The Hard Facts about the Soft Numbers in Subprime Litigation

By Thomas L. Porter

Allegations in many subprime litigation cases claim that investors in the institutions that issued subprime mortgages (referred to herein as "mortgage bankers") and investors in subprime mortgage asset-backed securities were misled with false information. Such allegations frequently point to the accounting disclosures made (or not made) with regard to subprime mortgage portfolios. For that reason, it is useful for anyone involved in subprime litigation to have an understanding of the accounting life of a mortgage loan. It is probably equally useful to understand that there is a high degree of estimation associated with numbers related to subprime mortgage portfolios.

By their very nature, subprime mortgages have, among other things, a higher probability of default and a wider possible distribution of outcomes than higher quality mortgages. Moreover, their performance is closely tied to macroeconomic factors. Because the accounting rules related to subprime mortgages require a present estimate of what is likely to occur in the future, and because those future events are unknown and widely variable, any estimation may contain a wide range of reasonableness. Plaintiffs often claim that the reported amounts related to subprime mortgages are false and misleading. However, despite plaintiffs' claims, those numbers may be good-faith current estimates of future events. Further, it is entirely possible that two reasonable minds, using the same information, might come up with different amounts for the same item, and each would be acceptable within the reasonableness constraint of generally accepted accounting principles.

The Accounting Life of a Mortgage Loan

While most of us think of our mortgages as a liability that hangs over our heads until fully repaid, mortgages are the primary assets on which mortgage bankers profit. Once a mortgage is in the hands of a mortgage banker, there are two potential paths for that loan: It can be held for investment, or it can be sold to another entity (usually for securitization).

Loans Held for Investment

Holding a mortgage as a long-term investment keeps it on the mortgage banker's balance sheet for a very long time. The loans that a banker intends to hold until maturity (or repayment) are categorized as "held for investment" and included on the balance sheet, as assets, at their original cost. To classify a mortgage as "held for investment," the banker must have "both the ability and the intent to hold the loan for the foreseeable future or until maturity." (Financial Accounting Standards Board (FASB), Accounting Standards Codification (ASC) subparagraph 320-10-25-1(c)). "Cost" refers to the original net investment made by the mortgage banker—the principal amount adjusted for certain costs and fees.

As the loan principal is repaid over time (usually in monthly increments, along with interest), the asset is reduced. The resulting lower amount (or balance) is referred to as the "carrying amount." As long as the borrower makes timely repayments of principal, the carrying amount will represent the amount the mortgage banker ultimately expects to collect from the borrower. Unfortunately, borrowers don't always repay what has been loaned to them. To the extent a mortgage banker is aware that some borrowers will not repay (through experience or otherwise), it is necessary for the mortgage banker to reduce the carrying amount through the use of a loan loss allowance.

Loan Loss Allowance. Mortgage bankers generally hold large portfolios of loans as investments. Until maturity, the loans are required to be shown at their expected collectible amount rather than their principal balance because it is highly unlikely that every penny of outstanding loans will be repaid. If there is an indication that the amount expected to be collected differs from the carrying amount on the balance sheet, the carrying amount of the loan portfolio is reduced by the "loan loss allowance." (When the loan loss allowance is subtracted from the carrying amount, the result is the net amount the mortgage banker expects to collect ultimately.) The loan loss allowance is created by recording an expense, commonly referred to as a provision for loan losses. Recording a provision for loan losses causes net income to decrease. There are two components of the loan loss provision. One is an estimate of any credit losses inherent in the portfolio of loans. It is usually based on factors that include borrowers' credit profiles, collection history, and servicing effectiveness. (This portion of the provision is often referred to as "the FAS 5 component." Statement of Financial Accounting Standard No. 5, *Accounting for Contingencies* (FAS 5), requires that a contingent loss be recognized if the loss is probable and estimable.) The second component of the provision for loan losses is an estimate of any other-than-temporary impairments on specifically identified loans for which there is a realization that the entire balance will not be collected. (This portion of the provision is often referred to as "the FAS 114 component." Statement of Financial Accounting Standard No. 114, *Accounting by Creditors for Impairment of a Loan* (FAS 114), requires mortgage bankers to identify any loans that should be evaluated for collectability. If it is probable that all amounts due will not be collected, the loan is impaired.)

An analysis of the loan loss allowance may provide an opportunity to gain a sense of the quality of a loan portfolio. If estimated properly, a "large" allowance (relative to the carrying amount of the loans outstanding) can indicate that the mortgage banker believes that a large number of borrowers may default. Similarly, a "small" allowance may be more indicative of the mortgage banker's perception that these are high-quality loans that are expected to be repaid. However, the provision and resulting allowance are only estimates. If the estimate turns out to be insufficient to absorb actual future losses, the losses will come as a surprise when defaults actually occur. Conversely, if the estimate turns out to be overstated, the repayment of loans previously written off will have caused an overstatement of expenses initially that is offset by income (a reversal of previous expenses) in the future.

Loans Sold

Mortgage bankers often sell large portfolios of loans that they have originated themselves or purchased from other originators. The loans are generally sold to a special purpose entity (SPE) that has been capitalized by investors through the purchase of securities issued by the SPE. (The securities issued by the SPE can be structured (i.e., tranched) to make them more marketable to investors. The structuring of those securities, while important, is beyond the scope of this article.) The sale provides the mortgage banker with liquid capital that can be used to make more loans. The investors in the SPE can match their risk-return and duration needs better with the tranched securities offered by securitizations.

There are two different ways to account for the sale of a portfolio of loans to an SPE, the choice of which depends on whether or not the banker has continuing involvement with the loans once they have been transferred. If the transfer includes a complete surrender of control over the mortgages, it is considered a "true sale" and qualifies for what is commonly referred to as "gain on sale accounting." There, the mortgages are removed from the banker's books, and the banker records any new assets received and liabilities incurred as a result of the sale. If the banker maintains any control over the portfolio of loans, then, despite the transfer of the loans to the SPE, the mortgage banker continues to carry the loans on its books, but they are classified as collateral in a secured borrowing. In the next sections, the method of accounting for loans prior to their transfer to an SPE is discussed, followed by a description of "gain on sale" accounting and secured borrowings.

Loans Held for Sale. If a mortgage banker intends to sell a loan, between the time of origination/funding and sale, the loan is accounted for at its original cost or its current fair value, whichever is lower. That is, the carrying amount is never marked above cost. "Fair value" is the amount that would be received if the mortgage were sold on the balance sheet date. Under the Generally Accepted Accounting Principles (GAAP), "fair value" is "the amount at which an asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than a forced or liquidation sale." (FASB, ASC Master Glossary). Because loans that are available for sale are not yet sold, the value that *would* be received upon sale must be estimated.

There are three ways to make an estimate of a loan's fair value. First, if there is an identical loan actively traded in an organized market, a market quote for that loan would provide a fair value estimate. If the loans traded in the marketplace are not identical but similar, market quotes on those similar loans can be adjusted for the differences between the two loans. If such market information is unavailable, the fair value must be entirely estimated through the use of some modeling technique, such as discounting future cash flows. (The degree to which fair value is determined using market quotes rather than modeling can be determined by examining the disclosures in the notes to the financial statements.)

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If the fair value of an available loan falls below its carrying amount, the loss in fair value is accounted for by reducing the carrying amount of the loan on the balance sheet to its new, lower fair value. This is achieved by adjusting the valuation allowance by recording a loss on the income statement.

Sale of Mortgage Loans. If a mortgage banker decides not to keep a loan as a long-term investment and "sells" it to a trust (or other entity), the transaction involves an exchange of assets—cash and other consideration are received in exchange for the portfolio of mortgage loans. The "other consideration" received usually includes servicing rights, a retained beneficial (equity) interest as part of the securitization credit enhancement, and a potential liability to replace defective loans sold into the securitization trust. If the banker surrenders control of the loans, the transfer is accounted for as a "true" sale and qualifies for "gain on sale accounting." If control is not surrendered, the transaction is considered a secured borrowing.

"True" Sale: "Gain on Sale" Accounting

The sale of mortgages is considered a transfer of financial assets and eligible for "gain on sale" accounting if there is an exchange in which the transferor (here, the mortgage banker) surrenders control over the assets transferred in exchange for consideration other than beneficial interest. If so, the mortgage banker must do the following:

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

Derecognition of assets sold requires the banker to remove from its books the loans it had previously recorded as assets. They are no longer considered owned by the banker. 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 enhancement for the securitization. Once all "old" assets have been derecognized and all "new" assets and liabilities have been identified and estimated, the gain on sale of the loans can be determined.

Servicing Asset or Liability. A mortgage banker 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, entitlement to a portion of the interest from the loans, late charges, and the temporary custody of cash from transfers among various required deposits specified in the trust agreement (commonly referred to as "float"). Obviously, the servicer will incur the costs associated with servicing, which include the costs of administrative functions and foreclosure activities on defaulted mortgages. If the fair value of the benefits of servicing is greater than the estimated costs, the mortgage banker 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 mortgage servicing asset or liability is amortized into income. But, because a mortgage servicing asset must be reflected at the lower of cost or fair value, it, like other items carried at fair value, must be monitored for potential impairment, once again calling for an estimation.

Residual Interest. To enhance the marketability of a securitization, a mortgage banker 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 any excess cash attendant to the securitization 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 to investors in the securitization have been fulfilled. To the extent a mortgage banker expects to receive residual cash flows, that residual interest must be reflected as an asset on the balance sheet.

Because the amount of residual interest that will be received is not fully known at the time loans are transferred, its value must be estimated. And, as time goes by and more information becomes available about how the portfolio of loans is performing, the mortgage banker 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 originally thought so that there is unlikely to be as much residual cash flow as originally thought), the mortgage banker must record an impairment of that asset with a charge to earnings in the period when that becomes known. This charge to earnings reduces the net income for the period.

Repurchase Obligations. Most securitizations stipulate that if there is an early default (e.g., the first payment is not made by the borrower) or some other defect (e.g., subsequent discovery of no or little documentation), the mortgage banker must repurchase that mortgage from the entity that purchased it and replace it with another. In essence, the mortgage banker incurs an obligation to repurchase any loans that meet the conditions described in the sale agreement. That obligation must be estimated and recorded as a liability.

Reserve for Losses on Repurchased Loans. If the mortgage banker is required to repurchase a defective mortgage from the entity that bought it, the fair value of the mortgage declines when the defect comes to light. Regardless of what the mortgage banker does next (i.e., keeps the mortgage as a long-term investment or sells it to someone else), the mortgage banker has incurred a realized loss because, when it repurchases the loan for the same amount at which it was originally sold, the mortgage banker pays a high price in exchange for a low-value asset. It is the mortgage banker who must bear the full weight of the default for repurchased loans. Although the loss is realized upon repurchase, the mortgage banker actually incurred an (unrealized) loss when it originally sold the loans. To accurately reflect the loss at the time it occurred, mortgage bankers are required to establish (estimated) reserves for that loss at the time of sale that will ultimately be realized in the future.

Secured Financing (Not a "True" Sale)

The transfer of mortgages to an SPE may not meet the requirements for "gain on sale" accounting. In that case, the banker must account for the transaction as a secured borrowing. The loans are regarded as collateral for a loan. They remain on the books of the banker and are classified as "held for investment." As discussed above, 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.

Estimations in Accounting

When it comes to numbers, accountants have a reputation for pinpoint precision. That is seemingly good because there is an abundance of numbers in the financial reports of public companies. Interested parties use those numbers to make big decisions that can affect a wide range of market participants. For example, stockholders and analysts are often interested in a company's *earnings per share* (EPS)—a measure that boils down the performance of an entire firm for an entire quarter or year into a single number. Usually measured in dollars and cents, it conveys profit per share. Prior to the release of an EPS number, analysts and market makers often have predictions about what a company's EPS will be. A one- or two-cent deviation between the actual EPS and the forecast EPS can cause large moves in share prices that can substantially change total market capitalization, sometimes by millions or even billions of dollars.

Considering the power that a single number like EPS can wield, users might be surprised to learn that it, along with almost all the numbers used to compute it, are the result of judgments and estimates. Judgment is required when making certain classifications. (For example, it may be necessary to decide which short-term investments should be included in "cash equivalents.") Estimates are required when certain information is not known with certainty. (For example, the calculation of depreciation requires an estimate of an asset's expected useful life.) Users might also be surprised to learn that, in making those judgments and estimates, reasonable minds can differ, resulting in different estimates for the same item—and none of them would be wrong.

In some financial statement items, the degree of estimation is small. For other items, the reported amount can be quite sensitive to the estimations and judgments used. Applying George Orwell's observation in *Animal Farm* that "[a]ll animals are equal, but some animals are more equal than others," it can be said that all accounting numbers are estimates, but some are more of an estimate than others.

For amounts reported on financial statements related to the subprime credit crisis, the degree of estimation is likely to be large. This is useful to know when there are allegations of fraud with respect to financial reporting because a number alleged to be "false and misleading" may be a number that is estimated reasonably (the GAAP threshold). In cases in which the primary allegations are not about accounting, highlighting the degree of estimation may be helpful if there is reliance on the numbers for some aspect of the case.

Among accountants, the fact that most numbers in financial statements are estimates will come as no surprise. The profession has long recognized that "the information provided by financial reporting often results from approximate, rather than exact, measures. The measures commonly involve numerous estimates, classifications, summarizations, judgments, and allocations." (FASB, *Statement of Financial Accounting Concepts No. 2: Qualitative Characteristics of Accounting Information*, ¶ 20).

Understanding the degree of judgment and estimation in certain accounting numbers can be helpful when those numbers are at the heart of litigation. Briefly stated, there are a number of qualitative characteristics about accounting numbers. Those characteristics are described in the FASB's *Statement of Financial Accounting Concepts No. 2: Qualitative Characteristics of Accounting Information*. They include relevance, reliability, verifiability, and comparability, among others. Standard-setters try to write their rules so that accounting numbers that are reported optimize as many of those sometimes competing characteristics. Because they cannot optimize on all fronts, the standard of accuracy in accounting is "reasonable" (as opposed to "right"). And because reasonable minds can differ in terms of the judgments made and estimates used to report items in financial statements, there is a "zone of reasonableness" to be considered when deciding whether a reported number is misreported or not. For amounts related to subprime mortgage loans, that zone can be very wide as those numbers have a large degree of both judgment and estimation.

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Putting It Together

In cases involving allegations of false and misleading accounting information, it is important to consider the degree of estimation related to each number. An expert trained in accounting can analyze how amounts are estimated. That involves an examination of work papers, an in-depth knowledge of the appropriate accounting standards, and the ability to consider and quantify the effect of alternative judgments and estimations.

By its nature, accounting for subprime mortgage loans involves a high degree of estimation that, when exposed, may reveal that reasonable minds could arrive at different estimations. It is important to have a thorough understanding of when and how estimates are made, the places one would look to determine that, and the ability to assess the reasonableness of those estimates.

Thomas L. Porter, Ph.D., C.P.A. is vice president in the Boston, Massachusetts, office of NERA Economic Consulting, Inc.