Securitization Accounting 101.

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Accounting for a Securitization Transaction

- Sale of Assets
- Accounting versus Legal Sale
- Consolidation
- Disclosure Requirements

- FAS 140: Recording the Sale of Assets
- Gain / Loss on Sale
- Residual Valuation

- Lessons Learned

Sale of Assets—Meeting the Requirements

- Appropriate guidance:
  - SFAS No. 140, Accounting for the Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (FAS 140)
  - FASB Interpretation No. 46, Consolidation of Variable Interest Entities (Revised December 2003) (FIN 46R)

- Is the transaction a sale of receivables?

- Should the transaction be accounted for as a secured borrowing?

- Should the transferor consolidate the entity that purchased the receivables?

Sale of Assets
Accounting versus Legal Sale

- Transfer of control has been accomplished if all the following criteria are met (FAS 140 paragraph 9):
  - Assets must be isolated from transferor, even in bankruptcy (legal sale)
  - Transferee has right, free of constraints or conditions, to pledge or exchange assets; or transferee is a QSPE whose holders of beneficial interests have same rights; and no condition both constrains the transferee from exercising the right to pledge or exchange and provides more than a trivial benefit to the transferor
  - Transferor does not maintain effective control over assets through repurchase or other agreement, or the ability to unilaterally cause the holder to return specific assets, other than through a clean up call

Sale of Assets
Consolidation—VIE or QSPE

- If assets transferred to a qualifying special purpose entity (QSPE), then no consolidation

- If assets not transferred to a QSPE, then must look to FIN 46R to consider what variable interests have been retained by the transferor in the SPE or variable interest entity (VIE)

Sale of Assets
Consolidation: Qualifying Special Purpose Entity

- Qualifying Special Purpose Entity
  - Demonstrably distinct from the transferor
  - Activities are very limited and outlined in the transaction documents
  - Only specified assets permitted
  - Can sell only in auto response to limited and described circumstances
  - May hold only passive derivative instruments
- Exposure drafts are in process.

Sale of Assets
Consolidation: FIN 46R

- If no variable interests retained (i.e. no interest only strips, no servicing rights, etc.) consolidation will not be required
- If variable interests are retained, a determination will need to be made to determine who, if anyone is the primary beneficiary of the VIE
- The entity that retains the majority of the VIE's expected losses or receives a majority of the VIE's expected returns, or both, is the primary beneficiary and required to consolidate the VIE
- The interpretation of FIN 46R and the analysis of the variable interests continues to be discussed and definitive guidance is evolving

FAS 140: Accounting for the Sale of Assets
Disclosure Requirements

- If securitizations are accounted for as a sale, required disclosures for each major asset class include:

- Cash flows between SPV and Transferor
- Static pool actual and projected losses as a percentage of the original balance of assets securitized
- Summary of the key assumptions used in the determination of fair value of any retained interests
- Stress test showing the hypothetical effect on the fair value of the retained interests which would result from two or more adverse changes in each assumption
- For both on-balance sheet and off-balance sheet assets, a summary of the delinquencies as of the end of the period, credit losses during the period, and principal amounts outstanding as of the end of the period

FAS 140: Accounting for the Sale of Assets

- SFAS No. 140 not only guides the determination of when a transfer is a sale or a secured borrowing, but also outlines the recordation of the transaction—i.e., “gain on sale”

- Uses financial component approach

FAS 140: Accounting for the Sale of Assets
Gain / Loss on Sale: Process

- Determine the deal components
- Determine the fair value of each component
- Determine which component was sold and which component was retained
- Allocate

FAS 140: Accounting for the Sale of Assets
Gain / Loss on Sale: Components

- What did the transferor receive in return for the pool of assets? Some typical components are:
  - Cash received for interest sold to investors
  - Interests retained in the pool:
    - Certificated interests (e.g., seller's certificate)
    - Interest only strip (I/O)
    - Other retained interests, including reserves held by the SPV
  - Servicing

FAS 140: Accounting for the Sale of Assets
Gain / Loss on Sale: Calculation

- Allocate the previous book carrying amount for the pool of assets between the classes sold and the retained interest in proportion of their relative fair value

- Record on balance sheet the fair value of any guarantees, recourse obligations or derivatives

- Recognize gain or loss only on the assets sold by comparing the net cash proceeds (after transaction costs and liabilities created) to the allocated book value of the classes

- Carry on the balance sheet any retained interest, including a servicing asset, if applicable

FAS 140: Accounting for the Sale of Assets
Gain / Loss on Sale: Calculation

- Example:
- Assumptions:
  - Aggregate Principal Amount of Pool: $100m
  - Net carrying amount: $99m
  - Deal structure:
    - Class A $96m
    - Class B $3.8m
    - Cash Reserve $1.0m
    - I/O Strip $1.5m

FAS 140: Accounting for the Sale of Assets
Gain / Loss on Sale: Sample Calculation

Component	Fair Value	%	Allocation	Sold	Retained
Class A	$96,000	93.2	$92,268	$92,268	
Class B	3,800	3.69	3,653.1	3,653.1	
Cash Reserve	1,000	0.97	960.3		$960.3
I/O Strip	1,500	1.46	1,445.4		1,445.4
Servicing	700	0.68	673.2		673.2
Total	$103,000		$99,000	$95,921.1	$3,078.9

FAS 140: Accounting for the Sale of Assets
Gain / Loss on Sale: Gain

- Total Proceeds, less transaction costs of $1.0m, = $98.8m

- Allocated carrying amount of sold components = $95.921

- Gain = $2.879

Residual Valuation

- Some retained interests carried on balance sheet at fair value
- Fair value of retained interests should be determined, at a minimum, on a quarterly basis
- Fair value can be determined by either a market quote, or if a market quote is unavailable, through the use of a projected cash flow model that utilizes similar approach and assumptions that a market participant would use to determine fair value
- Fair value must follow a cash-out method identifying the period in which cash becomes available to the transferor and discounting back each related cash flow at an assumed discount rate
- Using the periodic fair value and projected cash flows, an impairment test must be performed to determine if an other than temporary reduction in fair value has occurred, based upon the application of EITF 99-20

Residual Valuation: Projected Cash Flow Model

- Cash flow model must incorporate:

- Future collateral cash flows on the securitized assets are projected, incorporating scheduled payments, prepayments, defaults, recoveries, etc...

- Consider the expected future obligations of the trust, including the triggers, calculations and priority of payments, which could affect the priority, timing and amount of obligations of the SPE

- Consider the amount and timing of the projected future cash flows to be received by the residual holder

- These residual cash flows are discounted back at the selected discount rate to determine the fair value of the related residual interest

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