

Federal Reserve System

**Supervision and Regulation
Task Force on Securitization**

Accounting Issues
relating to Asset Securitization

Vol II of II

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ACCOUNTING ISSUES RELATING TO ASSET SECURITIZATION

SUMMARY

Asset securitization transactions are frequently structured to obtain certain accounting treatments, which, in turn, affect profitability and capital adequacy measures. For bank holding companies and their nonbank affiliates, or for any other entity publishing audited financial statements, these accounting treatments are determined by generally accepted accounting principles (GAAP). Insured commercial banks, on the other hand must report asset securitization transactions in accordance with regulatory reporting requirements as set forth in the instructions to the Reports of Condition and Income (Call Reports).

While these regulatory reporting requirements usually follow GAAP, certain attributes of asset securitization transactions may result in different reporting for regulatory purposes than is prescribed by GAAP. These differences mainly involve asset sales with recourse to the selling bank and the recognition of excess servicing fees arising from the securitization of non-mortgage assets.

The primary accounting issues that arise from asset securitization transactions are summarized below.

1. When asset-backed securities are issued, management must determine whether the transfer should be treated as a sale of the pool of assets or as a collateralized borrowing. When sale treatment is permitted, the asset pool and the related liabilities are removed from the sponsor's balance sheet, thus resulting in higher performance and capital ratios. Treatment of these transactions as financings, on the other hand, retains the pools of assets and related liabilities on the balance sheet. Asset securitization transactions that involve risk retention by the transferring bank will be treated as sales under GAAP when certain criterion are met. However, risk retention will generally result in financing treatment for regulatory reporting requirements.
2. The trust or other entity issuing CMOs or other asset backed securities must be consolidated by its majority owner under GAAP and regulatory principles. In certain other circumstances, it may be

appropriate for the entity to be consolidated by an organization, even when it does not have a majority owner.

3. Certain servicing fees and loan fees should be reported as income for the current period whereas other fees should be deferred and generally recognized over the life of the related loan or some other period. FASB Statements No. 65 and 91 provide most of the guidance in this area. Banking organizations can realize "upfront" income from fees as a result of (a) syndication fees, (b) deferred loan fees related to assets that are sold, and (c) recognition of any excess servicing fees created by the asset securitization process. FASB 65 also requires that purchased loan servicing rights be recorded as intangible assets and amortized as an expense on an accelerated basis when certain criteria are met. However, GAAP and regulatory reporting requirements differ on the treatment of excess servicing fee income arising from the securitization of non-mortgage assets.
4. For banking organizations publishing financial statements in accordance with GAAP, investments in interest-only and principal-only strips should be accounted for in accordance with FASB 91. FASB 91 requires that the carrying value of these assets be adjusted when actual prepayment experience differs from prepayment estimates. Other banks may follow FASB 91 or may carry these at market value or at the lower of cost or market value. Investments in these assets are discussed in the Federal banking agencies' joint supervisory policy on investment portfolios of banks.
5. Since GAAP does not specifically address the accounting for acquired residual interests, investors are typically accounting for these as investments in debt or equity instruments. Majority ownership of residuals might require consolidation of the issuer. For Call Report purposes, asset-backed residuals are treated as debt instruments, accounted for the same as IOs and POs, and should be reported as other assets.

Additional provisions of GAAP standards and regulatory reporting requirements are addressed in the chapter discussion of these accounting issues.

BACKGROUND INFORMATION

The asset securitization process begins with the segregation of loans or leases into pools that are relatively homogeneous with respect to credit, maturity, and interest rate risks. These pools of assets are then transferred to a trust or other entity known as an issuer because it issues the securities or ownership interests that are acquired by investors. These asset-backed securities may take the form of debt, certificates of beneficial ownership, or other instruments. The issuer is typically protected from bankruptcy by various structural and legal arrangements. A sponsor that provides the assets to be securitized owns or otherwise establishes the issuer.

Each issue of asset-backed securities has a servicer responsible for collecting interest and principal payments on the loans or leases in the underlying pool of assets and for transmitting these funds to investors (or a trustee representing them). A trustee monitors the activities of servicers to ensure that they properly fulfill their role.

A guarantor may also be involved to see that principal and interest payments will be received by investors on a timely basis, even if the servicer does not collect these payments from the obligors. Many issues of mortgage-backed securities are either guaranteed directly by GNMA, a government agency backed by the full faith and credit of the U.S. government, or by FNMA or FHLMC, which are government-sponsored agencies that are perceived by the credit markets to have the implicit support of the federal government. Privately issued, mortgage-backed securities and other types of asset-backed securities generally depend on some form of credit enhancement provided by the originator or third party to insulate the investor from some or all of any credit losses. Usually, credit enhancement is provided for several multiples of the historical losses experienced on the particular asset backing the security.

An investment banking firm or other organization generally serves as an underwriter for asset-backed securities. In addition, for asset-backed issues that are publicly offered, a credit rating agency will analyze the policies and operations of the originator and servicer, as well as the structure, underlying pool of assets, expected cash flows, and other attributes of such securities. Before assigning a rating to the issue, the rating agency will also assess the extent of loss

protection provided to investors by the credit enhancements associated with the issue.

Traditional lending activities are generally funded by deposits or other liabilities and both the assets and related liabilities are reflected on the balance sheet. Deposit liabilities must generally increase in order to fund additional loans.

In contrast, the securitization process generally does not increase on-balance sheet liabilities in proportion to the volume of loans or other assets securitized. As discussed more fully below, when banking organizations securitize their assets and these transactions are treated as sales, both the assets and the related asset-backed securities (i.e., liabilities) are removed from the balance sheet. The cash proceeds from the securitization transactions are generally used to originate or acquire additional loans or other assets for securitization and the process is repeated. Thus, for the same volume of loan originations, securitization results in lower assets and liabilities when compared to traditional lending activities.

Asset securitization involves different kinds of capital market instruments. These instruments may be structured as "pass-throughs" or "pay-throughs". Under a pass-through structure, the cash flows from the underlying pool of assets are passed through to investors on a pro rata basis. This type of security is typically a single-class instrument such as a GNMA pass-through. The pay-through structure, with multiple classes, combines the cash flows from the underlying pool of assets and reallocates them to two or more issues of securities that have different cash flow characteristics and maturities. An example is the collateralized mortgage obligation (CMO), which has a series of bond classes, each with its own specified coupon and stated maturity. In most cases, the assets that make up the CMO collateral pools are pass-through securities. Scheduled principal payments, and any prepayments, from the underlying collateral goes first to the earliest maturing class of bonds. This first class of bonds must be retired before the principal cash flows are used to retire the later bond classes. The development of the pay-through structure was a result of the desire to broaden the marketability of these securities to investors who were interested in maturities other than maturity generally associated with pass-through securities. (In legal form, PCs are evidences of ownership in the underlying pool of mortgages, whereas CMOs are debt securities that are collateralized by the

underlying mortgages.)

Multiple-class, asset-backed securities may also be issued as derivative instruments such as "stripped" securities. Investors in each class of a stripped security will receive a different portion of the principal and interest cash flows from the underlying pool of assets. In their purest form, stripped securities may be issued as interest-only (IO) strips, for which the investor receives 100 percent of the interest from the underlying pool of assets, and as principal-only (PO) strips, for which the investor receives all of the principal.¹

In addition to these securities, other types of financial instruments may arise as a result of asset securitization. One such instrument is loan servicing rights that are created when organizations purchase the right to act as servicers for pools of loans. The cost of these purchased servicing rights may be recorded as an intangible asset when certain criteria are met. Another financial instrument, excess servicing fee receivables, generally arise when the present value of any additional cash flows from the underlying assets that a servicer expects to receive exceeds standard normal servicing fees. Another instrument, asset-backed securities residuals (sometimes referred to as "residuals" or "residual interests"), represents claims on any cash flows that remain after all obligations to investors and any related expenses have been met. Such excess cash flows may arise as a result of overcollateralization or from reinvestment income. Residuals can be retained by sponsors or purchased by investors in the form of securities.

Securitized asset transactions must be reported in audited financial statements and in reports filed with the Securities and Exchange Commission (SEC) in accordance with generally accepted accounting principles (GAAP). Statements, interpretations, and technical bulletins of the Financial Accounting Standards Board (FASB) are the primary sources of GAAP for public and private companies in the U.S. However, in the absence

¹The Federal Reserve Board has issued a supervisory policy statement, dated April 20, 1988, on investment practices and other matters, which addresses these instruments. These securities are very volatile and may be unsuitable for an institution's investment portfolio, particularly if held in significant amounts. State member banks should consult this policy statement before acquiring these instruments.

of a FASB pronouncement addressing a specific accounting practice, organizations look to formal interpretations of the American Institute of Certified Public Accountants (AICPA) for guidance.

In addition, consensus positions of the FASB's Emerging Issues Task Force (EITF) provide interpretations of GAAP for specific issues relating to new transactions. While FASB and EITF pronouncements were not designed to address all asset securitization instruments, their guidance is typically applied by analogy to a wide variety of transactions. As part of its Financial Instruments Project, FASB plans to develop a comprehensive accounting and disclosure framework for all financial instruments, including asset-backed securities.

The SEC requires public companies such as public bank holding companies, to prepare their financial statements in accordance with GAAP and expects them to also adopt accounting practices that are consistent with the consensus positions of the EITF. It has also issued accounting and disclosure guidance that must be followed by public companies with respect to certain matters that have not been addressed by FASB or the AICPA.

In financial reports filed with the Federal Reserve Board under Regulation Y, bank holding companies must report asset securitization transactions in accordance with GAAP. Insured commercial banks, on the other hand, must report asset securitization transactions in the Reports of Condition and Income (Call Reports) in accordance with regulatory reporting requirements, which usually follow GAAP.² Regulatory reporting requirements for banks are contained in the instructions and glossary for the Call Reports issued by the Federal Financial Institutions Examination Council (FFIEC) and reflect consensus positions of the federal banking agencies.

²Regulatory reporting requirements for the asset securitization transactions of savings and loan associations are generally consistent with GAAP.

PRIMARY ACCOUNTING ISSUES

For insured commercial banks that invest in asset backed securities and related derivative instruments, the treatment of these assets under GAAP and regulatory reporting requirements is generally consistent. Investments in asset backed securities would generally be classified as Securities, carried at amortized cost, and otherwise be accounted for the same as any other securities investment. Reporting these securities as investments would be appropriate as long as the banking organization has the intent and ability to hold asset backed securities to maturity. Asset backed securities held for trading purposes, on the other hand, should be segregated, held in a trading account, and reported at market value or the lower of cost or market value. In addition, under both GAAP and regulatory reporting requirements, assets or asset pools which a banking organization is planning to securitize and sell must be carried at the lower of cost or market value.

CMO residuals, other asset-backed securities residuals, and excess servicing right receivables held by a bank would generally be reported as Other Assets. These instruments have given rise to a number of accounting issues, as have stripped asset-backed securities. Special regulatory reporting requirements for these instruments are discussed later in this volume.

For banks that are issuers or sponsors, the structure of asset securitization transactions and the risks retained by the issuing bank have given rise to different criteria for sales treatment (as opposed to financing treatment) under GAAP and regulatory reporting requirements. As a result, the design of particular structures and the related risk retention framework can have important accounting ramifications and can raise numerous supervisory concerns.

The principal accounting matters involved in asset securitization pertain to:

- o Sale vs. financing treatment for the sponsor or issuer;
- o Consolidation of the issuing entity by the sponsor or other entity;
- o Treatment of fees;
- o Equity or residual interests; and
- o Interest-only and principal-only strips.

The accounting treatments that result from the application of GAAP and regulatory reporting requirements are summarized below as they apply to these broader accounting issues.

Sale vs. Financing Treatment

The primary issue affecting the issuing bank is whether the issuance of the securities or evidences of ownership in the of assets should be reported as a sale of the pool of assets or as a transaction financing the ownership of the pool. If the transaction is viewed as a financing, the pool of assets must remain on the balance sheet and the capital instruments issued must be recorded as liabilities. However, if the transaction is reported as a sale, the pool of assets must be removed from the balance sheet.

Sales treatment generally results in lower total assets and liabilities and in higher performance ratios. In addition, in connection with asset sales without recourse, the removal of these securitized assets from the balance sheet would result in higher capital ratios. Therefore, banking organizations have generally sought to structure these transactions as sales.

Transfers of assets are treated as sales if, in substance, they involve transfers of all of the risks and rewards of ownership of the assets. Therefore, transfers of receivables not involving recourse would generally be treated as sales under GAAP. This treatment has developed under established accounting practice. Also, as long as all risks are transferred by the issuing bank, this sales treatment under GAAP is consistent with regulatory reporting requirements. However, it is possible for a transfer of assets involving recourse to be accounted for as a sale under GAAP as long as the future economic benefits are forfeited and the expected losses can be reasonably estimated. On the other hand, the existence of any recourse to the issuing bank (e.g., via ownership of a put option by the buyer) automatically results in treatment of the transfer as a financing under regulatory reporting requirements.

Under GAAP, there are two main sources of guidance relevant to the determination of "sale vs. financing" treatment of asset securitization transactions: (a) FASB Statement No. 77, Reporting by Transferors for Transfers of Receivables with Recourse (FASB 77), issued in December 1983, and (b) FASB

Technical Bulletin (TB) 85-2, Collateralized Mortgage Obligations. In addition, FASB's EITF has issued consensus interpretations of GAAP which address some asset securitization issues.

Under both GAAP and regulatory reporting requirements, retention of servicing rights by the issuing or sponsoring bank does not generally affect the determination of sales vs. financing treatment. In addition, banks which purchase servicing rights do not have to reflect the assets being serviced on their balance sheets. Moreover, organizations that are secondarily liable because they are guarantors do not have to reflect the guaranteed assets on their balance sheet.

Assets sold with recourse under GAAP

FASB Statement No. 77 defines recourse as the right of a transferee of receivables to receive payment from the transferor for the "failure of the debtors to pay when due, effects of prepayments, or adjustments resulting from defects in the eligibility of the transferred receivables." Statement 77 establishes three criteria that, if satisfied, permit a transfer of receivables with recourse to be recognized as a sale of the assets rather than as a financing transaction:

- (a) the transferor surrenders control of the future economic benefits relating to the receivables,³
- (b) the transferor can reasonably estimate its obligation under the recourse provisions, and
- (c) the transferee cannot return the receivables to the transferor except pursuant to the recourse provisions.⁴

³According to Statement 77, control has not been surrendered if the transferor has an option to repurchase the receivables at a later date. However, a right of first refusal based on a bona fide offer by an unrelated third party ordinarily is not an option to repurchase.

⁴According to Statement 77, some transfer agreements require or permit the transferor to repurchase the transferred receivables when the amount of outstanding receivables is minor. This is done in order to keep the cost of servicing those receivables from becoming unreasonable. If these reversionary interests are not significant to the transferor, these interests alone will not preclude the recognition of a transfer as a sale.

When the transfer of assets is deemed to be a sale in accordance with these criteria, the assets that have been sold are removed from the transferor's books. At the same time, the amount of losses estimated to accrue to the seller under the recourse provisions must be recorded as a direct liability on the seller's books. This balance sheet liability (the recourse liability account) must be periodically adjusted to reflect any changes in such loss estimates. The sales gain or loss is the difference between the sales price, adjusted for this accrual of estimated losses, and the net receivables (gross receivables, including any fees or charges owed by the debtors included therein, less the unearned portion of these fees and charges).

Assets sold under CMO structures (GAAP)

CMOs must meet stricter criteria in order to obtain sales treatment. Under the provisions of TB 85-2, CMOs should be presumed to be financings "unless all but a nominal portion of the future economic benefits inherent in the associated collateral have been irrevocably passed to the investor and no affiliate of the issuer can be required to make future payments with respect to the obligation." All of the following criteria must be met in order for a CMO transaction to be accounted for as a sale:

- (a) The issuer and its affiliates surrender the future economic benefits embodied in the collateral securing the obligation.
 - i) They can not have the right or obligation to substitute collateral or obtain it by calling the obligation.
 - ii) The expected residual interest (including excess servicing fees), if any, in the collateral is nominal (extremely small).
- (b) No affiliate of the issuer can be required to make any future payments with respect to the obligation.
 - i) The investor can look only to the issuer's assets or third parties (e.g., insurers or guarantors) for repayment of principal and interest on the obligation. Neither the sponsor nor any other affiliates of the issuer can be secondarily liable.
 - ii) Neither the issuer nor its affiliates can be required to redeem the obligation prior to

its stated maturity other than through the normal pay-through of collections on the collateral.

If the CMO meets these sale criteria, the collateral is removed from the balance sheet of the issuer and a gain or loss is recognized. At this point, the issuer is effectively a "shell" organization with no assets or liabilities. Its sole purpose was to act as a conduit to remove the assets from the balance sheet of the sponsoring firm. Any expected residual interest should not be recorded as an asset. Instead, the residual interest should be recorded as income as it accrues to the issuer or its affiliates.

Call Report instructions for assets sold with recourse

The treatment of recourse transactions for purposes of the commercial bank Call Reports was adopted long before the issuance of FASB 77 and has since been reaffirmed by the federal banking agencies. Prior to the adoption of FASB 77, the treatment of sales of assets with recourse under GAAP was the same as that specified in the Call Report instructions. The Call Reports currently contain a general rule applicable to "sales of assets" (other than participations in pools of residential mortgages) that provides that a transfer of loans or other assets is to be reported as a sale "only if the transferring institution:

- (1) retains no risk of loss from the assets transferred resulting from any cause and
- (2) has no obligation to any party for the payment of principal or interest on the assets transferred resulting from any cause.

A transfer involving any retention of risk or obligation for payment, even if limited under the terms of the transfer agreement, is considered a borrowing transaction and the entire amount of the assets transferred must remain on the books of the transferring institution.

Effect of an escrow or "spread" account on sale treatment under the general rule

Asset securitization of consumer credit, e.g., credit card receivables and auto loans, typically includes the establishment of an escrow or spread account to cover losses or make up delinquent payments on the loans backing the securities. As a result, the investor

is protected from borrower defaults or delinquencies. Usually, a bank will sell a participation in a pool of consumer loans, with servicing commonly retained, at the going market rate of interest that is less than the rate paid by the borrowers on the consumer loans. The differential includes a normal servicing fee while the remaining amount represents funds that would be placed in the escrow account. The amount of funds that will eventually be placed into the escrow account under contractual agreements underlying the asset securitization transaction is usually based on the selling bank's historical loss experience plus an amount providing an additional "cushion" against losses.

On November 21, 1986, the FFIEC announced an interpretation of the Call Report guidance for asset sales related to these escrow accounts. Under this interpretation, the existence of such accounts as part of asset securitization transactions (involving transfers without recourse) would not in and of itself require the transaction to be reported as a financing if, once these accounts have been treated as a sale under GAAP, there is no further possible charge against earnings or capital of the selling bank during the period that the transferred loans remain outstanding.

The residential mortgage exception to the current Call Report instructions

Under the separate instruction for "participation in pools of residential mortgages," banks that are engaged in the disposal of residential mortgage loan pools under the programs of the Government National Mortgage Association (GNMA), Federal National Mortgage Association (FNMA), and Federal Home Loan Mortgage Corporation (FHLMC) are able to treat such transactions as sales of the underlying mortgages without regard to the amount of risk retained by the seller.

Banks that sell "private" certificates of participation in pools of residential mortgages, (i.e., not sold through a government agency program) are permitted to treat such transactions as sales only when the selling "bank does not retain any significant risk of loss, either directly or indirectly." The FFIEC views such recourse as being significant when the maximum contractual exposure under the recourse provision (or through retention of a subordinated interest in the mortgages) at the time of the transfer is greater than the amount of the probable loss that the bank has reasonably estimated that will be incurred on the

transferred mortgages. Thus, the issuing bank has retained the entire risk of loss and the transfer of mortgages must be reported as a financing transaction.

The automatic sale treatment for Call Report purposes of sales of residential mortgage loan pools under the secondary mortgage market programs of the three U.S. Government agencies was devised at a time when such sales involved little or no risk retention by the selling bank in the event of default on mortgages included in the pool. However, in recent years these agencies' programs have changed and the entities assembling the mortgage pools have maximized the price they can obtain for the mortgages they sell by retaining more of the risk of loss on the underlying mortgages. In many cases, the sellers retain 100 percent of the risk of loss. Nonetheless, these transactions have been treated as sales under both GAAP and the Call instructions.

In addition, although the banking agencies had intended their "no significant risk of loss" test for sales of residential mortgage pools under private programs to mean that sale treatment would apply only when the risk retained by the seller was only slightly greater than zero. In recent years, the marketplace for such pools has reportedly come to interpret "no significant risk of loss" to include a transfer in which the "selling" bank retains risk up to ten percent of the amount of the pool. Since the definition of "significant" was only just clarified for the March 31, 1989 Call Report date, it is likely that some banks engaging in transfers of residential mortgage pools with up to ten percent limited recourse, that are not part of government agency secondary market programs, are reflecting such transactions as sales in their Call Reports. As a result, mortgage loan pools sold in the secondary market under GNMA, FNMA, and FHLMC programs and some pools sold privately have previously received a more favorable treatment than other types of loan sales even though the selling bank has retained some or all of the risk of loss on the mortgage sold.

Contrast between GAAP and the Call Report instructions

FASB 77 uses criteria for recognizing a transfer of receivables as a sale that are based on the transfer of the benefits of ownership rather than on the transfer of both the benefits and the risks of ownership. For regulatory reporting purposes, primacy has been given to the incidence of risk: where does the risk reside after the transfer of an asset. In transactions that are, in substance, recourse arrangements, all or some

portion of the risk is retained by the transferor. The supervisory staffs of the three federal banking agencies, under the auspices of the FFIEC, considered at length whether to adopt FASB 77 for Call Report purposes, concluding in October 1985 that the retention-of-risk standard used for determining whether a sale has occurred for Call Report purposes should be retained. The banking agencies cited a number of reasons for their decision not to adopt FASB 77 for regulatory reporting.

Supervisory concerns

FASB 77 establishes as a necessary condition before a transfer with recourse can be treated as a sale that "the transferor's obligation under the recourse provisions can be reasonably estimated." The banking agencies acknowledge that it may be possible to make such estimates for pools of consumer loans or residential mortgages, but have taken the position that it is very difficult, if not impossible, to do so for such other types of loans as commercial loans, construction loans, and loans to less developed countries. Furthermore, what is a "reasonable" estimate at the time an asset is transferred may not turn out to be reasonable at a later date. Hence, the banking agencies have considered the existence of a risk to the transferor a more relevant criteria for supervisory purposes than the transferor's ability to estimate the risk.

In some asset transfers, the transferor may be subject to a partial or limited recourse provision. Even when the terms of the transfer ostensibly seem to provide only limited recourse, the recourse may, in fact, be total. For example, in the transfer of a group of high quality assets with a "reasonably estimated" loss rate of one percent, if the transferor assumes the risk of default up to a maximum of ten percent of the total dollar value of the assets transferred, the transferor effectively retains the entire risk inherent in the assets transferred.

One final supervisory concern about allowing the use of FASB 77 for regulatory reporting exists. When "sales" can only be made with recourse, as opposed to selling assets at enough of a discount to insulate the purchaser of the assets from all but catastrophic losses, there may be a tendency for a bank to "sell" only its highest quality assets and keep those of lower quality.

The supervisory concerns about the risks a transferor retains in a recourse transaction derive from the necessity for the banking agencies to identify and

evaluate the risks to which an institution is exposed in order to evaluate the overall condition of a bank and assess whether its capital is adequate in light of these risks. In fact, the Call Report instruction governing the general "sales of assets" rule states that the retention-of-risk "rule for reporting transfers ('sales') of assets is for purposes of... agency determination of capital adequacy." Under the agencies' leverage ratios, i.e., primary and total capital to total assets, which are calculated on the basis of total assets from the Call Report, risks that are off the balance sheet are not explicitly incorporated into the computation of a bank's capital ratio. By requiring banks to include in their Call Report balance sheets assets transferred with recourse that would otherwise be removed from their GAAP balance sheets, the agencies have indirectly imposed a capital requirement on what would in many cases be an off-balance sheet activity under GAAP.

The special reporting requirements for transfers involving residential mortgages were adopted so as not to hamper the development of the secondary mortgage markets. When these reporting requirements were adopted, sales of residential mortgages entailed little or no risk retention by the selling institution. The FFIEC is now reviewing the general regulatory reporting treatment of asset sales with recourse. In connection with this review, the FFIEC is also evaluating the need for the special reporting requirements for residential mortgage sales and the appropriate way to apply capital requirements to transfers of residential mortgages with recourse. The FASB is also reviewing GAAP accounting standards in conjunction with its Financial Instruments Project and expects to develop a comprehensive set of accounting standards for all financial instruments, including those associated with asset securitization.

SEC Guidelines for securitization of problem assets

The Securities and Exchange Commission (SEC) staff has published its views on accounting for transfers of nonperforming assets by financial institutions to newly-formed entities (i.e., so-called "good bank/bad bank" transactions) in Staff Accounting Bulletin (SAB) No. 82. This prospective guidance also addresses the need for appropriate disclosure of the impact of financial assistance from regulatory agencies.

SAB 82 states that the transfer of nonperforming assets by a bank (or other financial institution) to the newly-formed entity should not be accounted for as a sale

unless both the risks and rewards of ownership have been transferred. Such transfers could not be accounted for as sales when the following exist:

Risks of ownership

- a. The new entity has recourse to the transferor bank;
- b. The transferor bank guarantees the debt of the new entity in whole or in part;
- c. The fair value of any significant non-cash consideration (e.g., a note or other redeemable instrument) received by the transferor bank cannot be reasonably estimated;
- d. Third party holders of residual equity interests do not have a significant amount of capital at risk;

Rewards of ownership

- e. The transferor bank participates in the rewards of ownership of the transferred assets (e.g., through a higher than normal incentive or other management fee arrangements); or
- f. The transferor bank retains rewards of ownership through holding significant residual equity interests.

Transfers having any of the above attributes should generally be accounted for as financings. Thus the nonperforming assets should remain on the balance sheet and the debt of the newly-formed entity would be reflected as a liability of the transferor bank.

When transfers of nonperforming assets meet the above sales criteria:

- a. The transfers should be recorded at the fair value of the assets transferred or, if more clearly evident, the fair value of the assets received (SAB 82 describes fair value as the amount that would be realizable in an outright sale for cash and summarizes certain accounting rules that should be followed in this area); and
- b. The selling bank must record a loss for any excess of the net carrying value (i.e., carrying value less any allocable allowance for credit

losses or other valuation allowances) of the transferred assets over their fair value.

When the transfer is appropriately accounted for as a sale and a portion of the consideration received are notes or other redeemable instruments, the transferor bank must determine the appropriateness of recording profits on any management fee arrangements, or interest or dividends on the instrument received. Although it is not explicitly stated, the SAB infers that it may be necessary in some cases to defer such income or reflect such amounts as income on a cost recovery basis (i.e., apply cash flows first to reduce the carrying value of the instrument to zero; then reflect any additional cash received as income).

Also, as previously noted, sales treatment will not be appropriate when the fair value of any significant non-cash consideration (e.g., a note or other redeemable instrument) received by the transferor bank cannot be reasonably estimated.

In addition, when the instruments received by the transferor bank represent subordinate claims on the new entity and the permanent equity of the new entity is eliminated by losses, SAB 82 would generally require the bank to record the probable loss that it expects to incur in its investment.

SAB 82 requires that financial assistance received from Federal regulatory agencies should be separately disclosed and identified in financial statements and statistical information filed with the SEC. In addition, the nature, extent and impact of such assistance should be fully discussed in management's discussion and analysis (MD&A) sections of the SEC registrant's financial reports.

Consolidation of the Issuer by the Sponsor

In general, controlled subsidiaries must be consolidated by their parents. Control is generally evidenced by majority ownership but may also be evidenced by other arrangements of the parent and the issuer. GAAP requires that all majority-owned subsidiaries be consolidated and, more specifically, FASB TB 85-2 requires the sponsor to consolidate a majority-owned CMO issuer. Therefore, issuers that are majority-owned must be consolidated.

The existence of explicit or implicit guarantees of the issuer's debt by a sponsor that does not technically own the issuer may also warrant consolidation of the issuer. In addition, consolidation by a majority owner of the residual interests in the issuer, although not a sponsor, may be appropriate.

However, if the asset securitization transaction is accounted for as a sale, consolidation of the issuer is not really an issue since, as a result of sale treatment, the pool of the underlying assets is removed from the issuer's balance sheet.

Treatment of Fees

Securitization of assets will generally involve a number of different types of fees, including various types of loan fees, servicing fees and other fees associated with the asset structure. Banking organizations can realize "upfront" income from fees as a result of (a) syndication fees, (b) deferred loan fees related to assets that are sold, and (c) recognition of any excess servicing fees created by the asset securitization process. While a detailed discussion of these fees and appropriate accounting methods is beyond the scope of this paper, certain key points and considerations are summarized below.

Loan fees

Accounting for loan fees is prescribed by two main FASB Statements: (a) No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases and (b) No. 65, Accounting for Certain Mortgage Banking Enterprises, as amended. Statement 91 addresses loan fees for all lending activities of organizations in general while Statement 65 addresses fees and other matters that specifically relate to mortgage banking operations of banks, savings and loans, and, of course, mortgage bankers.

Statement 91 describes loan fees as origination fees, commitment fees and syndication fees. It requires loan origination fees to be recognized over the life of the loan as an adjustment of yield. Commitment fees must generally be deferred and recognized as an adjustment of yield over the life of the related loan, or recognized in income upon expiration of the commitment (commitment fees meeting certain specific criteria may be recognized

over the commitment period). Fees earned by banks for managing syndications, on the other hand, may generally be recognized in income once the syndication is complete.

Statement 65 complements this approach by requiring that loan origination fees and related costs that pertain to mortgage loans held for resale must be deferred until the loan sale occurs. Also, in connection with these loans, fees received for arranging a commitment directly between a permanent investor and a borrower (loan placement fees) must be recorded as income when all significant services have been performed. In addition, in all mortgage banking situations, fees representing reimbursement for the costs of specific loan origination services performed by third parties must be recognized as income when the services have been performed. Except for these provisions, the accounting treatment prescribed by Statement 91 must generally be followed for all other lending related activities associated with mortgage banking.

Once a securitized asset transaction is deemed to be a sale, the loan fees that pertain to the assets sold that were deferred in accordance with FASB Statement 91 can be recognized in current period income. Thus, securitization activities that are treated as sales will accelerate the recognition of income. However, deferred loan fees for any portion of these assets retained, or for securitization transactions that are financings, must continue to be recognized over the life of the related loans in accordance with Statement 91.

Servicing Fees and Mortgage Servicing Rights

A bank or other organization may buy or originate loans and then sell these loans to investors but retain the right to service these loans. Servicing generally entails collecting monthly payments from debtors; forwarding payments and related accounting reports to investors or their trustees; collecting escrow account deposits for the payment of property taxes and insurance; and paying taxes and insurance from escrow accounts when due.

Servicing fees must be accrued as income over the life of the servicing contract as they are earned. If servicing will be provided as part of the securitization transaction, but an explicit servicing fee is not charged, both FASB Statement 77 and TB 85-2 require that a normal servicing rate be determined and

a portion of the sales proceeds must be deferred in order to provide for a normal servicing fee in each subsequent servicing period.

Under GAAP and regulatory reporting requirements, when servicing rights pertain to loans that the banking organization has originated, the expected future benefits resulting from these retained servicing rights may not be reflected as an asset. This would also be the case for servicing rights pertaining to purchased loans which are on a banking organization's balance sheet, except when certain criteria, which are discussed below, are met. These benefits must be recognized in income in future periods as they are earned.

Organizations may acquire servicing rights from others (a) separately, (b) in a purchase of mortgage loans, or (c) in a business combination. These purchased servicing rights are recorded as intangible assets under GAAP and regulatory reporting requirements based upon the cost of acquiring the rights, subject to certain conditions. These conditions and other accounting guidelines used for loan servicing rights may generally be derived by analogy from the specific accounting standards for mortgage servicing rights prescribed by FASB Statement No. 65, and FASB TB 87-3, Accounting for Mortgage Servicing Fees and Rights.⁵

FASB Statement No. 65 requires that the amount recorded as a mortgage servicing right intangible asset must not exceed the amount by which the present value of estimated future servicing revenues exceeds the present value of expected future servicing costs. Estimates of future servicing revenue must include expected late charges and other ancillary revenue. Estimates of expected future servicing costs must include direct costs associated with performing the servicing function and appropriate allocations of other costs. The rate used to discount the present value must be an appropriate long-term interest rate.

When mortgage servicing rights are acquired in connection with a purchase of mortgage loans, the

⁵The FASB Emerging Issues Task Force (EITF) has addressed a number of accounting issues relating to mortgage servicing rights. Consensus positions on these issues provide interpretative guidance on mortgage servicing rights, and by analogy, to other loan servicing rights. The asset securitization accounting issues that the FASB EITF has addressed are listed in Appendix A.

following criteria must be met before the portion of the purchase price representing the cost of acquiring the servicing rights may be recorded as a mortgage servicing right intangible asset:

1. When the mortgage loans are purchased, a definitive plan for the sale of these mortgage loans must exist. A definitive plan exists if:
 - a. The organization has obtained, before the purchase date, commitments from permanent investors to purchase the mortgage loans or related mortgage-backed securities, or makes a commitment, generally no more than 30 days after the purchase date, to sell the loans or related mortgage-backed securities to a permanent investor or underwriter, and
 - b. The plan includes estimates of the purchase price and selling price.
2. The amount recorded as a mortgage servicing right intangible asset must not exceed:
 - a. The purchase price of the loans, including transfer fees paid, in excess of the market value (at the purchase date) of the loans without servicing rights, or
 - b. The present value of the net servicing income (determined in accordance with the provisions of the previous paragraph).
3. The mortgage servicing right intangible must be reduced by any amount that the final sales price of the mortgage loans to the permanent investor exceeds the market value of the loans at the purchase date.

In all cases, mortgage servicing right intangible assets must be amortized over the period of the estimated net servicing income (i.e., servicing revenue in excess of servicing cost). The amortization method must result in an amortization expense that is proportionate to the estimated net servicing income. Because of mortgage repayments and prepayments, this requirement of FASB Statement No. 65 will generally result in an accelerated amortization method.

FASB TB 87-3 states that mortgage servicing right intangible assets may need to be adjusted when the serviced loans are refinanced by the servicer. An

adjustment would be necessary when the loan prepayments (i.e., resulting from the refinancing) were not anticipated by the servicer and reflected in the initial calculation of the servicing asset. Any adjustment required by unanticipated prepayments must be reflected in current income or expense and not by adjusting future amortization expense.

Excess Servicing Fees

Excess servicing fees can arise in asset securitization transactions involving all types of loans when the seller retains servicing rights related to the underlying asset pool that has been sold. However, FASB pronouncements have generally only addressed the appropriate accounting for excess mortgage servicing. This guidance can usually be applied by analogy to asset securitization transactions involving other loans.

Excess mortgage servicing arises when the spread between mortgage-backed securities and the underlying mortgages is greater than the combined amount of the guarantee fee paid to the secondary market maker (FNMA, for example) and the normal servicing fee received by the selling bank. The residual amount is excess servicing. Generally accepted accounting principles (GAAP) requires that the present value of the future income stream be treated as an immediate gain on the income statement and that an asset be set up, sometimes termed "excess servicing fee receivable" or "deferred premium," and amortized over the expected life of the underlying mortgages.⁶

For Call Report purposes, however, an asset and immediate gain may not be recorded for excess servicing fees related to sales of non-mortgage assets. Instead, excess servicing fees must be reported as income as they are realized over the life of the assets qualifying for sale treatment under Call Report requirements.

According to an interpretation of Statement 91 by the FASB's EITF, under GAAP, when an organization experiences unanticipated prepayments, the carrying value of excess servicing should be written down to the present value of the estimated remaining future excess service

⁶Unlike the mortgage servicing right asset, which is classified as an "intangible asset", this excess servicing receivable would generally be classified as an "other asset".

fee income. The excess servicing fee receivable should not be adjusted upwards for favorable changes in actual prepayment rates. However, the amortization would be adjusted prospectively.

As an illustration of how excess servicing develops under GAAP, consider a pool of mortgages, with a weighted average interest rate of 10 percent, that are securitized, by FNMA, with a coupon rate of 9.25 percent. Of the remaining 75 basis point (bps) spread, 25 bps are a fee to FNMA for its guarantee of the timely payment of principle and interest on the securitized mortgages, another 25 bps is a normal servicing fee retained by the selling bank, and the remaining 25 bps are the excess servicing. The 25 bps servicing fee received by the selling bank has a normal or expected profit margin built in the fee and is not considered excess servicing.

The FASB defines a "normal" servicing fee in FASB Statement No. 65 (FASB 65), Accounting for Certain Mortgage Banking Activities, as a servicing fee rate that is representative of servicing fee rates most commonly used in comparable servicing agreements covering similar types of mortgage loans. However, the definition was vague and lead to various interpretations. In response to a number of questions raised, FASB issued Technical Bulletin 87-3, Accounting for Mortgage Servicing Fees and Rights, in which a normal servicing fee is defined as the minimum servicing fee rates specified by the secondary market makers, e.g., GNMA, FNMA, and FHLMC, for transactions with them. Anything less than the minimum servicing fee rate is not considered a normal servicing fee.

For transactions with private sector investors, TB 87-3 states that the servicer should consider the normal servicing fee rate that would apply to comparable transactions with the federally sponsored agencies. If these agencies do not do comparable sales, then the company must determine the predominant servicing rates used by major private-sector secondary market makers and consider this the normal servicing rate for similar loans.

FNMA considers 25 bps to be a normal servicing fee, whereas, GNMA is generally 50 bps and FHLMC has a standard fee of 37.5 bps. Commercial banks have been following this practice relatively closely, however, a substantial number of thrifts have used normal servicing fees much lower than those specified by the market makers. The thrifts argue that normal servicing should be a flexible figure sufficient to cover costs and a

reasonable profit. Therefore, larger, more efficient servicers would have lower normal servicing fees than other lower volume servicers.

The rationale behind the desire for low servicing fees is that with a given spread, the lower the normal servicing fee excess servicing and the resulting net income, capital, and asset item.

Besides the initial interest rate spread and the normal servicing fee, there are several other factors that are important in determining the volume of excess servicing that an institution can book on its balance sheet.

First, there is the assumption that the institution makes on the average life of the block of mortgages sold, from which the present value of the future stream of servicing income is derived. The longer the life expectancy of the mortgages, the greater the amount of excess servicing that can be booked as an asset receivable and capital (done indirectly through the income statement). Second, assumptions must be made about the discount rate or reinvestment rate that is used in the present value calculation. The lower the assumed discount rate used in the valuation, the more excess servicing available to the institution. FASB Statement 65 offers no specific guidance with respect to the discount rate except to say that the rate used should be an appropriate long-term interest rate. However, many institutions use their internal cost of funds which is usually lower than long-term market rates.

Other factors that will affect the "excess servicing fee receivable" and related income include the assumption made with respect to the annual amortization rate (which may differ from the assumed life expectancy above) and the provision made for mortgage prepayments.

Some savings and loan associations have booked "excess servicing receivables" in amounts that range from 194 percent to 300 percent of tangible net worth. Historically, banks have been more conservative in establishing carrying values for these assets but the potential for abuse exists for banks and bank holding companies with large mortgage servicing activities that are experiencing earnings pressure.

Other Fees

Another common fee associated with asset securitization is the guarantee fee which the bank servicing the mortgages pays to the secondary market makers. The guarantee fee, based upon the outstanding principal amount, is a charge for the governmental entities' guarantee to investors that they will receive timely payment of principal and interest (or in FHLMC's case, the timely payment of interest and the ultimate payment of principal).

In most cases, when a bank sells mortgages to FNMA or FHLMC, they continue to service the transferred mortgages. The transferring bank usually has to choose between two guarantee fees depending upon whether it assumes the risk of loss on the transferred mortgages. Over the last few years, it has become more and more common for banks to pay the lower guarantee fee and retain the entire risk of loss on the mortgages sold.

Interest-Only and Principal-Only Strips

As previously mentioned, multiple-class asset backed securities may also be issued as stripped securities, with each class receiving a different portion of principal and interest cash flows from the underlying pool of assets. In their purest form, stripped securities may be issued as interest-only (IO) strips, where the investor receives 100 percent of the interest cash flows received from the underlying pool of assets, and as principal-only (PO) strips, where the investor receives all of the principal cash flows from this collateral.

Under the Federal Reserve's investment policy, IOs and POs may be unsuitable for an institution's investment portfolio, particularly if held in significant amounts. Generally, these guidelines state that state member banks should not invest in stripped mortgage backed securities, such as IOs and POs, unless they have highly sophisticated and well managed securities portfolios, mortgage portfolios, or mortgage banking functions. In such institutions, however, the acquisition of IOs and POs should only be undertaken in conformance with carefully developed and documented plans prescribing specific positioning limits and control arrangements that have been approved by the bank's board of directors.

Generally, POs increase in value when interest

rates decline (since prepayments shorten the maturity of mortgages), while IOs increase in value when interest rates rise (since prepayments decline, maturities lengthen, and more interest is collected on the underlying mortgages). Therefore, the purchase of a PO is sometimes viewed as useful to offset the effect of interest rate movements on the value of mortgage servicing, and the purchase of an IO is sometimes viewed as useful to offset interest rate risk associated with mortgages and similar instruments of banks.

However, when purchasing an IO or PO the investor is speculating on future interest rate movements and how these movements will affect the prepayment of the underlying collateral. Furthermore, stripped mortgage backed securities that do not have the guarantee of a government agency or government-sponsored agency as to principal and interest have an added element of credit risk.

For regulatory reporting purposes, banks publishing financial statements in accordance with GAAP must account for these instruments in accordance with FASB Statement No. 91, which requires that the carrying amount of IOs be adjusted when actual prepayment experience differs from prepayment estimates.⁷ Other banks may follow FASB Statement 91 or account for these at market value or the lower of cost or market value.

Equity or Residual Interests

Residual interests are the expected excess cash flows from an asset securitization transaction after the payments due to bondholders (or other investors) and the trust administrative expenses have been satisfied. These cash flows are extremely sensitive to prepayments, and thus have a high degree of interest rate risk. Generally, the value of residuals rises when interest rates rise because, as a result of prepayment rate declines, more interest is earned as the average life of asset backed securities lengthens.

Residuals have attributes of both debt and equity instruments. They are like debt because they provide for the periodic distribution of cash flows, they have limited lives, and investors buy them for their

⁷This treatment and its application to IOs is specifically discussed in FASB EITF Issue 86-38.

expected yield. On the other hand, they seem like equity instruments because they usually are the most junior security as far as the asset backed security's cash flows are concerned, are sometimes in the form of common stock or partnership interests, and are generally expected to cover short falls in the operating cash flows of the issuer.

As previously mentioned, TB 85-2 forbids recording residual interests as an asset when CMOs qualify for sale treatment. However, GAAP has not comprehensively addressed other issues relating to residual interests (FASB's EITF will address some issues relating to CMO residuals later this year). In the absence of authoritative accounting guidance on this issue, investors generally follow the accounting models for investments in debt or equity securities.

Investors viewing residuals as debt would generally account for these using the effective yield (interest) method generally as set forth in FASB Statement 91. Under this method, the purchase price of the residual would be recorded as an asset. The investor would then calculate an internal rate of return (IRR) using the best available estimate of expected future cash flows, including the rate of prepayments. For each accounting period, the beginning balance of the residual is increased and interest income accrued based on the application of the IRR to the beginning balance of the residual. Actual cash received from the residual would be reflected as a reduction of carrying value of the residual. The IRR would have to be adjusted when actual prepayment experience differs from the prepayment rate initially used.

Those viewing residuals as an equity instrument would generally account for residuals using the equity method. Under this method, the purchase price of the residual would also be recorded as an asset. However, the investor would then calculate his share of the income of the investment every period and increase the residual and accrue income based on the application of this calculated share of investment income. Actual cash received from the residual would be reflected as a reduction of carrying value of the residual. In addition, the initial purchase price of the residual must be amortized to income over the estimated period of benefit, generally using an accelerated method. Adjustments to these calculations may be necessary if the estimated life of the residual changes as a result of changes in prepayment rates.

As previously mentioned, GAAP generally requires consolidation when control of a subsidiary exists. This is generally evidenced by majority ownership. When an investor owns a majority of the residual interests in an asset backed security, the economic substance of this arrangement may indicate that he has assumed control of the risks and rewards of ownership as would be experienced, in substance, by the issuer's parent. In such cases, it may be appropriate for the investor to consolidate the issuer in its financial statements.

Residuals are treated as debt instruments and should be reported as Other Assets for Call Report purposes. Residuals should be reported in accordance with the regulatory guidelines previously discussed for IOs and POs.

APPENDIX A

This appendix lists accounting issues related to asset securitization that have been addressed by the FASB's Emerging Issues Task Force (EITF). Consensus positions of the EITF provide interpretations of FASB standards and other authoritative literature that comprise GAAP. A number of the issues listed below have been discussed in this chapter.

- 84-15 Grantor trusts consolidation
- 84-30 Sales of loans to special-purpose entities
- 85-13 Sale of mortgage service rights on mortgages owned by others
- 85-20 Recognition of fees for guaranteeing a loan
- 85-26 Measurement of servicing fees under FASB Statement No.65 when a loan is sold with servicing retained
- 85-28 Consolidation issues relating to collateralized mortgage obligations
- 86-24 Third-party establishment of CMOs
- 86-38 Implications of mortgage prepayments on amortization of servicing rights
- 86-39 Gains from the sale of mortgage loans with servicing rights retained
- 87-25 Sales of convertible, adjustable-rate mortgages with contingent repayment agreement
- 87-34 Sales of mortgage servicing rights with a subservicing agreement
- 88-11 Sale of interest-only or principal-only cash flows from loans receivable
- 88-22 Securitization of credit card portfolios
- 88-17 Accounting for fees and costs associated with loan syndications and loan participations
- 88-20 Difference between initial investment and principal amount of loans in a purchased credit card portfolio
- 89-4 Collateralized Mortgage Obligation residuals
- 89-5 Sale of mortgage loan servicing rights

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- a. FASB Statement No. 65, Accounting for Certain Mortgage Banking Enterprises, as amended.
- b. FASB Statement No. 77, Reporting by Transferors for Transfers of Receivables with Recourse.
- c. FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases.
- d. TB 85-2, Collateralized Mortgage Obligations.
- e. TB 87-3, Accounting for Mortgage Servicing Fees and Rights.

2. Financial Accounting Standards Board, EITF Abstracts: A Summary of Proceedings of the FASB Emerging Issues Task Force, October 6, 1988.

3. Federal Financial Institutions Examination Council, Instructions - Reports of Income and Condition (Call Reports).

4. The Board of Governors of the Federal Reserve System, "Supervisory Policy Concerning Selection of Securities Dealers and Unsuitable Investment Practices," April 20, 1988.