

6 December 2007

The Subprime Meltdown: Understanding Accounting-Related Allegations

Part II of A NERA Insights Series

By Dr. Thomas L. Porter, CPA and Dr. Airat Chanyshv



Forthcoming topics in this subprime lending series will include:

- Anatomy of a Fraudulent Conveyance
- De-Mystifying the Economics of Complex Mortgage Transactions
- The Domino Effect: Economic Impact of When Exotic Mortgages Reset

Introduction

In the first paper in this series, NERA Economic Consulting provided a primer on “The Subprime Meltdown.”¹ That paper described the players and their roles in the subprime securitization process. This paper focuses on mortgage originators and the accounting-related allegations made against them in recent subprime lawsuits. A sampling of those allegations, with the accounting-related topic in **bold**, includes the following:

...the Company lacked sufficient internal controls to determine **loan loss provisions**; the Company mischaracterized its Low Documentation Loans as prime loans, and as a result of the deteriorating market conditions, it needed to take on more risky loans in order to maintain its growth.²

- (a) The Company lacked requisite internal controls, and as a result, the Company’s projections and reported results issued during the Class Period were based upon defective assumptions and/or manipulated facts;
- (b) The Company’s financial statements were materially misstated due to its failure to properly account for its **allowance for loan repurchase losses**;
- (c) The Company’s financial statements were materially misstated due to its failure to properly account for its **residual interests in securitizations** by failing to timely **write down the impaired assets**.³

¹ “The Subprime Meltdown: A Primer, Part I of a NERA Insights Series, by Dr. Faten Sabry and Dr. Thomas Schopflocher (http://www.nera.com/publication.asp?p_ID=3209)

² *Jack McBride v. Countrywide*, paragraph 52

³ *Richard Damore, et al. v. New Century Financial Corporation et al.*, paragraph 8.

The Prospectus further failed to detail that the failure to sell these packages of sub-prime loans would necessitate that the Company keep them as investments and have to weather **the full weight of the risk of default.**⁴

What is a “loan loss provision?” What is an “allowance for loan repurchase losses?” What is a “residual interest in securitization?” How does one know if a residual interest in securitization is impaired or not? What are the financial reporting implications of weathering “the full weight of the risk of default?” This paper will answer each of those questions and provide some suggestions for how to analyze the pertinent accounting issues in subprime lending cases.

Accounting for Mortgage Banking Activities

A mortgage originator’s business involves originating or purchasing mortgage loans, holding some of those loans as a long-term investment, and selling the rest to be securitized. Holding loans as a long-term investment ties up capital until the loan is repaid, whereas selling loans to be securitized provides immediate funding so the mortgage originator can continue to make new loans.

While the accounting for the origination or purchase is relatively straightforward, the same cannot be said for what happens afterwards. As will be discussed below, some mortgages that are actually “sold,” in a legal sense, remain on the originator’s books because they are not considered “sold” from an accounting perspective. Further, the accounting makes a distinction between market factors that affect the current fair value of a mortgage and credit factors that affect the amount of principal that will ultimately be collected.

Mortgage Loans Held for Investment

Mortgage loans that a mortgage originator intends to hold until maturity as an investment are categorized as “held for investment”⁵ on the mortgage originator’s books and reflected as an asset on the balance sheet at amortized cost.⁶ As principal is repaid over time, the original cost is reduced and the resulting amount is referred to as the “carrying amount.” At any time until maturity, if it becomes doubtful that the carrying amount will not be recovered and the impairment is considered to be other than temporary, the carrying amount is reduced and a loss is included in income in the period in which the impairment occurs.

In addition to impairments, which affect individual loans in a portfolio, originators are required to estimate and record an allowance for credit losses inherent in a portfolio of loans. That allowance is referred to as the “loan loss reserve.” A loan loss reserve is netted against loans held as an investment, in the asset section of the balance sheet. The resulting amount is a reflection of the principal that is expected to be collected from borrowers. The loan loss reserve is increased by recording a loss that appears on the income statement.

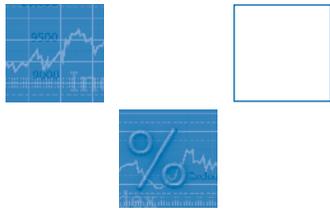
⁴ *Jack McBride v. Countrywide*, paragraph 55.

⁵ In order to classify a mortgage as “held for investment,” the mortgage originator must have “both the ability and the intent to hold the loan for the foreseeable future or until maturity.” (Statement of Financial Accounting Standard No. 65, *Accounting for Certain Mortgage Banking Activities*, paragraph 6.)

⁶ “Cost” refers to the original net investment made by the originator—the principal amount adjusted for certain costs and fees.



In attacking or defending allegations related to the fair value estimate, counsel must understand the methodology that was actually used.



The manner in which loan loss reserves are estimated is bound to be a key element in subprime lawsuits.

Loan Loss Reserve

An analysis of the loan loss reserve may provide an opportunity to gain a sense of the quality of the loan portfolio. A “large” reserve can indicate that the mortgage originator anticipates a large number of borrowers will default. A “small” reserve is indicative of high-quality loans that are expected to be repaid. However, the reserve is only an estimate. If the estimate is insufficient to absorb actual future losses, when defaults actually occur, the losses will come as a surprise.

The manner in which loan loss reserves are estimated is bound to be a key element in subprime lawsuits. There is no accounting standard that provides guidance about *how* to estimate loan loss reserves. In attacking or defending a particular company’s method of estimating reserves, it will be necessary for counsel to understand completely how the mortgage originator determined the amount of the loan loss reserve and be ready to analyze all assumptions, estimations, and methodologies used to calculate the amount of the reserve. Some of the sources for learning about how the reserve was estimated include internal documentation, contemporaneous spreadsheet calculations, and interviews with the accounting staff responsible for making the estimate.

“Available for Sale” Mortgage Loans

If a mortgage originator intends to sell a loan, between the time of origination and sale, the loan is accounted for at cost or fair value, whichever is lower. “Fair value” is the amount that would be received if the mortgage were sold on the balance sheet date.⁷ Since loans that are available for sale are not yet sold, the value that would be received upon sale must be determined. “A quoted price in an active market provides the most reliable evidence of fair value.”⁸ In the event that quoted prices for identical items are not available, prices for similar items may be used. If there are no similar items, then the fair value must be estimated.

When the fair value of an available-for-sale loan falls below its cost, the difference is accounted for by reducing the amount on the balance sheet to fair value and recording a loss on the income statement.

It is the estimation of the fair value that determines whether or not losses will be recorded on the income statement. There is no specific accounting guidance about how to estimate fair value apart from what is reflected above. Different mortgage originators use different methodologies to make that estimate. Consequently, in attacking or defending allegations related to the fair value estimate, counsel must understand the methodology that was actually used. The sources for that information include internal documentation, spreadsheet calculations, and interviews with the accounting staff responsible for making the estimate.

Sale of Mortgage Loans

If a mortgage originator decides not to keep a loan as a long-term investment and “sells” it to a trust (or other entity) for securitization, the transaction involves an exchange of assets—generally, cash is received in exchange for the mortgage loans. The difference between the amount received and the amount at which the loans were recorded on the books represents a gain or loss on the sale of the mortgage. However, the prescribed accounting for that transaction is not so tidy. The

⁷ “Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” (Statement of Financial Accounting Standard No. 157, Fair Value Measurements, paragraph 5.)

⁸ Ibid, paragraph 24.

mortgage originator often does not surrender *all* of its rights to the mortgages it sells *and* it often acquires additional assets (other than cash) and incurs certain obligations as a result of the sale. The net effect of the additional assets acquired and the liabilities assumed can ultimately increase or decrease the amount of gain the mortgage originator can record for the sale.

“True” Sale: “Gain on sale accounting”

The sale of mortgages is considered a transfer of financial assets. The appropriate accounting guidance is contained in Statement of Financial Accounting Standard No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 140) and its related pronouncements.

FAS 140 permits “gain on sale”⁹ accounting if there is an exchange in which the transferor (here, the mortgage originator) *surrenders control* over the assets transferred in exchange for consideration other than beneficial interest.

Control over transferred assets is surrendered if and only if *all of the following conditions* are met:

- a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.
- b. Each transferee (or, if the transferee is a qualifying special-purpose entity (SPE), each holder of its beneficial interests) has the right to pledge or exchange the assets (or beneficial interests) it received, and no condition both constrains the transferee (or holder) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor.
- c. The transferor does not maintain effective control over the transferred assets through either (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity or (2) the ability to unilaterally cause the holder to return specific assets, other than through a cleanup call.¹⁰

Condition (a) is usually met by selling the mortgages to an SPE. If that entity can freely use the mortgages however it chooses, condition (b) is met. The usual use of the mortgages is to pledge them as collateral for bonds issued by the SPE.

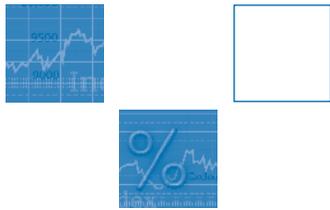
Condition (c) addresses whether or not the originator has surrendered control of the mortgages. If there is any agreement that allows the originator to repurchase mortgages or to cause the SPE to return certain mortgages, then effective control has *not* been surrendered and the loans are not considered “sold.”¹¹ In that event, the loans remain on the books of the mortgage originator *even though they have been sold to another entity!* So, even though the transaction may look the same as a true sale transaction, it is accounted for as a secured financing on the books of the mortgage originator. This is discussed further in the next section.

⁹ Accounting for the transfer of mortgages as a sale generally gives rise to a gain (because fair value exceeds cost). Hence, the accounting treatment prescribed in FAS 140 is frequently referred to as “gain on sale” accounting.

¹⁰ Statement of Financial Accounting Standard No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, Paragraph 9.

¹¹ A provision in an agreement that requires the originator to repurchase defective loans (i.e., loans that do not meet the representations and warranties included in the agreement) does not preclude “gain on sale” accounting because the event that causes the repurchase is not caused, unilaterally, by the originator.





The terms of the sale of mortgages may give rise to new assets and liabilities.

If the conditions for a surrender of control are met, the mortgage originator must reflect *all* the elements of the transaction. Specifically, the originator must:

- a. Derecognize all assets sold.
- b. Recognize all assets obtained and liabilities incurred in consideration as proceeds of the sale.
- c. Measure, at fair value, assets obtained and liabilities incurred in a sale.
- d. Recognize in earnings any gain or loss on the sale.¹²

Derecognition of assets sold requires the mortgage originator to remove from its books the mortgage loans it had previously recorded as assets. They are no longer considered owned by the originator. As discussed above, the terms of the sale of mortgages may give rise to new assets and liabilities. Those include servicing rights, reserves for repurchases, reserves for losses on repurchased loans, and the recognition of any interests that are retained in the pool of mortgages to provide credit support for the securitization. Once all “old” assets have been derecognized and all “new” assets and liabilities have been identified, the gain on sale of mortgage loans can be determined.

Servicing Asset or Liability

A mortgage originator may retain the rights to service the mortgages that are sold to a trust. The benefits of servicing include revenues from contractually specified servicing fees, a portion of the interest from the assets sold, late charges, and “float” from transfers of cash among various required deposits specified in the trust agreement. Obviously, the servicer will incur the costs associated with servicing, which include administrative functions and foreclosure activities on defaulted mortgages. If the fair value of the benefits of servicing is greater than the fair value of the costs, the mortgage originator who retained servicing must recognize a servicing asset. If the opposite is true (i.e., the costs outweigh the expected benefits) the originator/servicer must recognize a servicing liability. Over time, the value assigned to the servicing assets must be evaluated for potential impairment.

Residual Interest

As part of the structure of a securitization, a mortgage originator may retain some type of beneficial interest in the mortgage loans that were sold. That interest could be a “residual interest,” which is the right to receive cash collected from borrowers that is not required to be paid to other participants in the securitization. In other words, a residual interest is the right to receive any cash that is “left over” after all other obligations have been fulfilled. To the extent a mortgage originator anticipates the receipt of residual cash flows, it must be reflected as an asset on the balance sheet. Because residual interests are not fully known at the time loans are transferred, their value must be estimated. And, as time goes by and more information is available about how the portfolio of loans is performing, the mortgage originator must assess whether the value initially assigned to the residual interest is still valid. If it is not (for example, if there are more defaults than anticipated so that there is unlikely to be as much residual cash flow as originally anticipated), the mortgage originator must record an impairment of that asset with a charge to earnings in the period when that becomes known.

¹² FAS 140, p. 11. “Derecognize” means to remove from the books of the originator.



It is the mortgage originator that must weather the full weight of the default for repurchased loans.

Repurchase Obligations

Most securitizations stipulate that if there is an early default (e.g., first payment is not made by the borrower) or some other defect (e.g., subsequent discovery of no or little documentation), then the mortgage originator must repurchase that mortgage from the SPE.¹³ As a result of the sale of the mortgages, the mortgage originator incurs an obligation to repurchase any loans that meet the conditions described in the sale agreement.

Reserve for Losses on Repurchased Loans

In a first payment default, the mortgage originator is required to repurchase the defective mortgage from the entity that bought it. Because it is a defective mortgage, its fair value declines when the defect comes to light. Regardless of what the mortgage originator does next (i.e., keeps the mortgage as a long-term investment or sells it to someone else), the mortgage originator has incurred a realized loss because, when it repurchased the loan for the same amount at which it was originally sold for, the mortgage originator pays a high price in exchange for a low-value asset. It is the mortgage originator that must weather the full weight of the default for repurchased loans. Although the loss is realized upon repurchase, the mortgage originator actually incurred the (unrealized) loss when it sold the loans. To accurately reflect the loss at the time it occurred, mortgage originators are required to establish reserves for the loss that will ultimately be realized. If the estimate for the expected loss is too small, when the larger loss is ultimately realized, it will be a surprise to users of financial statements because previous estimates were not indicative of the ultimately realized losses.

Secured Financing (Not a “True” Sale)

As discussed earlier, the transfer of mortgages to a special purpose entity may not meet the requirements for a sale under GAAP. In that case, the mortgage originator must account for the transaction as a secured borrowing. The mortgage loans are regarded as collateral for a loan. The mortgage loans remain on the books of the mortgage originator and are classified as “held for investment.” As discussed above, mortgage loans classified in that manner are subject to a loan loss provision. The borrowing (which represents the obligation to repay bondholders of the trust) is classified as a liability.

Summary

This paper described certain accounting issues that are cited in current litigation involving mortgage originators. All of the items share one common feature—they require current estimates. Loan loss provisions and the allowance for loan repurchase losses are estimates as of today of losses that will be realized in the future. Residual interests in securitizations are estimates of the amount expected to be realized from funds that remain after all other investors have been repaid.

In attacking or defending allegations related to each of these areas, it is important to understand how the estimates were derived and whether those estimates reflect a reasonable representation within the confines of GAAP. Learning about how those estimates were made by different entities involves examining internal documentation and spreadsheets, audit workpapers, and interviewing accounting personnel involved in the estimation.

¹³ As noted above, the obligation to repurchase defective loans does not prevent “gain on sale” accounting.



About NERA

NERA Economic Consulting is an international firm of economists who understand how markets work. We provide economic analysis and advice to corporations, governments, law firms, regulatory agencies, trade associations, and international agencies. Our global team of more than 600 professionals operates in over 20 offices across North and South America, Europe, and Asia Pacific.

NERA provides practical economic advice related to highly complex business and legal issues arising from competition, regulation, public policy, strategy, finance, and litigation. Our more than 45 years of experience creating strategies, studies, reports, expert testimony, and policy recommendations reflects our specialization in industrial and financial economics. Because of our commitment to deliver unbiased findings, we are widely recognized for our independence. Our clients come to us expecting integrity and the unvarnished truth.

NERA Economic Consulting (www.nera.com), founded in 1961 as National Economic Research Associates, is a unit of the Oliver Wyman Group, an MMC company.

Contact

For further information and questions, please contact the authors:

Dr. Thomas L. Porter, CPA

Vice President

+1 617 621 2604

thomas.porter@nera.com

Dr. Airat Chanyshv

Senior Consultant

+1 212 345 7336

airat.chanyshv@nera.com