service the financial asset for a fee, the transferor recognizes either a servicing asset or a servicing liability for that servicing contract. If the fee to be received is not expected to compensate the entity adequately for the servicing, a servicing liability is recognized at its fair value. If the fee to be received is expected to be more than adequate compensation for the servicing, a servicing asset is recognized for the servicing right at an amount determined on the basis of an allocation of the carrying amount of any larger financial asset that the derecognized asset was previously a part of. [24]

What is the difference between an IO strip and a servicing asset?

A transferor may retain the right to a part of the interest payments on transferred assets as compensation for servicing those assets. The part of the interest payments that the entity would give up upon termination or transfer of the servicing contract is allocated to the servicing asset or servicing liability. The part of the interest payments that the entity would not give up is an interest-only strip receivable. For example, if the entity would not give up any interest upon termination or transfer of the servicing contract, the entire interest spread is an interest-only strip receivable. The fair values of the servicing asset and interest-only strip receivable are used to allocate the carrying amount of the receivable between the part of the larger asset that is derecognized and the part that continues to be recognized. If there is no servicing fee specified or the fee to be received is not expected to compensate the entity adequately for performing the servicing, a liability for the servicing obligation is recognized at fair value. [AG45]

How is a gain or loss on sale calculated?

On derecognition of a financial asset in its entirety, the difference between:

a. The carrying amount and
b. The sum of (i) the consideration received (including any new asset obtained less any new liability assumed) and (ii) any cumulative gain or loss that had been recognized directly in equity is recognized in earnings currently. [26]

If the transferred asset is part of a larger financial asset (e.g., when an entity transfers interest cash flows that are part of a debt instrument and the part transferred qualifies for derecognition in its entirety), the previous carrying amount of the larger financial asset shall be allocated between the part that continues to be recognized and the part that is derecognized, based on the relative fair values of those parts on the date of the transfer. For this purpose, a retained servicing asset shall be treated as a part that continues to be recognized. The difference between:

a. The carrying amount allocated to the part derecognized and
b. The sum of (i) the consideration received for the part derecognized (including any new asset obtained less any new liability assumed) and (ii) any cumulative gain or loss allocated to it that had been recognized directly in equity is recognized as a gain or loss in earnings of the period. A cumulative gain or loss that had been recognized in equity is allocated between the part that continues to be recognized and the part that is derecognized, based on the relative fair values of those parts. [27]

Are there any special considerations about estimating fair value?

When a transferor allocates the previous carrying amount of a larger financial asset between the part that continues to be recognized and the part that is derecognized, the fair value of the part that continues to be recognized needs to be determined. When the entity has a history of selling parts similar to the part that continues to be recognized or other market transactions exist for such parts, recent prices of actual transactions provide the best estimate of its fair value. IAS 39 does not permit the recognition of a positive "arbitrage" that might result from a securitization execution vs. a whole loan sale, whenever there are illiquid securities or other non-traded instruments retained by the transferor. When there are no price quotes or recent market transactions to support the fair value of the part that continues to be recognized, IAS 39 says that the best estimate of the fair value is the difference between the fair value of the larger financial asset as a whole and the consideration received from the transferee for the part that is derecognized. [28]

So what if the transfer does not qualify for derecognition?

If a transfer does not result in derecognition because the transferor has retained substantially all the risks and rewards of ownership of the transferred asset, the transferor continues to recognize the transferred asset in its entirety and records a liability for the consideration received. In subsequent periods, the transferor continues to recognize any income on the transferred asset and any expense incurred on the financial liability. [29]

If a transferred asset continues to be recognized, the asset and the associated liability are not offset. Similarly, there is no offsetting of any income arising from the transferred asset against any expense incurred on the associated liability. [36]

If the transferred asset is measured at amortized cost, the option in IAS 39 to designate a financial liability at fair value through profit or loss is not applicable to the associated liability. [35]

To the extent that a transfer of a financial asset does not qualify for derecognition, the transferor's contractual rights or obligations related to the transfer are not accounted for separately as derivatives if recognizing both the derivative and either the transferred asset or the liability arising from the transfer would result in recognizing the same rights or obligations twice. For example, a call option retained by the transferor may prevent a transfer of financial assets from being accounted for as a sale. In that case, the call option is not separately recognized as a derivative asset. [AG49]

To the extent that a transfer of a financial asset does not qualify for derecognition, the transferee does not recognize the transferred asset as its asset. The transferee derecognizes the cash or other consideration paid and recognizes a receivable from the transferor. If the transferor has both a right and an obligation to reacquire control of the entire transferred asset for a fixed amount (such as under a repurchase agreement), the transferee may account for its receivable as a loan or receivable. [AG50]

What if I have "continuing involvement" in the transferred assets?

One aspect of IAS 39 that we find quite confusing (and is quite controversial) is the accounting for retained subordinated interests. If the transferor has transferred a substantial portion of the risks and rewards, but not substantially all of them, the transferor needs to account for its continuing involvement. The retained subordinated interests stay on balance sheet, as would be expected. However, the subordination effectively provides a credit guarantee for a portion of the interest sold to investors; this is considered a form of continuing involvement. This means that a portion of the investors' interest that is credit enhanced does not qualify for derecognition. Instead, an additional amount equal to the subordinated retained interest stays on balance sheet as loans and an associated amount received as sales proceeds plus the fair value of the credit enhancement is recorded as a borrowing. The continued recognition of both the subordinated retained interest and the continuing involvement in the portion sold has been described by many as "double-counting." The IASB debated this issue and determined that it would have had to create an exception to its continuing involvement model for subordinated retained interests if it wanted to avoid this result. It decided not to create an exception. Paragraph AG 52 in IAS 39 shows a numerical example of this phenomenon.

If a transferor transfers some but not substantially all the risks and rewards of ownership of a transferred asset, and retains control of the transferred asset, the transferor continues to recognize the transferred asset to the extent of its continuing involvement. The extent of the transferor's continuing involvement in the transferred asset is the extent to which it is exposed to changes in the value of the transferred asset. For example:

- When the transferor's continuing involvement takes the form of guaranteeing the transferred asset, the extent of the transferor's continuing involvement is the lower of the amount of the asset and the maximum amount of the consideration received that the transferor could be required to repay ("the guarantee amount").
- When the transferor's continuing involvement takes the form of a written or purchased option (or both) on the transferred asset, the extent of the transferor's continuing involvement is the amount of the transferred asset that the transferor may repurchase. However, in case of a written put option on an asset that is measured at fair value, the extent of the transferor's continuing involvement is limited to the lower of the fair value of the transferred asset and the option exercise price. These provisions apply to both cash-settled and physically settled arrangements. [30]

When a transferor continues to recognize an asset to the extent of its continuing involvement, the transferor also recognizes an associated liability. Irrespective of the other measurement requirements in IAS 39, the transferred asset and the associated liability are measured on a basis that reflects the rights and obligations that the transferor has retained. The associated liability is measured in such a way that the net carrying amount of the transferred asset and the associated liability is:

- The amortized cost of the rights and obligations retained by the transferor, if the transferred asset is measured at amortized cost.
- Equal to the fair value of the rights and obligations retained by the transferor when measured on a stand-alone basis, if the transferred asset is measured at fair value. [31] This approach is intended to result in the asset and the associated liability being measured in a way that ensures that any changes in value of the transferred asset that are not attributed to the transferor are not recognized by the transferor. [BC 68]

If a guarantee provided by a transferor to pay for default losses on a transferred asset prevents the transferred asset from being derecognized to the extent of the continuing involvement, the retained asset at the date of the transfer is measured at the lower of the carrying amount of the asset and the maximum amount of the consideration received in the transfer that the transferor could be required to repay ("the guarantee amount"). The associated liability is initially measured at the guarantee amount plus the fair value of the guarantee (which is normally the consideration received for the guarantee). Subsequently, the initial fair value of the guarantee is recognized in profit or loss on a time proportion basis and the carrying value of the asset is reduced by any impairment losses. [AG48(a)]

The transferor continues to recognize any income arising on the transferred asset to the extent of its continuing involvement and shall recognize any expense incurred on the associated liability. [32]

If a transferor's continuing involvement relates to only a part of a financial asset (e.g.,when an transferor retains an option to repurchase part of a transferred asset, or retains a residual interest that does not result in the retention of substantially all the risks and rewards of ownership and the transferor retains control), the transferor allocates the previous carrying amount of the financial asset between the part it continues to recognize under continuing involvement, and the part it no longer recognizes on the basis of the relative fair values of those parts on the date of the transfer. For this purpose, the requirements of paragraph 28 apply. The difference between:

a. The carrying amount allocated to the part that is no longer recognized, and
b. The sum of the consideration received for the part no longer recognized and any cumulative gain or loss allocated to it that had been recognized directly in equity

is recognized in profit or loss currently.

A cumulative gain or loss that had been recognized in equity is allocated between the part that continues to be recognized and the part that is no longer recognized on the basis of the relative fair values of those parts. [34]

What are some common forms of "continuing involvement?"

Call options. The servicer of transferred assets, which may be the transferor, may hold either of two types of options to reclaim previously transferred assets. A "removal of accounts provision" (ROAP) is an option to repurchase assets, usually subject to certain limitations on how the particular assets are selected for call, how frequently and in what total amount the call can be exercised. A clean-up call represents the option to purchase remaining transferred assets when the amount of outstanding assets falls to a specified level at which the cost of servicing those assets becomes burdensome in relation to the benefits of servicing. Provided that such a ROAP or clean-up call results in the transferor neither retaining nor transferring substantially all the risks and rewards of ownership and the transferee cannot sell the assets, it precludes derecognition only to the extent of the amount of the assets that is subject to the call option. [AG51 (l) and (m)]

Amortizing interest rate swaps. A transferor may transfer to a transferee a fixed rate financial asset that is paid off over time, and enter into an amortizing interest rate swap with the transferee to receive a fixed interest rate and pay a variable interest rate based on a notional amount. If the notional amount of the swap amortizes so that it equals the principal amount of the transferred financial asset outstanding at any point in time, the swap would generally result in the transferor retaining substantial prepayment risk, in which case the transferor either continues to recognize the entire transferred asset or continues to recognize the transferred asset to the extent of its continuing involvement. Conversely, if the amortization of the notional amount of the swap is not linked to the principal amount outstanding of the transferred asset, such a swap would not result in the transferor retaining prepayment risk on the asset. Hence, it would not preclude derecognition of the transferred asset provided the payments on the swap are not conditional on interest payments being made on the transferred asset and the swap does not result in the transferor retaining any other significant risks and rewards of ownership on the transferred asset. [AG51(q)]

Subordinated retained interests and credit guarantees. The transferor may provide the transferee with credit enhancement by subordinating some or all of its interest retained in the transferred asset. Alternatively, the transferor may provide the transferee with credit enhancement in the form of a credit guarantee that could be unlimited or limited to a specified amount. If the transferor retains substantially all the risks and rewards of ownership of the transferred asset, the asset continues to be recognized in its entirety. If the transferor retains some, but not substantially all, of the risks and rewards of ownership and has retained control, derecognition is precluded to the extent of the amount of cash or other assets that the transferor could be required to pay. [AG51 (n)]

Comparison of IASB IAS 39 and FASB 140/FIN 46R

	IAS 39	**FASB 140/FIN 46R**
Spelling	Securitisation	Securitization
Legal isolation of assets	Not required	Required
Transferee/Investors ability to pledge or exchange	Not required*	Required
Call options	Borrowing to the extent of the option**	Borrowing to the extent of the option, for most types
Cleanup calls	Borrowing to the extent of the option**	Does not preclude 100 percent sale
Transferee put options	Borrowing to the extent of the option**	Still a sale provided true sale opinion is obtained
Consolidation of SPEs	Usually, under SIC 12	If a QSPE, no consolidation except under very limited circumstances. If not a QSPE, consolidation is required if one party absorbs majority of expected losses or majority of expected residual returns.
Ability to guarantee	Borrowing to the extent of the guarantee**	Still a sale provided true sale opinion is obtained
Ability to retain subordinated interest	Borrowing to the extent of the subordinated amount**	Senior interests still eligible for sale accounting
Ability to enter into a total return swap	Borrowing	May be a sale if legal isolation can be achieved
Cap on gain based on whole loan proceeds	Yes	No
Ability to repurchase any individual loan	Borrowing to the extent of repurchase option limit**	100 percent borrowing
Revolving structures	Unclear-see ¶ 19c	OK

* Unless some but not substantially all of the risks and rewards are transferred. Then to derecognize, the entity must not retain control as evidenced by the transferee having the ability to sell the assets.

** Assuming some but not substantially all of the risks and rewards are transferred and control has been retained (i.e., the transferee cannot sell the asset).

Canada

The Canadian GAAP guidance (Accounting Guideline 12, *Transfers of Receivables* ("AcG-12"), issued in March 2001 and Emerging Issues Abstract No. 139, *Accounting for Retained Interests by the Transferor in a Securitization Transaction Accounted for as a Sale Under AcG-12* issued in September 2003) as it relates to securitization transactions is virtually identical to the requirements of FASB 140 and EITF 99-20. As the FASB amends/updates its framework, it is expected that the Canadian accounting standard setters will adopt similar amendments to the Canadian guidance in order to remain in line.

The Canadian Institute of Chartered Accountants has not picked up all of the background material and implementation guidance relating to FASB 140 and does not plan to make interpreting AcG-12 a major part of its mission in life. Using the U.S. interpretative accounting literature is a good place to start, but be careful of certain substantive differences that remain between the overall U.S. and Canadian GAAP frameworks, including: hedging and derivatives (particularly embedded derivatives), accounting for investments (including retained interests) and, until recently, consolidation.

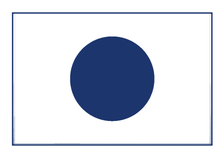
Although Canadian GAAP has moved closer to the U.S. rules relating to derivative accounting, there still are a number of differences. One in particular is that Canadian reporting entities are not permitted to look for or split out embedded derivatives with one exception-for embedded options in equity-linked GIC's. This will change with the introduction of CICA Section 3855, *Financial Instruments – Recognition and Measurement* which is effective for fiscal years beginning on or after October 1, 2006. Beware, however, CICA 3855 is not exactly the same as FAS 133 and there are no plans to mandate the use of Derivatives Implementation Group guidance for Canadian GAAP, so caution continues to be required.

Similarly the introduction of CICA Section 3855 will bring the Canadian framework closer (but not identically) in line with the U.S. guidance set out in FAS 115. This section will replace the two category classification model of investment securities and trading securities and will introduce the concept of available-for-sale, held-to-maturity and held-for-trading which is generally consistent with FAS 115.

Until recently, Canadian GAAP focused on "control in substance" in deciding if non-QSPE entities should be consolidated by the seller (or any other party to the transaction). Beneficiary trusts are often used as securitization vehicles in Canada. There, trustee authority to direct the investing and financing operations of the vehicle is governed by the original trust documents and the trustee's decisions are designed to benefit all beneficial interest holders. Since neither the transferor, nor any investor, have the unilateral ability to change or influence the strategic operating, investing and financing policies, historically the Canadian accounting judgment has been that none of them control the trust or need to consolidate it in their financial statements. No minimum equity capitalization was required to support this conclusion nor was a multi-seller structure required. As a result, QSPE structures in Canada have been far less prevalent. All of this has changed, however, with the introduction of Accounting Guideline 15, *Consolidation of Variable Interests Entities* ("AcG–15") which took effect for fiscal periods beginning on or after November 1, 2004. AcG–15 is effectively a carbon copy of the FIN 46R requirements issued by the FASB in 2003. The past year has seen numerous QSPE conversions of previously non-qualifying single seller trusts. There also has been an increasing trend for larger securitizers to enter into two-step structures through a QSPE when dealing with multi-seller conduits in order to ensure the seller is protected from the consolidation result that typically will arise if a seller has more than 50 percent of the assets in a particular conduit. Needless to say, the Canadian market is following FASB developments with respect to amendments to the QSPE rules closely.

Finally, it is worth noting that differences in bankruptcy and receivership rules allow transactions executed under Canadian law to meet the legal isolation standard using different structures than one might see in the U.S. For example, single step transfers directly from the originator to the securitization vehicle are prevalent in Canada.

Japan



Like Canada, Japan has adopted accounting rules influenced by the U.S. standards. The Business Accounting Deliberations Council's Accounting Standard for Financial Instruments was issued on January 22, 1999 and is effective for transfers of all types of financial assets occurring on or after April 1, 2000. Prior to this standard, Japanese GAAP had no explicit or comprehensive accounting framework for dealing with securitization transactions. In those days, Japanese securitizers looked to other countries' accounting rules for guidance and frequently would follow FASB 125.

The Japanese standard requires a familiar three criteria to achieve derecognition and sale accounting. However, the three criteria are phrased in subtly different ways.

Japan - continued

Legal Isolation - English language translations use the phrases "legally secured from the transferor and its creditors" and "certainly isolated from risks of bankruptcy" when describing this standard. The criteria also says it "should be judged from a legal perspective," so we believe that a reasoned legal analysis to a high standard (e.g., "would" level lawyers opinion) should be sufficient to conclude that the criteria has been met. Also interesting is that the criteria specifically mentions that a retained repurchase right, in other words a "call" option held by the transferor, is inconsistent with an affirmative legal isolation conclusion.

Transferee Enjoys Benefits

This criteria assesses whether the transferee can enjoy the contractual rights of the transferred asset "in an ordinary manner directly or indirectly." Those contractual rights include rights to receive "almost all" principal, interest and dividends. Like U.S. accounting, substantive restrictions imposed by the transferor on further transfers by the transferee precludes derecognition.

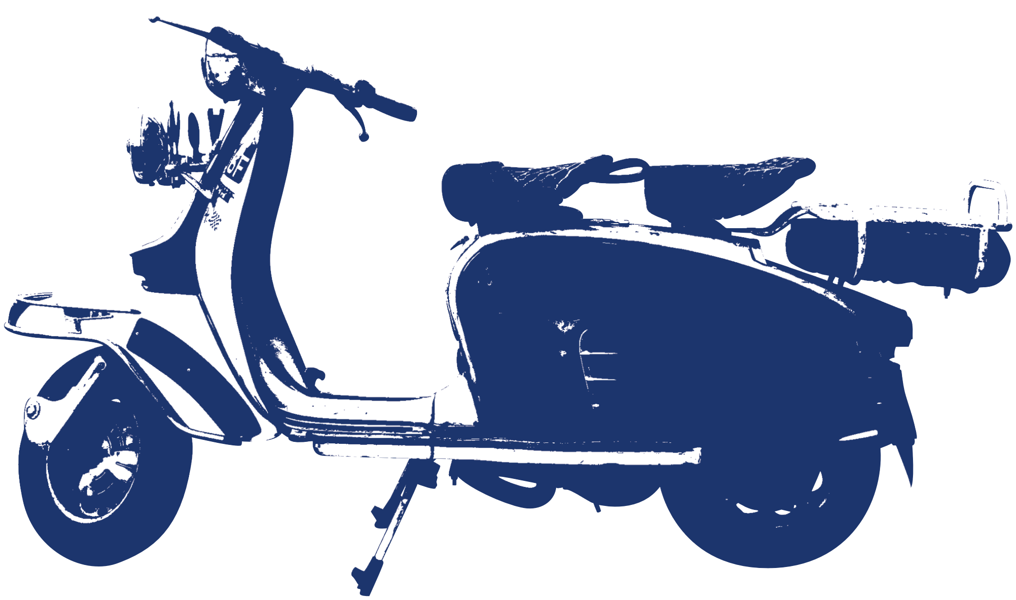
The idea of indirect enjoyment refers to the use of special purpose securitization vehicles. In this case, there is no explicit distinction between a "qualifying" and a "non-qualifying" SPE. Any company, trust or partnership incorporated under the Asset Liquidation Law and operating appropriately to convey the receipts from transferred assets to the ultimate investors qualifies for nonconsolidation by both the transferor and investors. The "pass through" accounting theory is at work here and the ultimate investors should be considered to be the transferees for purposes of assessing whether they enjoy the benefits of the assets transferred.

No Repurchase Agreement

Any arrangement that, in substance, gives both the right and obligation to repurchase before maturity precludes sale accounting. Since call options were already dealt with in the first criteria, there is no need to repeat that prohibition here.

Investor accounting for securitization interests roughly follows FASB 115 with the following exceptions:

- For investments classified as available for sale, there are two possible accounting methods. The most popular method closely parallels the FASB 115 approach of carrying the investment at fair value with changes reported in other comprehensive income. The second method, which is not widely used, only reflects changes in fair value above amortized cost in the other comprehensive income line in the balance sheet equity section; changes in fair value below amortized cost are reflected in current earnings. Think of it as a cross between FASB 115 and lower-of-cost-or-market accounting. Also, for either method, fair value may be measured consistently either as the balance sheet date fair value or the average fair value over the last month before the balance sheet date.
- Premiums and discounts are amortized and accreted as yield adjustments under the "amortized" method. However, methods for adjusting yield to recognize changes in expected variable future cash flows are not specifically defined.



Chapter 10

The SEC's New Minimum ABS Servicing Criteria and Compliance Reporting Regime

The SEC has released its 495-page Regulation AB (http://www.sec.gov/rules/final/33-8518.pdf). About 30 pages are devoted to Section 1122 on assessments of compliance with the SEC's new minimum servicing criteria for mortgage and asset-backed securities and attestation reports by accounting firms on such assessments. The SEC's uniform servicing criteria, which will replace the USAP reporting regime, appear starting on page 76.

The SEC does not require audited financial statements for the issuing entity in either prospectuses or 10-K annual report filings. Often a new issuing entity is created for each transaction, so prior financial information about that entity would likely be of little use. On an ongoing basis, while an annual audit could provide benefits in providing some assurance with respect to controls over the administration of the transaction and the pool assets, the SEC indicated that their amendments to require registered public accounting firm attestation reports as to assessments of compliance with particular servicing criteria are a more direct and targeted approach to achieve such objectives. Similarly, the SEC expressed the view that one of the other objectives for financial statements - to present results of financial activity during a period - can be addressed more particularly by their disclosure requirements regarding distributions on the asset-backed securities.

When?

Existing deals are grandfathered and there is a one-year transition period. Mortgage and asset-backed securities that are the subject of registered offerings commencing after December 31, 2005 must comply with the new rules and forms. Accordingly, the first filing of an ABS 10-K under the new rules will not have to be until March of 2007 for ABS registrants filing on a calendar year basis. (Note to procrastinators: This is not sufficient cause for you to stop reading now.)

There is no requirement that the year-end adopted by the ABS registrant be the same as the year-end of its sponsor. However, the reporting period for the 10-K and the reporting period for the servicing reports should be coterminous, which has not always been the case in the past.

As in the past, a 10-K report is required for the fiscal year in which the takedown off of a registration statement occurs. If, at the beginning of the next fiscal year, the securities of each class in the takedown are held of record (as defined) by fewer than 300 persons (as defined), a Form 15 may be filed and no further annual or periodic distribution reports need be filed.

What's the difference between an assertion, an assessment, an attestation, a statement and a certification?

The 10-K must include, among other things:

- Assessments of compliance with the SEC's minimum servicing criteria from each party participating in the servicing function (Section 1122)
- Accountants' attestation reports evaluating each servicer's assertion regarding compliance with the minimum servicing criteria (Section 1122)
- Statements from each servicer to the effect that the servicer has fulfilled its obligations under the servicing agreement for the particular transaction (Section 1123)
- A certification by the person signing the 10-K that the 10-K and Form 10-D distribution reports do not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made not misleading, and that all assessments and attestations required to be included have been included, except as otherwise disclosed (Section 302)

Who must submit a servicer's assessment of compliance?

The 10-K must include assessments of compliance from each party participating in the servicing function. A party participating in the servicing function means any entity (e.g., master servicer, primary servicers, trustee) that is performing activities that address the minimum servicing criteria unless such entity's activities relate only to 5 pecent or less of the pool assets. The release does not specify whether the 5 percent is to be calculated based on principal amount or number of assets nor does it specify whether this is a one-time test at closing or would be applied throughout the year covered by the 10-K. Each party participating in the servicing function will be responsible for having an attestation engagement performed by a registered public accounting firm.

Who must take overall responsibility for collecting servicer assessments?

The person responsible for signing the Sarbanes-Oxley Section 302 certification must certify that all of the reports on assessment of compliance with the entire servicing function and their related attestation reports required to be included in the 10-K have been included as an exhibit to the 10-K, except as otherwise disclosed. Further, any material instances of noncompliance described in such reports must be disclosed in the 10-K.

The certification must be signed either on behalf of the depositor by the senior officer in charge of securitization of the depositor or on behalf of the issuing entity (e.g., trust) by the senior officer in charge of the servicing function of the servicer. If a servicer is to sign the report on behalf of the issuing entity and multiple servicers are involved in the servicing of the pool assets, the senior officer in charge of the servicing function of the master servicer (or entity performing the equivalent function) must sign. The trustee is not permitted to sign the report as an alternative to the depositor or the servicer.

Must there be an assessment for each individual transaction?

Although a separate 10-K must be filed for each trust, the same assessment of compliance with the minimum servicing criteria required by Section 1122 can be filed in each of the 10-Ks. This means that the assessment is to be made on a platform level for that asset class (i.e., all transactions involving the asserting party that are backed by assets of the type backing the ABS covered by the particular10-K). On the other hand, Section 1123 requires a statement of compliance regarding the servicer's obligations under the particular servicing agreement for the ABS transaction rather than at the platform level. There is no requirement for an accountant's attestation report on the Section 1123 servicer compliance statement with the particular servicing agreement for the ABS transaction.

For example, if an entity sponsored and serviced four mortgage loan transactions and four auto loan transactions in a given year, there would be a requirement for eight 10-Ks and eight section 1123 servicer compliance statements and eight section 302 Sarbanes-Oxley certifications but only two section 1122 servicer assessments and only two accountants' attestation reports (i.e., one for the mortgage platform and one for the auto loan platform). When multiple unaffiliated servicers are involved in a transaction, the math gets more challenging.

What is meant by the "entire servicing function"?

The servicing of an asset-backed security consists of many functions, including: collecting principal, interest and other payments from obligors; paying taxes and insurance from escrowed funds; monitoring and accounting for delinquencies; executing foreclosure if necessary; temporarily investing funds pending distribution; remitting fees and payments to enhancement providers, trustees and others providing services; and allocating and remitting distributions to security holders. The minimum servicing criteria are separated into four categories, which are reproduced below:

- General servicing considerations
- Cash collection and administration
- Investor remittances and reporting
- Pool asset administration

What if some of the SEC's criteria are not applicable to my activities?

A servicer may exclude a particular criterion either because in its servicing platform it does not participate in that element of the servicing function or the criterion is broadly inapplicable in the context of the asset class being serviced. However, a party may not voluntarily select to exclude specific servicing criteria if they are otherwise applicable to that party. In the event that servicing criteria are excluded for those reasons that are permitted, the inapplicability of the criteria must be disclosed in both the asserting party's assertion and the related registered public accounting firm's report. However, while the individual asserting parties will be permitted to exclude criteria they do not perform, the person making the Section 302 certification must certify whether all required reports covering the entire servicing function, including all the criteria applicable to the asset class, are included with the 10-K.

Are there penalties for instances of noncompliance with the servicing criteria? What if instances of noncompliance are subsequently corrected in the period?

Disclosure will be required of material instances of noncompliance during the reporting period, even if such noncompliance was subsequently corrected in the period.

A material instance of noncompliance identified in the reports will not by itself have regulatory restrictions on market access, such as an effect on continued Form S-3 eligibility for additional ABS transactions. Rather, the assessment and reporting on the criteria is designed to operate within a disclosure-based framework that the SEC believes will promote investor confidence and market efficiency by decreasing information asymmetries and promoting more efficient pricing and valuation of the securities as well as competition among issuers.

What is an accountant's attestation report?

The accounting firm engaged to perform the examination engagement issues a report expressing its opinion as to whether the servicer's assessment of compliance with the minimum servicing criteria is fairly stated in all material respects or an opinion to the effect that an overall opinion cannot be expressed and why. The report is prepared in accordance with Statement on Standards for Attestation Engagements No. 10, the *Attestation Standards for Compliance Attestation* (AT § 601).

The report must be available for general use and not contain restricted use language. The substitution of another type of accountant's report, such as a USAP report or an agreed-upon procedures report will not satisfy the SEC requirement. ABS transactions may continue to require a separate accountant engagement in addition to the report called for Regulation AB.

Has the SEC considered the additional cost burden of the new 10-K requirements?

Under the Paperwork Reduction Act requirements, the SEC estimated that currently it takes an ABS issuer an average of 90 hours to prepare a 10-K. The most significant difference between the amendments and the existing system is the assessment of compliance with servicing criteria. They estimated that completing and filing a 10-K under the amendments will result in an average increase of approximately 33 percent over the amount of time currently spent by entities completing the form, or 30 hours per response. It was further estimated that 25 percent of the reporting burden is borne by the ABS issuer and that 75 percent of the burden is borne by outside professionals retained by the issuer at an average cost of $300 per hour.

The SEC's New Standard ABS Servicing Criteria

1. General servicing considerations.
   - i. Policies and procedures are instituted to monitor any performance or other triggers and events of default in accordance with the transaction agreements.
   - ii. If any material servicing activities are outsourced to third parties, policies and procedures are instituted to monitor the third party's performance and compliance with such servicing activities.
   - iii. Any requirements in the transaction agreements to maintain a back-up servicer for the pool assets are maintained.
   - iv. A fidelity bond and errors and omissions policy is in effect on the party participating in the servicing function throughout the reporting period in the amount of coverage required by and otherwise in accordance with the terms of the transaction agreements.
2. Cash collection and administration.
   - i. Payments on pool assets are deposited into the appropriate custodial bank accounts and related bank clearing accounts no more than two business days of receipt, or such other number of days specified in the transaction agreements.
   - ii. Disbursements made via wire transfer on behalf of an obligor or to an investor are made only by authorized personnel.
   - iii. Advances of funds or guarantees regarding collections, cash flows or distributions, and any interest or other fees charged for such advances, are made, reviewed and approved as specified in the transaction agreements.
   - iv. The related accounts for the transaction, such as cash reserve accounts or accounts established as a form of overcollateralization, are separately maintained (e.g., with respect to commingling of cash) as set forth in the transaction agreements.
   - v. Each custodial account is maintained at a federally insured depository institution as set forth in the transaction agreements. For purposes of this criterion, "federally insured depository institution" with respect to a foreign financial institution means a foreign financial institution that meets the requirements of 17 CFR § 240.13k-1(b)(1).
   - vi. Unissued checks are safeguarded so as to prevent unauthorized access.
   - vii. Reconciliations are prepared on a monthly basis for all asset-backed securities related bank accounts, including custodial accounts and related bank clearing accounts. These reconciliations:
     - – Are mathematically accurate;
     - – Are prepared within 30 calendar days after the bank statement cutoff date, or such other number of days specified in the transaction agreements;
     - – Are reviewed and approved by someone other than the person who prepared the reconciliation; and
     - – Contain explanations for reconciling items. These reconciling items are resolved within 90 calendar days of their original identification, or such other number of days specified in the transaction agreements.

3. Investor remittances and reporting.
   i. Reports to investors, including those to be filed with the Commission, are maintained in accordance with the transaction agreements and applicable Commission requirements. Specifically, such reports:
      – Are prepared in accordance with timeframes and other terms set forth in the transaction agreements;
      – Provide information calculated in accordance with the terms specified in the transaction agreements;
      – Are filed with the Commission as required by its rules and regulations; and
      – Agree with investors' or the trustee's records as to the total unpaid principal balance and number of pool assets serviced by the servicer.
   i. Amounts due to investors are allocated and remitted in accordance with timeframes, distribution priority and other terms set forth in the transaction agreements.
   ii. Disbursements made to an investor are posted within two business days to the servicer's investor records, or such other number of days specified in the transaction agreements.
   iii. Amounts remitted to investors per the investor reports agree with cancelled checks, or other form of payment, or custodial bank statements.
4. Pool asset administration.
   i. Collateral or security on pool assets is maintained as required by the transaction agreements or related pool asset documents.
   ii. Pool assets and related documents are safeguarded as required by the transaction agreements.
   iii. Any additions, removals or substitutions to the asset pool are made, reviewed and approved in accordance with any conditions or requirements in the transaction agreements.
   iv. Payments on pool assets, including any payoffs, made in accordance with the related pool asset documents are posted to the applicable servicer's obligor records maintained no more than two business days after receipt, or such other number of days specified in the transaction agreements, and allocated to principal, interest or other items (e.g., escrow) in accordance with the related pool asset documents.
   v. The servicer's records regarding the pool assets agree with the servicer's records with respect to an obligor's unpaid principal balance.
   vi. Changes with respect to the terms or status of an obligor's pool asset (e.g., loan modifications or re-agings) are made, reviewed and approved by authorized personnel in accordance with the transaction agreements and related pool asset documents.
   vii. Loss mitigation or recovery actions (e.g., forbearance plans, modifications and deeds in lieu of foreclosure, foreclosures and repossessions, as applicable) are initiated, conducted and concluded in accordance with the timeframes or other requirements established by the transaction agreements.
   viii. Records documenting collection efforts are maintained during the period a pool asset is delinquent in accordance with the transaction agreements. Such records are maintained on at least a monthly basis, or such other period specified in the transaction agreements, and describe the entity's activities in monitoring delinquent pool assets including, for example, phone calls, letters and payment rescheduling plans in cases where delinquency is deemed temporary (e.g., illness or unemployment).
   ix. Adjustments to interest rates or rates of return for pool assets with variable rates are computed based on the related pool asset documents.
   x. Regarding any funds held in trust for an obligor (such as escrow accounts):
      – Such funds are analyzed, in accordance with the obligor's pool asset documents, on at least an annual basis, or such other period specified in the transaction agreements;
      – Interest on such funds is paid, or credited, to obligors in accordance with applicable pool asset documents and state laws; and
      – Such funds are returned to the obligor within 30 calendar days of full repayment of the related pool asset, or such other number of days specified in the transaction agreements.
   xi. Payments made on behalf of an obligor (such as tax or insurance payments) are made on or before the related penalty or expiration dates, as indicated on the appropriate bills or notices for such payments, provided that such support has been received by the servicer at least 30 calendar days prior to these dates, or such other number of days specified in the transaction agreements.
   xii. Any late payment penalties in connection with any payment to be made on behalf of an obligor are paid from the servicer's funds and not charged to the obligor, unless the late payment was due to the obligor's error or omission.

xiii. Disbursements made on behalf of an obligor are posted within two business days to the obligor's records maintained by the servicer, or such other number of days specified in the transaction agreements.

xiv. Delinquencies, charge-offs and uncollectible accounts are recognized and recorded in accordance with the transaction agreements.

xv. Any external enhancement or other support, identified in Item 1114(a)(1) through (3) or Item 1115 of Regulation AB, is maintained as set forth in the transaction agreements.

Instructions to Item 1122- Servicer Assessments

1. If certain servicing criteria are not applicable to the asserting party based on the activities it performs with respect to asset-backed securities transactions taken as a whole involving such party and that are backed by the same asset type backing the class of asset-backed securities, the inapplicability of the criteria must be disclosed in that asserting party's and the related registered public accounting firm's reports.
2. If multiple parties are participating in the servicing function, a separate assessment report and attestation report must be included for each party participating in the servicing function. A party participating in the servicing function means any entity (e.g., master servicer, primary servicers, trustees) that is performing activities that address the criteria in paragraph (d) of this section, unless such entity's activities relate only to 5 percent or less of the pool assets.
3. If the asset pool backing the asset-backed securities includes a pool asset representing an interest in or the right to the payments or cash flows of another asset pool and both the issuing entity for the asset-backed securities and the entity issuing the asset to be included in the issuing entity's asset pool were established under the direction of the same sponsor and depositor, see also Item 1100(d)(2) of Regulation AB.

What is the required form of the assessment?

The assessment must include:

- A statement of the party's responsibility for assessing compliance with the servicing criteria applicable to it.
- A statement that the party used the servicing criteria to assess compliance with the applicable servicing criteria.
- The party's assessment of compliance with the applicable servicing criteria as of and for the period ending the end of the fiscal year covered by the 10-K. The report must include disclosure of any material instance of noncompliance identified by the party.
- A statement that a registered public accounting firm has issued an attestation report on the party's assessment of compliance with the applicable servicing criteria as of and for the period ending the end of the fiscal year covered by the 10-K.

Chapter 11

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 equity and secured bank loans.

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

You envision a classic 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 cash and 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 on the following page. 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.

Your final answer

Is the pre-tax gain?:
A. $5,838,869.86
B. $4,463,869.86
C. Zero
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 mrosenblatt@deloitte.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 million 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.

See page 81 for resolution of issues.

Resolution of Issue

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 would 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	One approach would be to include the $2.5 million seed deposit in the assets transferred. 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. See the credit card example on page 35 and *"How are cash reserve accounts handled?"* on page 43 for alternatives.
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 140. Thus, FASB 140 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, 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.

Chapter 12

What to Expect in 2006 - FASB 140 (R)

At the time of this writing, the FASB has three projects underway to amend FASB 140. They are:

1. QSPEs and Isolation of Financial Assets
2. Hybrid Financial Instruments, an amendment of FAS 133
3. Servicing Rights

FASB said they expect to issue the Exposure Drafts in the third quarter of 2005 and the final Statements by early 2006. Readers should go to the FASB website at www.fasb.org for current information.

The more significant changes contemplated are summarized below for each project. These represent tentative conclusions of the FASB and are subject to change.

QSPEs and Isolation of Financial Assets

Participating interests

A QSPE must be used for all transfers of **portions** of financial assets except those transfers for which each interest in the original financial asset, including any interest retained by the transferor, has equal, pro rata rights to each cash flow from the underlying assets, no interest is subordinate to any other interest, and there is no recourse to the transferor or any other interest holder. For those transfers that do not require the use of a QSPE, the resulting portions would be called participating interests. A participating interest retained by the transferor is not considered a new financial asset and should be initially measured at allocated carry-over basis.

If a portion of a financial asset does not meet the criteria of a participating interest, the whole asset must be transferred to a QSPE. The resulting interests from a QSPE would be called beneficial interests and the derecognition criteria in paragraph 9 of FASB Statement 140 would be applied to the entire original asset. Beneficial interests held by the transferor are considered new financial assets and are initially measured at fair value.

Legal isolation

The revised FASB Statement 140 will provide additional implementation guidance to describe the legal analysis and conclusions required to achieve isolation of financial assets:

- The implementation guidance on isolation will clarify that isolation requires a legal analysis, which concludes that a transfer must meet the requirements of a true sale at law and an attorney's opinion that the transferred assets would not be included in the estate of the transferor or any consolidated affiliate that is not a special-purpose corporation or other entity designed to make remote the possibility that it would enter bankruptcy or other receivership (nonconsolidation opinion).
- Implementation guidance will be added that describes the FASB's understanding of the conditions that attorneys require to issue a true-sale-at-law opinion and a nonconsolidation opinion under U.S. bankruptcy and receivership law.
- The amount of recourse (or guarantee) that can be provided by a transferor that would prevent a transaction from meeting the requirements of a true sale would be left to an attorney's professional judgment based on the facts and circumstances (including the jurisdiction) of the transaction.

Transferor support commitments and derivatives

If transferors provide support commitments or derivatives either directly to beneficial interest holders of a QSPE or in connection with the beneficial interests, those obligations should be considered in the same manner as if they were provided directly to the QSPE for purposes of evaluating isolation. That requirement would include support commitments entered into with third parties who provide "back-to-back" guarantees to beneficial interest holders.

Prohibition of equity instruments

A QSPE will be prohibited from holding equity instruments, unless they are received as a result of efforts to collect its financial assets. The definition of equity instrument would be the same as the one in FASB Statement 115 but equity security would be replaced by equity instrument.

Reissuance (Rollover) of beneficial interests

Reissuance or rollover of beneficial interests will be defined as the issuance of beneficial interests to provide cash or assets with which to repay existing beneficial interests held by parties other than the transferor. In the case of a QSPE that reissues beneficial interests, no party should be permitted to hold combinations of rights and obligations that provide it with an opportunity to obtain more than a trivial incremental benefit as compared to similar rights and obligations held by separate parties.

Secondary market trading by a transferor in beneficial interests of a QSPE will not be considered a rollover. Obligations of the transferor to purchase beneficial interests from holders should be considered in determining the isolation of transferred assets.

Hybrid Financial Instruments

Initial measurement

All retained interests, including servicing rights, from transfers of financial assets accounted for as sales will be initially measured at fair value rather than based on an allocation of the previous carrying amount between the assets sold and the retained interests based on their relative fair values. Further, interests acquired/retained in connection with transfers of loans for securities in guaranteed mortgage securitizations will be initially measured at fair value.

Both purchasers of beneficial interests and transferors retaining beneficial interests need to evaluate whether those interests contain an embedded derivative requiring bifurcation.

Hybrid financial instruments with embedded derivatives features

Any hybrid instrument with embedded derivative features that would otherwise require bifurcation from the host contract under FASB Statement 133 can be accounted for, at the holder's election (on an instrument-by-instrument basis), either:

1. At fair value with changes in fair value recorded through earnings; or
2. By separating the embedded derivative features from the host contract and accounting for such features as derivatives under FASB Statement 133.

Interest-only and principal-only strips that are simple separations of interest and principal in noncomplex instruments without concentration of any risks except those naturally resulting from the separation will be exempted from the requirement to bifurcate or carry at fair value through earnings.

Securities with concentrations of credit risk like subordinated classes should not recognize the credit concentration as an embedded derivative.

Passive derivatives held by a QSPE can pertain to another derivative.

Servicing Rights

Servicing rights recognized as a result of transfers of financial assets accounted for as sales should be initially measured at fair value rather than based on an allocation of the previous carrying amount between the assets sold and the retained rights based on their relative fair values.

Entities will be permitted to choose either fair value or the lower-of-carrying-amount-or-market (LOCOM) as the subsequent measurement attribute for all servicing rights that are separately accounted for under GAAP. Subsequent changes in the fair value of all servicing rights for those entities that elect fair value measurement will be recognized in earnings. The FASB noted the difficulties of hedging MSRs for accounting purposes, because the fair value of MSRs do not change in a linear fashion as interest rates change due to the nature of prepayment estimates. This causes MSRs to lose value at a faster rate when interest rates decline than the rate at which MSRs gain value when interest rates increase. By reporting MSRs at fair value, mortgage bankers would be provided relief from the substantial record keeping requirements needed to obtain hedge accounting treatment.

Excerpt from SEC's June 2005 *Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers*

"Although there is debate about whether the guidance in SFAS No. 140 is effective, much of the controversy is caused not by the standards themselves, but by transaction structuring. Issuers often structure transfers in order to achieve or avoid sale accounting, trigger or avoid the recognition of losses (or gains), or change the measurement attribute applied to the recorded assets and liabilities. The Staff believes based on its reviews of issuer filings, that the most frequent structuring goal is to achieve sale treatment without consolidation of any related SPEs. While economic motivations for most asset transfers exist, some transfers of financial assets appear to be significantly, primarily, or even solely entered into with accounting motivations in mind.

"Some of this structuring has been undertaken by using QSPEs in situations that appear to the Staff to be beyond those originally contemplated by the FASB. The FASB originally intended a QSPE to be merely a pass-through entity to essentially serve as custodian of the underlying financial assets, and attempted to define it in such a way as to ensure that this was the case. There are restrictions on the types of assets that an SPE can hold while remaining 'qualified,' and when it is acceptable for the QSPE to dispose of certain non-cash financial assets. Although the limitations on the activities of QSPEs do not permit the QSPE to manage the assets on its balance sheet, there are few explicit limitations on managing the balance sheet liabilities. That is, in structures where the QSPE holds longer term assets and funds the purchase of such assets through the issuance of shorter term interests to investors, decisions have to be made regarding the nature of the new interests to be issued when the original short term interests mature. In practice, these decisions are made by the issuer transferring the financial assets. Accountants and auditors have concluded that the SPE – despite such management of liabilities -- is a QSPE under SFAS No. 140, and is therefore exempt from consolidation. These and other interpretations of the QSPE guidance have expanded the activities of QSPEs beyond the simple pass-through entities originally envisioned by the FASB.

"Despite persistent work by the FASB and the Commission, the Staff considers the accounting for sales of financial assets to be in need of improvement. Indeed, the FASB already has several projects on its agenda relating to transfers of financial assets. However, this area is challenging to standard setters, in large part because financial structures are virtually limitless and continue to evolve at a rapid pace. However, because the areas in need of improvement in their accounting stem mainly from structured transactions that have accounting motivations, improvement in transparency and comparability across issuers can perhaps most directly and quickly be accomplished by eliminating the use of such structured transactions."

Appendix

QSPE Qualifications Checklist

Name of Entity:	**Prepared by:**		
Closing Date:	**Date:**		
Purchased From:			
Parties to the Agreement:			
Who is the Transferor?			
Have There Been Any Amendments Since the Closing Date?			
	Insert Pooling Agreement/ Indenture Reference or Not Applicable:	**In Compliance?**	
Applicable Accounting Literature		**Yes**	**No**
FIN 46R Guidance on QSPEs:			
4.d.(1) Does the investor have the unilateral ability to cause the entity to liquidate?			
4.d.(2) Does the investor have the unilateral ability to change the entity so that it no longer meets the qualifications of a QSPE?			
QSPE REVIEW (unless otherwise specified below, use of the term, "transferor" also includes its affiliates and its agents.) The description of a QSPE is restrictive. The accounting for QSPEs and transfers of financial assets to them should not be extended to any entity that does not currently satisfy all of the conditions articulated in ¶35. A QSPE is a trust or other legal vehicle that meets all of the following conditions: 35.a. It is demonstrably distinct from the transferor. ¶36 A QSPE is demonstrably distinct from the transferor only if it cannot be unilaterally dissolved by the transferor and either: (a) at least 10% of the fair value of its beneficial interests is held by parties other than any transferor (at all times), or (b) the transfer is a guaranteed mortgage securitization. (A guaranteed mortgage securitization is a securitization of mortgage loans that is within the scope of FASB Statement No. 65, Mortgage Banking Activities, as amended, and includes a substantive guarantee by a third party.) An ability to unilaterally dissolve an SPE can take many forms, including but not limited to: 1) holding sufficient BIs to demand that the trustee dissolve the SPE, 2) the right to call all the assets transferred to the SPE, and 3) a right to call or a prepayment privilege on the BIs held by other parties.			
35.b. The SPE's activities: (1) are significantly limited; (2) were entirely specified in legal documents that established it or created the BIs in the transferred assets that it holds; and (3) may be significantly changed only with the approval of at least a majority of the beneficial interests held by entities other than any transferor. [¶37 and 48]			

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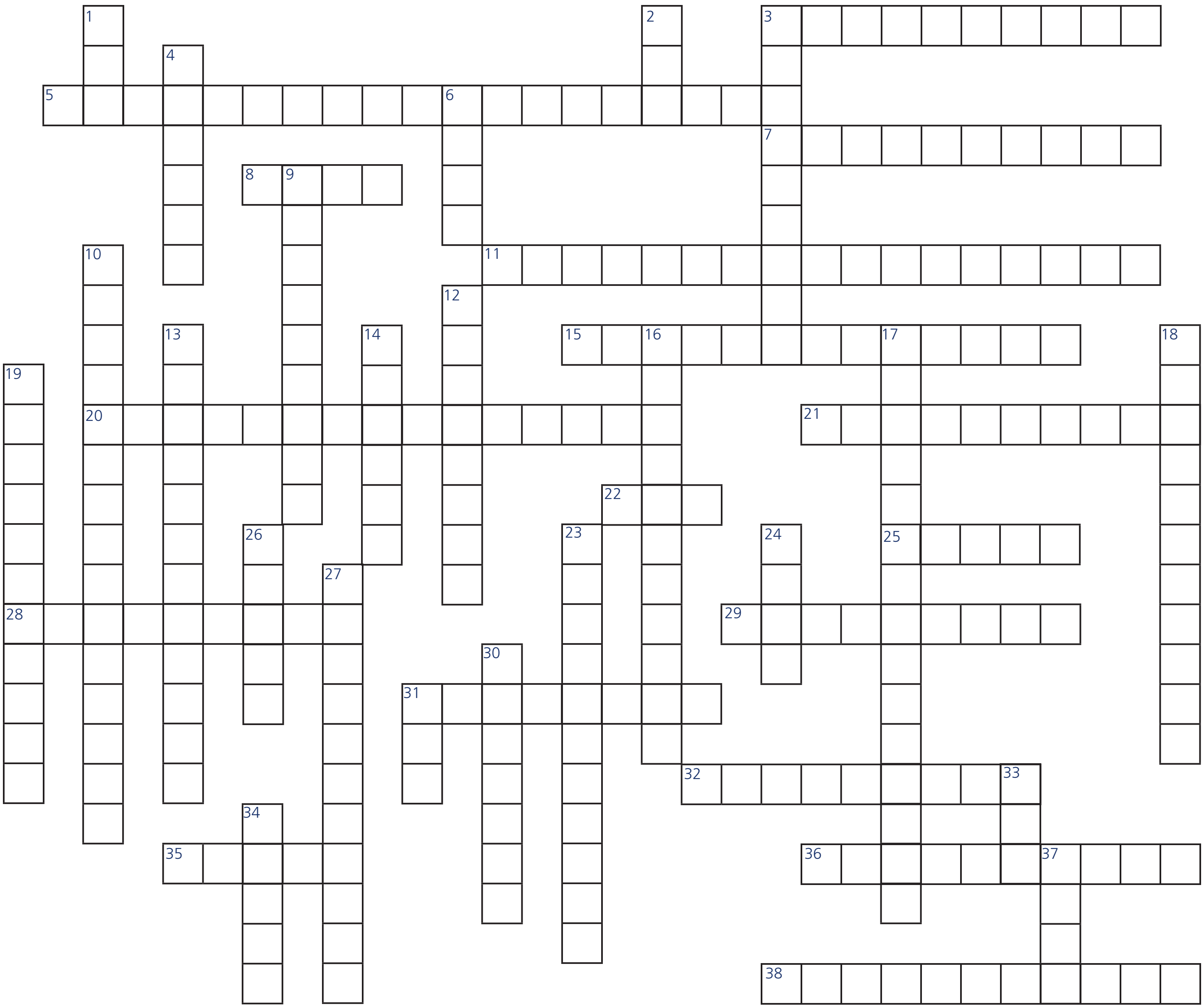
Applicable accounting literature	Insert Pooling Agreement/ Indenture Reference or Not Applicable:	In Compliance? Yes	No
35.c. It may hold only: (1) Financial assets transferred to it that are passive in nature. [¶39] A financial asset or derivative financial instrument is passive only if holding the asset or instrument does not involve its holder in making decisions other than the decisions inherent in servicing. [¶61] An equity instrument is not passive if the QSPE can exercise the voting rights and is permitted to choose how to vote. A derivative financial instrument is not passive if, for example, it includes an option allowing the SPE to choose to call or put other financial instruments; but other derivative financial instruments can be passive, for example, interest rate caps and swaps and forward contracts. (2) Passive derivative instruments that pertain to beneficial interests (other than another derivative financial instrument) issued or sold to parties other than the transferor. [¶39 and 40] ¶40. A derivative financial instrument pertains to beneficial interests (other than another derivative financial instrument) issued only if it: a. Is entered into when the BIs are issued by the QSPE to parties other than the transferor or sold to such other parties after being issued by the QSPE to the transferor, or when a passive derivative financial instrument needs to be replaced upon occurrence of an event or circumstance (specified in the legal documents that established the SPE or created the BIs in the transferred assets that it holds) outside the control of the transferor, for example, when the counterparty to the derivative defaults or is downgraded below a specified threshold. b. Has a notional amount that does not initially exceed the amount of those [third party] BIs and is not expected to exceed them subsequently. c. Has characteristics that relate to, and partly or fully but not excessively counteract, some risk associated with those [third party] BIs or the related transferred assets. (3) Financial assets (e.g., guarantees or rights to collateral) that would reimburse it if others were to fail to adequately service financial assets transferred to it or to timely pay obligations due to it and, that it entered into when it was established, when assets were transferred to it, or when BIs (other than derivative financial instruments) were issued by the SPE. (4) Servicing rights related to assets that it holds. (5) Temporarily, nonfinancial assets associated with the collection of financial assets that it holds. [¶41] A QSPE may hold nonfinancial assets other than servicing rights only temporarily and only if those nonfinancial assets result from collecting the transferred financial assets. For example, a QSPE could be permitted to temporarily hold foreclosed nonfinancial collateral. In contrast, an entity cannot be a QSPE if, for example, it receives from a transferor significant secured financial assets likely to default with the expectation that it will foreclose on and profitably manage the securing nonfinancial assets.			

Applicable accounting literature		Insert Pooling Agreement/ Indenture Reference or Not Applicable:	In Compliance? Yes	No
35.c.	It may hold only (continued): (6) Cash collected from assets that it holds and investments purchased with that cash pending distribution to holders of BIs that are appropriate for that purpose (that is, money-market or other relatively risk-free instruments without options and with maturities no later than the expected distribution date)			
35.d.	If it can sell or dispose of noncash financial assets, it can do so only in automatic response to one of the following conditions. (1) Occurrence of an event or circumstance that is specified in the legal documents that established the SPE or created the BIs in the transferred assets that it holds; is outside the control of the transferor, and causes, or is expected at the date of transfer to cause, the fair value of those financial assets to decline by a specified degree below the fair value of those assets when the SPE obtained them (¶42 and 43) (2) Exercise by a BIH (other than the transferor) of a right to put that holder's BI back to the SPE. [¶44] (3) Exercise by the transferor of a call or ROAP [removal-of accounts provision] specified in the legal documents that established the SPE, transferred assets to the SPE, or created the BIs in the transferred assets that it holds. [¶51-54 and 85-88] (4) Termination of the SPE or maturity of the BIs in those financial assets on a fixed or determinable date that is specified at inception. [¶45]			
¶55	A change in law, status of the transferee as a qualifying SPE, or other circumstance may result in the transferor's regaining control of assets previously accounted for appropriately as having been sold, because one or more of the conditions in paragraph 9 are no longer met.			

Crossword Puzzle



Across

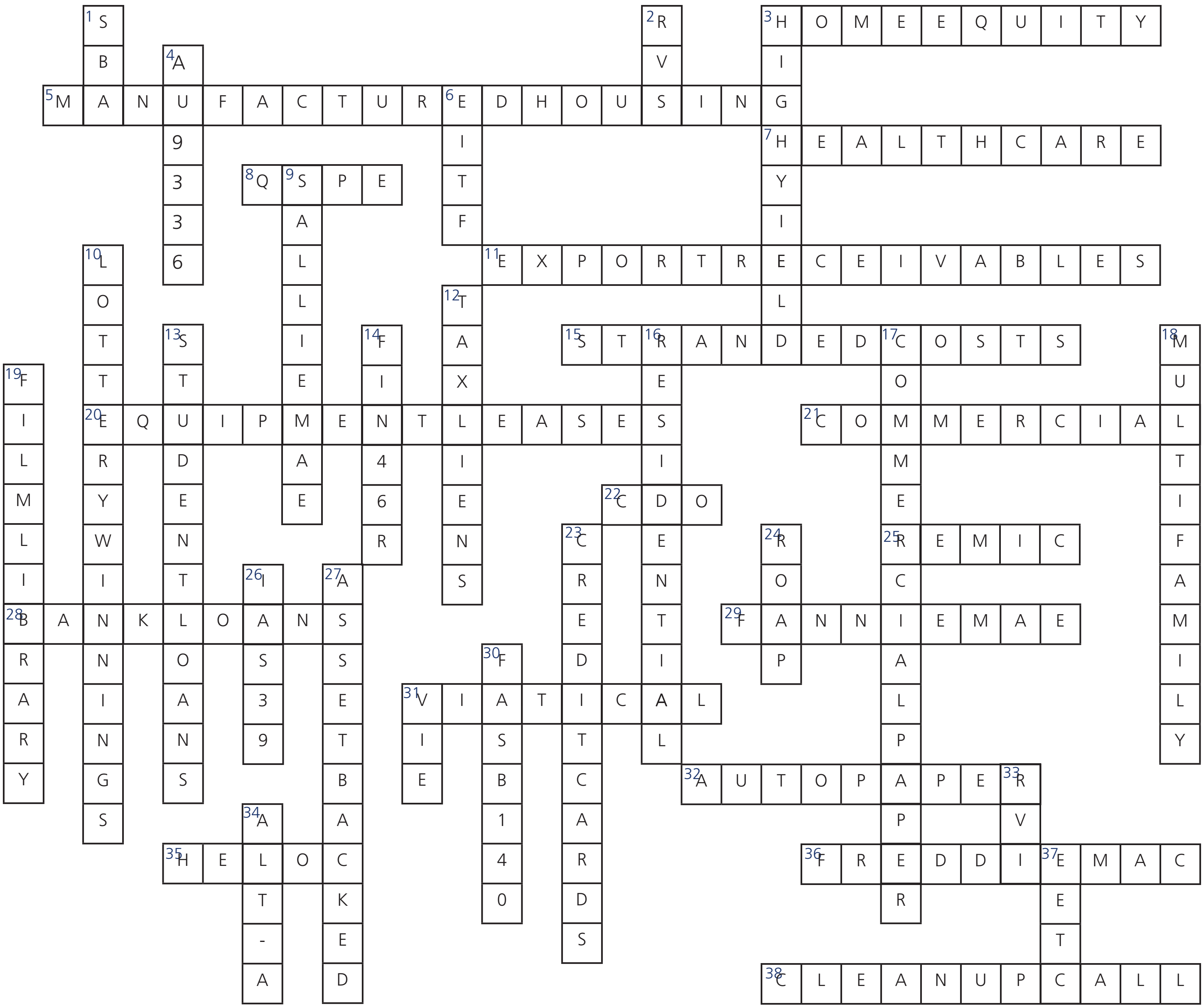
3 Sometimes, a second lien
5 MH
7 Doctor bills, for example
8 The quintessential deal vehicle
11 Foreign trade funding
15 Utility "rescuer"
20 FASB 13 assets
21 Like an "advertisement"
22 A "C" note
25 Tax structure
28 Frequently syndicated
29 "She" GSE
31 Insurance accelerator
32 Notes for the Cars
35 A "lock" for your home
36 "He" GSE
38 Servicer's swan song

Down

1 Commerce Dept. guarantor
2 Retirement rolling stock
3 "Junk" bonds
4 Auditors' rule for lawyers' letters
6 FASB support group
9 "Ex" GSE
10 Scratch-off "scratch"
12 Title clouds
13 "Classy" asset class
14 VIE accounting rule
16 "Prime"ary collateral
17 Rolled over by Beethoven Funding
18 Apartments, for example
19 "Check out" a movie here
23 Purchasing plastic
24 An asset "puller"
26 EU accounting rule
27 The "AB" in ABS
30 US accounting rule
31 A non-Q spe
33 Lease guarantee
34 A low-doc, for example
37 Plane bond

Answers to crossword puzzle are located on page viii

Crossword Puzzle Answers



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To be continued…

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