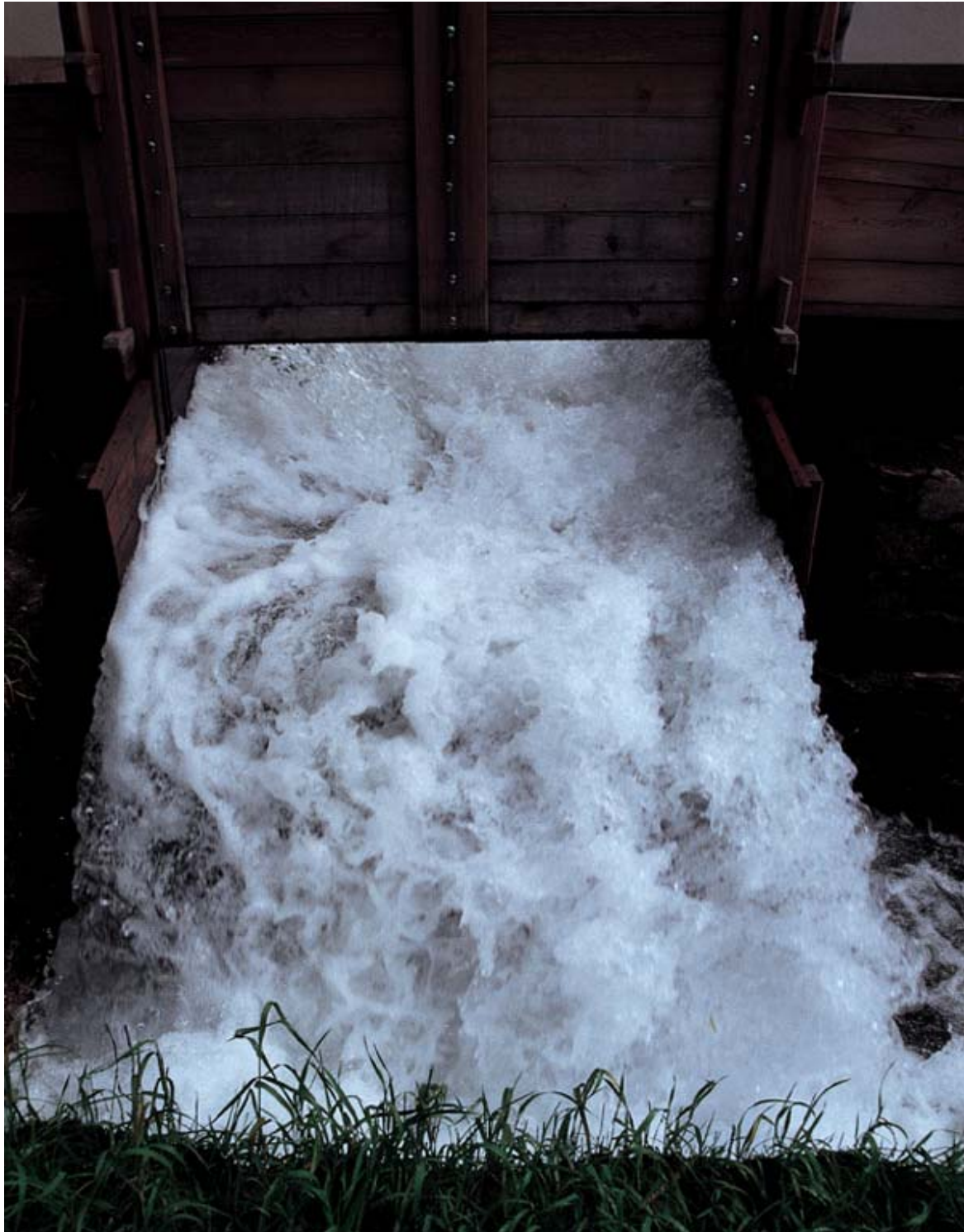


Accounting Considerations for 2006

A discussion for the consumer finance industry

December 2005



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Editor's Comments

As we approach the end of 2005 and enter a new year, we who serve in the accounting profession are more keenly aware than ever of the burgeoning volume and complexity of the accounting and reporting issues that affect our industry. The year 2006 promises to be an unusually active year for accounting and reporting professionals as several high profile regulations and accounting rules are scheduled to be issued in final form or as initial exposure drafts. Additionally, increasing the standard of compliance reporting, the SEC's Regulation AB provisions will become a reporting reality for issuers of publicly-issued asset-backed securitizations.

In response, this special year-end publication of the PricewaterhouseCoopers Consumer Finance Group contains a summary of several emerging accounting and reporting technical issues that may be of importance to the financial reporting staff of consumer finance companies. These articles are meant to summarize several key accounting and auditing changes taking place with relevance to consumer finance companies. In addition to the emerging new requirements, we have observed increased scrutiny surrounding the application of SFAS No. 91. We have included a brief discussion of several issues that we believe may be helpful in understanding some emerging trends in the application of this Standard. Of course, as with the adoption of any new accounting and reporting standard, the most difficult task is in applying these standards to specific facts and circumstances. Such application requires greater understanding of individual transactions affected by the standard than would be contemplated by this publication and, accordingly, we encourage early and detailed discussion of these matters with your accountants.

We hope that you will find the collection of issue summaries relevant and helpful. We are excited about both the prospects for and challenges of 2006. As always, we look forward to being of service to our clients and readers regarding these issues.

Best wishes for success in meeting these challenges in 2006,

The Partners of the Consumer Finance Group of PricewaterhouseCoopers LLP

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Proposed Amendments to FAS 140

The Financial Accounting Standards Board (FASB) has issued the following exposure drafts (EDs):

- Accounting for Transfers of Financial Assets – An amendment of FASB Statement No. 140
- Accounting for Servicing of Financial Assets – An amendment of FASB Statement No. 140
- Accounting for Certain Hybrid Financial Instruments – An amendment of FASB Statement Nos. 133 and 140

The FASB has indicated that the primary intent of these exposure drafts is to improve the consistency and comparability of the accounting for certain transactions accounted for pursuant to FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 140). These exposure drafts will likely have considerable impact on the consumer finance and mortgage banking industries as outlined within the commentary below.

Accounting for Transfers of Financial Assets – an amendment of FAS 140

Since the issuance of FAS 140 in 2000, the FASB believes that certain transactions have been structured in order to allow the derecognition of financial assets despite the transferor continuing to effectively control either the assets themselves or the Special Purpose Entity (SPE) holding the financial assets. Additionally, the FASB believes that there have been inconsistencies in practice in applying the guidance in FAS 140 related to both the requirements of the use of a Qualifying SPE (QSPE) to obtain sale treatment (as opposed to a secured borrowing), and the related permitted activities of a QSPE. In response to these concerns, the FASB proposed amendments to:

- clarify the permitted activities of a QSPE by:
 - prohibiting a QSPE from holding equity instruments;
 - allowing a QSPE to hold passive derivatives up to the total beneficial interests of the QSPE; and
 - prohibiting a QSPE used in a transaction that rolls over beneficial interests from having a party (including that party's consolidated affiliates or agents) with multiple rights or obligations that provide it with the potential for obtaining a more-than-trivial incremental benefit as compared to separate parties that have those same rights or obligations.
- clarify that a QSPE must be used for transfers of undivided interests (transfers of partial assets) in order to achieve sale accounting;
- require that arrangements between the transferor and the holders of beneficial interests, and arrangements entered into subsequent to the transfer, be considered in determining whether a transfer meets the isolation criteria for sale treatment;
- require beneficial interests held by the transferor (previously referred to as a "retained interest") to be initially measured at fair value as the FASB considers them to be new financial assets purchased from the QSPE; and
- clarify how the gain or loss on the transfer of financial assets should be determined.

These changes should be considered in the structuring of future transactions in order to comply with the requirements for sale accounting. While the above exposure draft clarifies and further defines certain

activities with regard to QSPE structures, it may have a significant impact on a company's securitization activities.

Accounting for Servicing of Financial Assets – An amendment of FAS 140

Companies that economically hedge their separately recognized servicing rights are often subject to income statement volatility arising from the use of different measurement attributes for the servicing rights (lower of cost or market - LOCOM) and the related derivative financial instruments (fair value). As a result, the FASB is proposing the following amendments to FAS 140:

- Require a separately recognized servicing right to be initially measured at fair value;
- Provide an irrevocable fair value option for day two accounting by major class of servicing (i.e., mortgage loans, credit card receivables, and automobile loans) for servicing rights; and
- Require additional disclosures for all separately recognized servicing rights.

The amendments proposed above will have a significant effect on the method in which servicing rights will be recorded and subsequently measured over time. The goal of this Statement is to reduce certain reported hedging ineffectiveness (if hedge accounting is achieved), or reduce income statement volatility (if hedge accounting is not achieved that has historically resulted from the requirement that the asset be recorded pursuant to a lower of cost or market model while the hedge instruments were marked to market pursuant to FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FAS 133). Many holders of mortgage servicing rights believe that the adoption of this Standard will significantly reduce the burden and cost of applying hedge accounting standards to these relationships.

Accounting for Certain Hybrid Financial Instruments – An amendment of FASB Statements No. 133 and 140

There has been some debate on whether beneficial interests in securitized financial assets meet the definition of a derivative under FAS 133, contained an embedded derivative, or were eligible for the scope exception described in Paragraph 14 of FAS 133 related to interest-only or principal-only strips. As a result, the FASB proposed amendments to FAS 133 and FAS 140 to:

- provide an instrument-by-instrument fair value election for hybrid financial instruments with an embedded derivative that otherwise would be bifurcated;
- clarify that the determination of whether a beneficial interest in a securitization transaction contains an embedded derivative should (1) be based on the contractual terms of the beneficial interests and (2) involve obtaining sufficient information about the payoff structure and the payment priority of the instrument;
- clarify that credit risk resulting from a financial instrument or other assets and liabilities held by the issuing entity and the concentration of credit risk in the form of subordination of one interest to another are not considered embedded derivatives; and
- narrow the exception for interest-only and principal-only securities from bifurcating embedded derivatives provided in Paragraph 14 of FAS 133.

While these exposure drafts are not currently effective, the literature should be considered when undertaking activities and entering into transactions in 2006, as the guidance is expected to be issued as final in the first or second quarters of 2006. In their redeliberations of the EDs, the FASB tentatively decided that the guidance will be effective for years beginning after September 15, 2006, with early adoption permitted. Also, the implementation of this new guidance may require significant time and resources, for no other reason than to review and modify securitization documents.

FASB Fair Value Option Project

The FASB is currently debating a proposal to permit entities to elect to report a wide range of financial instruments at fair value. The potential scope of the project includes certain financial assets and financial liabilities. The election would be available on an instrument-by-instrument basis, is irrevocable, and election must occur at the time the instrument is entered into. The Board has provided a number of reasons for this project that include the following:

1. To mitigate problems in determining reported earnings caused by the mixed-attribute model (that is, problems related to some assets or liabilities being reported at the fair value measurement attribute, but other related liabilities and assets being reported at another measurement attribute, such as amortized cost)
2. To enable entities to achieve an offset accounting effect for the changes in the fair values of related assets and liabilities without having to apply more complex hedge accounting provisions, thereby providing some potential simplicity in the application of the accounting guidance for this area
3. To achieve further convergence with the IASB, which has incorporated a fair value option (FVO) for financial instruments in its IAS 39, *Financial Instruments: Recognition and Measurement*
4. To expand the use of the fair value measurement attribute, particularly for financial instruments

Many consumer finance companies are eagerly anticipating the completion of this project as it would potentially reduce or eliminate the need to apply hedge accounting to certain complex assets such as pools of loans held for sale that have significant basis risk. Although current deliberations do not contemplate permitting entities to partially mark assets to market in a manner similar to benchmark interest rate hedge strategies contemplated in FAS 133, many companies still believe that a fair value option would lead to increased simplicity and clarity in their financial reporting. Although much remains to be discussed, the FASB has indicated that exposure drafts of this guidance should be issued in the first quarter of 2006.

FASB Fair Value Measurement Project

Background

The FASB is in the process of finalizing and issuing guidance to assist entities in measuring the fair value of assets and liabilities, and components of multiple-element transactions that are required to be disclosed, recorded or carried at fair value. The project objective is to define fair value and establish a framework for applying the fair value measurement objective in GAAP. The current proposed effective date and transition of the final Standard is for fiscal years beginning after December 15, 2006, with earlier application encouraged.

Currently, many in the mortgage and other consumer finance industries do not expect the effects of this valuation guidance to result in widespread valuation adjustments. However, given the pervasive use of fair value estimates by consumer finance companies in the preparation of financial statements, specifically for assets such as mortgage servicing rights, mortgage loans and securitized beneficial interests, companies with these types of assets should plan to undertake projects to reconcile current fair value techniques with the guidance that is expected to be issued at the conclusion of this phase of the FASB Fair Value Project.

Key Conclusions Proposed

Fair value will be defined as the price that would be received for an asset or paid to transfer a liability in a *current transaction* between marketplace participants in the *reference market* for the asset or liability. A current transaction is an orderly transaction at the measurement date, motivated by normal business decisions, which reflects the economic (market) conditions existing at that date. The appropriate reference market is the “principal market” (generally the most active market, or the market in which the entity would transact). The principal market would be the most advantageous market to the entity, absent evidence to the contrary. If no single market represents the principal market, the appropriate reference market is the most advantageous market. If there is no market for the asset or liability being measured, the appropriate market is a hypothetical market. Fair value measurement should incorporate the following valuation premises:

- Assets should be valued based upon inflows from the asset's highest and best use.
- Liabilities should be valued based upon outflows for settlement or transfer of the liability.

Valuations may require more than one valuation approach to the extent that different valuation techniques provide a more reliable overall estimate. The following valuation techniques may be applied in determination of fair value:

- *Market Approach*: Observable market prices, etc., generated by actual transactions involving identical, similar or otherwise comparable assets or liabilities.
- *Income Approach*: Valuation techniques are used to convert future amounts (e.g., cash flow) to a single, present amount (i.e., discounted).
- *Cost Approach*: Valuation of the amount that would be currently required to replace its service capacity. The estimate of fair value considers the cost to acquire a substitute asset of comparable utility, adjusted for obsolescence.

The final Statement will establish a “fair value hierarchy.” The FASB established the “fair value hierarchy” to rank inputs to valuation techniques used to estimate fair value, which is intended to provide a framework for assessing the relative reliability of the estimates. The hierarchy attempts to apply a “general measurement principle” that all valuation techniques used to estimate fair value should

maximize market inputs that represent the assumptions and data that marketplace participants would use in their estimates of fair value. In general, the more market inputs, the more reliable the estimate.

- Level 1: Quoted prices for identical assets or liabilities in active markets
- Level 2: Quoted prices for similar assets or liabilities
- Level 3: Direct market inputs other than quoted prices
- Level 4: Indirect market inputs
- Level 5: Entity inputs

The final Statement prescribes new disclosure guidance:

For each major category of assets and liabilities re-measured at fair value during the period, the disclosures should segregate fair value amounts into three disclosure levels: fair value amounts at the end of the period determined using quoted prices for identical assets or liabilities (Level 1); direct market inputs (Level 2 and Level 3); and indirect inputs (Level 4 and Level 5).

The disclosure should include information about the valuation techniques used. Total gains or losses (unrealized and realized) should be disclosed for each major category of assets and liabilities measured at fair value during the period, segregating amounts included in earnings and in other comprehensive income. Unrealized gains or losses related to those assets and liabilities still held at the reporting date should be separately disclosed for each disclosure level below Level 3.

Other Considerations

Companies should not interpret the final guidance as prescribing "when" to measure fair value. Actual market transactions between willing parties should continue to be arms-length in order for the transaction price presumption to hold.

Absent actual market transactions, companies will be required to, in effect, construct a hypothetical reference market using inputs obtained from one or more sources that are relevant to the asset or liability being measured. The guidance should thus be applied regardless of a company's intent to currently enter into a transaction for the asset or liability being measured. The fair value hierarchy assigns relevance and priority to the individual valuation inputs obtained.

During recent deliberations of the project, the FASB discussed that the most relevant fair value measurement of a liability will always reflect the credit standing of the entity obligated to pay, which implies that a liability could be settled or transferred to a third party for a lower amount than previously recorded, thereby reducing future outflows and creating a "gain" scenario. While the FASB affirmed that credit standing should be a required consideration when measuring fair value, it may reconsider practical application during a separate project.

Companies should not use an undue cost and effort criterion as a basis for determining whether to not apply a valuation technique that is otherwise relevant, as the most relevant valuation technique might also be the most costly valuation technique. The FASB has determined that the benefits of compliance outweigh the costs involved. We expect the final Fair Value Measurement Statement will apply broadly to current pronouncements requiring the use of fair value, except those related to share-based payments, financial guarantees, and certain revenue recognition of software.

Upcoming Regulation AB Compliance Requirements and Readiness

January 1, 2006 is rapidly approaching and will mark the beginning of a new era in the disclosure and periodic reporting requirements related to publicly-issued asset-backed securities (ABS) under regulation AB (Reg AB). With the year drawing to a close, there are several open questions with which the industry and the accounting profession are grappling and which further clarification from the Securities and Exchange Commission may be required.

Reg AB does not supplant the Securities and Exchange Acts of 1933 and 1934, but rather enhances them to reflect the development, growth and maturation of the traditional MBS and ABS markets, now collectively referred to as the ABS markets. As a result of Reg AB, there are numerous changes to what now can be defined as an ABS, as well as new and enhanced requirements surrounding the composition, registration, disclosure and reporting responsibilities of issuers associated with a public transaction.

Reg AB also addresses one of the most critical components in the success of any issuance – that is, the servicing of the supporting assets and bonds on behalf of investors. Changes to the disclosures surrounding the servicing function, as well as the new servicing criteria to be applied to servicing activities, are stipulated in sections 1108 and 1122 of Reg AB, respectively.

Why Is Servicing So Important?

Following the issuance of an asset-backed security, the servicing of the assets is a critical component in maintaining the viability of the issuance. Generally, market and credit risk are clearly explained in the prospectus and are known at issuance. Many transactions have multiple servicers (i.e., master, primary, and sub-servicing relationships) and special servicers (e.g., foreclosure, workout or repossession experts), some of which are private companies or are relatively inexperienced in making assessments as to their compliance with the nuances of servicing individual asset classes that are within the ever-expanding ABS market. The SEC intends for the adoption of Reg AB's uniform criteria for servicing and the related cyclical disclosures to provide investors with greater transparency as to the performance of the servicers who are supporting the value of the underlying assets and ensuring the proper application of cash flows to the bond holders.

Prior to the issuance of this regulation, the servicing of the underlying assets was reported upon under a framework known as the Mortgage Banker's Association (MBA) Uniform Single Attestation Program. Reg AB provides for broader and more formal servicing performance reporting and also expands upon the definition of a servicer. A servicer is now defined as "...any person responsible for the management or collection of the pool assets or making allocations or distributions to holders of the asset-backed security(ies)." The criteria to be applied and disclosures required for all those entities deemed servicers are extensive and extend beyond the historic perception of servicing activities.

Nearly a year after its release, the industry continues to debate this definition and question who might qualify as a servicer under the expanded rules. As Reg AB is a principles-based standard, the broad based application of the definition should be applied. However, diligence should be taken in any application of the term. The MBA and the Asset Securitization Forum have been instrumental in advancing common industry views on some of these matters and in seeking further guidance where warranted.

Servicer Disclosures: Section 1108

The disclosures that are a part of Section 1108 are designed to provide insight into what a "...reasonable investor would find material in considering an investment in the asset-backed securities and the servicing and administration of the pool assets and the ABS." The three broad areas that need to be addressed are as follows:

1. *Identifying information and experience:* A narrative on the qualifications and expertise of the servicer in performing their functions as they relate to the pool of assets as well as any material financial information or changes to servicing policies and procedure that may affect the pool being serviced.
2. *Servicing agreements and servicing practices:* A description of the terms of the servicing agreement, general and unique elements to servicing a particular asset class, and any limitations on servicer liability.
3. *Back-up servicing:* The naming of an identified back-up servicer as well as a description of the material terms necessary and process in place to bring in a back-up servicer, if needed.

The clear identification of all roles and responsibilities of all material servicers (as defined above) will provide further disclosure to investors as to the level of competence of the parties involved in daily maintenance and monitoring of pool assets, as well as their expertise in the administration of cash allocations and distributions. These disclosures now allow investors to evaluate the manner in which the underlying assets and cash administrative processes are being governed and to make an informed investment decision about a significant component of the process that was formally never disclosed.

Servicing Criteria: Section 1122

There are over thirty specific servicing criteria mentioned in section 1122 of Reg AB, which will become the de facto servicing criteria for all ABS. These criteria will usurp the MBA's Uniform Single Attestation Program (USAP) servicing criteria that have been the residential mortgage industry standard, but were often inappropriately applied to other asset types within the greater ABS market. As no official standard existed for other asset classes, Reg AB marries the newly defined role of servicer (above) with servicing criteria that can be applied across a broader class of assets in the marketplace.

The four general categories of servicing criteria with brief summaries of content are as follows:

1. *General servicing considerations:* Review of the monitoring of trigger events, a third party's performance and compliance of servicing, preparedness for backup servicing, and assurance that the fidelity bond and errors and omissions policies are in effect.
2. *Cash collection and administration:* A focus on establishing and maintaining proper controls around all forms of cash that may relate to a transaction - inflows, disbursements, and reserve amounts - are all covered as well as the application of cash to obligor's accounts and the subsequent timely reconciliation of the cash accounts.
3. *Investor remittance and reporting:* Assurance that all requisite investor filings with the SEC have been verified, are accurate, and are in accordance with the underlying transaction agreements.
4. *Pool asset administration:* Detailed descriptions of daily servicing activities (e.g., substitutions of assets, loan modifications, I/R adjustments, etc.) are conducted in accordance with the transaction documents and that credit enhancement is properly maintained.

Each of the parties that are defined as servicers must now formally assess and make an assertion regarding their compliance with the criteria in 1-4 above. On an annual basis, public accountants will be required to perform an attestation of the servicing party's assertion on compliance with the criteria and note any areas of material non-compliance that have occurred throughout the year, regardless of whether the issue has been remediated by year-end. The ramifications of any material instance of non-compliance include clearly disclosing these elements on the 10-K and, in some cases, could affect an issuer's ability to issue securities via their shelf registration. Therefore, market participants must be diligent in their preparation for the implementation of these new rules that take effect on January 1, 2006.

Reflections, Thoughts and Comments

Many investors have indicated that they welcome these changes as an attempt to create transparency in the market and that a uniform measure in the evaluation of servicing attributes is long overdue. The road ahead for servicers will require greater levels of internal scrutiny and evaluation, and compliance in the initial year for many will be challenging and costly as improvements to processes and systems may be necessary to ensure and demonstrate compliance.

In some cases diversity remains in the definition of critical terms; however, their interpretation should be broad-based to ensure compliance. It is essential that all servicers clearly understand and know their role in the transaction and what is required of them by principal parties to the transaction. Companies are urged to think through their initial platform designations (not too narrow, not too broad) and to ensure that all parties impacted by the servicing criteria are notified and expectations managed. A best practice is to create a matrix of the criteria and to denote each responsible party for which an assertion may be required. Many servicers may find that the list of parties supporting the servicing function is more extensive than first believed. Servicers should have already started an internal assessment of their ability to adopt these principles. It is important for them to evaluate the controls that are in place and ensure that they are assessing and/or executing properly, based on their role in the transaction.

While there remain several key questions and issues that require further clarification around Reg AB and its forthcoming implementation, the industry, along with the accounting profession, is attempting to resolve the open questions and will continue to do so into early 2006. From now through the first quarter of 2007, the business of servicing will once again be front and center. The process of how information will be reported, by whom and when it will be reported will be vetted as the industry makes its first attempts at asserting compliance with the new criteria, and accounting firms prepare their initial year attestation reports.

Statement of Position 03-3 Summary

Introduction

Consumer finance companies are facing a recent challenge in implementing the now effective Statement of Position 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer* (SOP 03-3). This Statement became effective early in 2005 and affects most consumer finance companies that acquire loan portfolios and hold them for investment. As a result of this guidance, certain consumer finance companies have had to modify their loan systems in order to adhere to the guidance as well as to change how loans are reported within their financial statements.

This article addresses many intricacies related to SOP 03-3. This SOP significantly changes the manner in which certain business decisions, such as the purchase or calling of financial assets, are reflected in a company's financial statements. Some of the significant challenges posed by this SOP include:

- applying SOP 03-3 to a portfolio of loans at a loan level upon acquisition rather than in the aggregate;
- initially valuing the loans acquired, especially in the event other assets are acquired along with loans with deteriorated credit quality;
- subsequently tracking that portfolio (as acquired) for the life of the loans or until sold;
- determining the method of applying valuation allowances to the portfolio; and
- determining the method by which income is recognized.

One also should consider that no valuation allowance is recorded at acquisition of the loan portfolio as prescribed within the Statement. This can have a significant affect on how these loans are valued and reported within corresponding financial statements. The following discussion speaks to each of the above items with the intent of providing a summation of SOP 03-3 meant to help the reader identify the key components and comply with this new Statement.

How SOP 03-3 May Affect Consumer Finance Companies

The Statement became effective January 1, 2005, requiring all non-governmental entities to consider the accounting treatment of loans acquired with deteriorated credit quality. There are certain scope limitations to SOP 03-3 that exclude:

- loans valued at fair value if all changes in fair value are included in earnings;
- mortgage loans classified as held for sale;
- leases as defined in FASB Statement No. 13, *Accounting for Leases*;
- loans acquired in a business combination accounted for at historical cost;
- loans held by liquidating banks;
- revolving credit agreements (i.e., credit cards and home equity loans); and
- loans that are retained interests.

Therefore, the scope of the SOP would potentially include all loans purchased, including investment securities subsequently classified as available-for-sale or held-to-maturity. According to SOP 03-3,

“deteriorated credit quality” would be determined to exist in the event the investor believes it is probable that it will be unable to collect all contractually required payments receivable.

Acquisition Accounting under SOP 03-3

It is clear that upon the purchase of a portfolio of assets it must be determined whether any such assets have “deteriorated credit quality.” In order to determine this, a cash flow analysis should be applied. When applying such cash flow analyses, the undiscounted cash flows expected throughout the entire life of the asset should be compared with all contractual cash flows. No discount rate is utilized in determining such cash flow streams. In the event the expected undiscounted cash flows are less than the contractual cash flows required, the asset would be determined to have “deteriorated credit quality.” This analysis should be done at the loan level in order to determine which loans would fall within the scope of SOP 03-3 and which assets would be excluded from SOP 03-3.

Once it has been determined which assets fall within SOP 03-3 and which assets are excluded, a company must then undertake to determine their valuation and classification. According to the Statement, the assets must be recorded at the present value of future cash flows; usually the amount paid for such assets. Accordingly, the book basis of a loan will equal the purchase price of that loan. This accounting method results in no accretable yield (difference between expected cash flows and cash paid) or non-accretable yield (difference between contractual cash flows and expected cash flows) being reflected within the financial statements.

The application of such guidance may be complicated with the acquisition of multiple assets (some with “deteriorated credit quality” and some under previous guidance) that are acquired with one lump sum as a single transaction. This presents a complexity that only the assets acquired with “deteriorated credit quality” should be recorded at the amount paid. All other assets acquired in a single transaction should be accounted for pursuant to other relevant accounting guidance. This assessment should be completed at the inception of the purchase, as the loans required to be accounted for under SOP 03-3 most likely will need to be tracked separately from other loans within the entity’s portfolio until either the loans are paid off in their entirety or are subsequently sold.

According to the SOP, each portfolio of assets acquired must continue to be tracked individually and separately from all other loans (previously held and other portfolios acquired) throughout the life of the loans for subsequent valuation purposes. This could present operational problems because upon the initial boarding of the loans acquired, an additional flag within the servicing system would need to be assigned to each portfolio of loans in order to track the loans over time. Additionally, in the event such loans were securitized within a transaction accounted for as a secured borrowing under FAS 140, the loans would continue to be tracked within the initial acquired portfolio rather than, or in addition to, the new security pools.

The SOP also delineates the classification requirements for debt securities and non-debt securities that fall under the scope of SOP 03-3. SOP defines a debt security similarly to the definition contained in FAS 115. In the event the purchasing entity classifies the acquired assets as “not a debt security,” the entity may track and subsequently record the acquired assets at the aggregate level rather than at the individual asset level. In the event the acquired assets are classified as debt securities, the entity must track and subsequently record at the individual asset level.

Subsequent Loan Revaluation under SOP 03-3

According to SOP 03-3, loans acquired must be subsequently re-valued based on expected cash flows over the course of the loans life or until sold. These cash flows would most likely be based on undiscounted cash flow streams in order to compare with those cash flows estimated at the time of acquisition. One must re-evaluate the initial value attributed to the asset based on cash flows expected at the time of acquisition. In the event the assets are determined to have a lesser value based on cash flows expected subsequent to acquisition, in comparison to those cash flows expected at the time of acquisition, the entity must record a valuation allowance for such assets.

However, in the event the subsequent valuation of acquired assets results in future cash flows that are greater than those expected at the time of acquisition, the increased value is reflected through an adjustment of accretable yield. As mentioned previously, accretable yield is the amount of expected cash flows greater than the amount paid for the acquired assets. This yield is then realized in income over the life of the loan. SOP 03-3 generally requires that revenue recognition be recognized through the application of the effective interest method, resulting in the yield being continuously adjusted for performance of the loan or pool of loans.

In order to perform the subsequent revaluations throughout the life of the loans held, the entity must likely be able to separately track not only the loans, but also any associated valuation allowance. Companies should be aware that this may present unexpected complexity with inflexible servicing systems that may not allow an entity to effectively track the acquired loans apart from the entire loan portfolio. In practice, many companies adjust the overall loan loss allowance at the aggregate portfolio level, thus resulting in additional or less income statement impact (impairment). This practice may not allow for the acquired loans to be properly valued over time because the valuation allowance must be adjusted based on the changes in the assets acquired, rather than the aggregate loan portfolio.

Implications of SOP 03-3 for Securitization Activities

Securitization activity may present some additional challenges for companies subject to SOP 03-3. One area of challenge may be the practice of calling of previously securitized loans through some form of a “clean-up call.” Many loans within the securitization that may be called would most likely not fall within the deteriorated credit quality bucket; however, given the seasoning of the pool of loans at the clean up call date, it is likely that some of the called loans may fall under the scope of the SOP. Companies engaged in these types of transactions need to take particular care in determining the classification of the acquired loans and in evaluating their ability to comply with the subsequent accounting and reporting requirements.

Conclusion

SOP 03-3 has several effects on how a company should recognize the value of a loan and subsequently mark it over time. This may have considerable impact on the manner in which a company records loans and the method in which they are acquired. As consumer finance companies adopt and implement this guidance, more and more questions will arise. As the consumer finance industry enters a time of slower origination volume and higher merger activity, this SOP will have an increasing effect on entities within the market as more and more portfolios are acquired.

Proposed FSP Staff Position No. SOP 94-6-a, Non-traditional Loan Products

Background

The FASB has undertaken a project to codify the disclosure requirements and other accounting considerations required for entities that originate, hold, guarantee, service or invest in non-traditional loan products, including option adjustable-rate mortgages (ARMs). Specifically, the FASB Staff Position (FSP), when issued as final, is expected to address whether non-traditional loan products represent a concentration of credit risk and the potential disclosure requirements.

The exposure draft of the FSP defines non-traditional loans as:

- loans with the contractual ability to negatively amortize
- loans with a high loan-to-value ratio
- home equity lines of credit, second mortgages or other products that result in a high loan-to-value ratio when combined with other mortgages on the same collateral
- option ARMs or similar products that may expose the borrower to future increases in repayments
- loans with below market or teaser interest rates
- interest-only loans

Disclosure Considerations

Non-traditional loan products generally expose a reporting entity to greater credit risk than traditional mortgage products. For example, these products may provide for reduced payment requirements in the early part of the loan's term, which may increase the likelihood of a delay in defaults. The proposed FSP addresses a number of the potential disclosure requirements that should be considered.

Since non-traditional loans may delay a creditor's determination that the conditions have been met for the accrual of a loss (FASB Statements No. 5 and No. 114), this may result in a *concentration of credit risk* as that term is used in FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (FAS 107). Paragraph 15A of FAS107 requires disclosures about each significant concentration, which may include, but are not limited to:

- borrowers subject to significant payment shocks
- loans with the contractual ability to negatively amortize
- loans with high loan-to-value ratios

FAS 107 also encourages the disclosure of "quantitative information about the market risks of financial instruments that is consistent with the way [the reporting entity] manages or adjusts those risks." For example, an entity may disclose how underwriting procedures are designed to control the credit risk in relation to future payment shocks experienced by borrowers.

AICPA Statement of Position No. 94-6, *Disclosure of Certain Significant Risks and Uncertainties* (SOP 94-6) requires disclosure of risks and uncertainties related to nature of operations, use of estimates in the preparation of financial statements, certain significant estimates, and current vulnerability due to certain concentrations.

Other concentrations should be disclosed if they meet the requirements of SOP 94-6. Specifically, a disclosure is required if a concentration exists at the date of the financial statements, the concentration makes the entity vulnerable to the risk of a near-term severe impact, and it is at least reasonably possible that the events that could cause the severe impact will occur in the near term.

In the case of negatively amortizing loans (e.g., option ARMs), negative amortization results in the recognition of interest income that is not received in cash, but rather, is added to the principal balance of an outstanding loan. To the extent that this non-cash interest income is significant, it is required to be included in the reconciliation of net income to net cash flows from operating activities as required by FASB Statement No. 95, *Statement of Cash Flows*.

An entity that has recognized a servicing asset for the servicing of non-traditional products is required to consider whether the predominant risk characteristics of the specific product type result in a separate stratum when determining impairment. FAS 140 requires the disclosure of the risk characteristics used to stratify recognized servicing assets for purposes of measuring impairment.

For public entities, additional disclosures may be required by applicable SEC Rules and Regulations (for example, Item 303 of Regulation S-K, *Management's Discussion and Analysis of Financial Condition and Results of Operations*). For banks and bank holding companies subject to the requirements of SEC Regulation S-X, Rule 9-03, and the Securities Act Industry Guide 3, additional disclosures may be required.

Other Considerations

The proposed FSP reminds entities that FASB Statement No. 91, *Accounting for Non-refundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases* (FAS 91) requires the use of the interest method for recognizing interest income. The following are related considerations:

- In accordance with FAS 91, Par 18(a), companies that originate or purchase loans with teaser rates (e.g., I/O, option ARM) at a net discount cannot amortize that discount to the extent that interest recognition would increase the carrying value of the loan above the amount at which it could be settled. This would likely occur during the teaser period where the effective yield on the loan (near the stated rate) is significantly higher than the teaser rate.
- Companies that originate or purchase loans with teaser rates at a net discount may experience accelerated discount accretion during the teaser period if the loan's effective rate is significantly higher than the teaser rate.
- Straight line or other forms of amortization may not approximate the interest method for many non-traditional loans.
- Incorporating a prepayment assumption into net cost or fee deferrals will in general be overly difficult to apply correctly, and would require a sophisticated amortization model that is well controlled.

Entities are also reminded of the potential credit risks associated with non-traditional loan products, with the primary risk associated with the payment shock facing the borrower once an I/O or option ARM loan, for example, resets or recasts. Monthly payment spikes can severely affect a borrower's ability to repay the loan leading to excessive defaults and losses. A rising interest rate environment could exacerbate these risks.

FASB Clears Two DIG Issues with Widespread Effect on Embedded Derivatives

The FASB recently issued Derivatives Implementation Group (DIG) Issue B38, *Evaluation of Net Settlement with Respect to the Settlement of a Debt Instrument through Exercise of an Embedded Put Option or Call Option* (B38), and DIG Issue B39, *Application of Paragraph 13(b) to Call Options That Are Exercisable Only by the Debtor* (B39). These two DIG issues provide guidance in applying FAS 133. B38 will change the accounting for many embedded put options and call options in non-public debt instruments. B39 was introduced to minimize the impact of B38 for call options exercisable by debtors, for example, prepayment features. Together, these two issues provide sweeping changes to the current accounting for embedded derivatives in non-public debt instruments.

The basic premise of FAS 133 is that all derivatives should be reported at fair value on the balance sheet, with changes in fair value recorded as income or expense (marking to market). When devising the model, the FASB was concerned that companies might move derivatives inside other arrangements to avoid marking them to market. As a result, the FASB included guidance to capture “embedded derivatives,” that is, those that may be included in other contractual arrangements, which are called hosts. An example of an embedded feature is a prepayment feature within a loan. A prepayment feature is a call option that gives the debtor the right, but not the obligation, to buy the loan at a fixed price—that is, prepay the loan—at a certain time or during a certain period, such as over the life of the loan. Embedded derivatives must be accounted for separately from their hosts, that is, marked to market, if:

- their economic risks and characteristics are not clearly and closely related to the hosts;
- the hosts are not reported at fair value; and
- the embedded derivatives would meet the definition of a derivative if not embedded.

Call options and put options in debt instruments must be carefully considered under the FAS 133 embedded derivative model. When evaluating whether embedded puts and calls meet the definition of a derivative, the key assessment is whether the call or put can be “net-settled.” An instrument is net-settled if neither party is required to deliver an asset, but settles the net payable or receivable. An instrument is also net-settled even if an asset is delivered if that asset can be easily sold in the market, or an offsetting contract can be purchased or if the asset is readily convertible to cash.

For publicly traded debt instruments, accountants have agreed that the net settlement criteria can generally be met since, by definition, there is a public market for such instruments and therefore, the instrument can be readily converted to cash. That said, it is not so easy to determine if a non-public instrument can be net-settled, but B38 provides guidance around the definition of net settlement, specifically concerning puts and calls in non-public debt instruments. Because many companies do not currently consider prepayment options within non-public debt instruments to have the characteristic of net settlement, B38 has a widespread impact on several industries.

Non-public debt instruments are not easily sold in the market or readily converted to cash. Accordingly, to be net-settled in accordance with FAS 133, neither party must be required to deliver an asset. There has been some disagreement over whether an asset is delivered when a debt instrument is pre-paid. Some historically believed that when a debtor prepays an obligation, the debtor receives the cancelled note in return, which was an asset in the hands of the lender. Thus, gross physical delivery of an asset has occurred and the debt was not net-settled. Others believed (now including the FASB) that because the note is not an asset in the hands of the debtor, an asset has not been delivered and thus, the instrument is net-settled. The FASB incorporated this view in B38: if a put or call option embedded in a debt instrument is exercised, then the settlement of the obligation by the debtor to the creditor constitutes net settlement.

Since the implementation of FAS 133, many issuers and holders of non-public debt instruments have not marked embedded put and call options in debt instruments to market. This is because they held the first view, that settlement of an obligation constituted delivery of an asset, and since the instrument was not readily convertible to cash, the embedded put and call options were not considered net-settled. Under B38, the embedded put and call options in debt instruments will be considered net-settled. Thus, the embedded put and call options will meet the definition of a derivative and will have to be further considered under the remaining FAS 133 criteria to determine if they must be accounted for separately. B38 may not be applied by analogy to embedded put and call options in hybrid instruments that do not contain debt host contracts. B38 also cannot be applied in situations where put or call options are added to a debt instrument by a third party.

The remaining FAS 133 criteria to consider are whether the host is reported at fair value and whether the embedded feature is clearly and closely related to the host. Determining whether the host is reported at fair value is a fairly easy assessment, but determining whether an embedded feature is clearly and closely related to its host is often not so easy. Paragraph 13 of FAS 133 provides guidance regarding whether an embedded derivative with an interest rate or interest rate index as an underlying is clearly and closely related to its host. B39 somewhat mitigates the impact of B38 by providing an exemption from the requirements of Paragraph 13(b) of FAS 133 for call options that are exercisable by the debtor. In other words, if a call option is exercisable by the debtor, such as a pre-payment feature in a loan, then it is automatically considered clearly and closely related to its host. In that case, it would not be accounted for separately. It is worth noting that mortgage-backed securities do not contain call options and are therefore not subject to B39.

Both B38 and B39 will be effective at the same time: the first day of the first fiscal quarter beginning after December 15th. Once these issues are effective, companies will apply them prospectively to new and existing contracts – they will not change the previous accounting in prior reporting periods. Implementation of B38 will require a cumulative effect-type adjustment in accordance with the transition provisions in Paragraph 51 of FAS 133 for all existing embedded put and call options that will need to be accounted for separately because they meet the definition of a derivative. Under B39, if a previously marked-to-market call option no longer qualifies as a derivative, the fair value will be added back to the carrying value of the instrument.

Because of the guidance in B38 and B39, the FASB has also cleared technical revisions to DIG Issue B16, which provides additional guidance on how to determine if embedded put and call options are clearly and closely related to their hosts.

Current Scrutiny Regarding FAS 91

Throughout 2005, we have noted increasing scrutiny around how companies are accounting for non-refundable fees and costs associated with originating or acquiring mortgage loans as defined by FASB Statement No. 91, *Accounting for Non-refundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases* (FAS 91). Although, no formal interpretations or significant amendments to the Standard have been issued for some time, several areas have remained troublesome for practitioners in the consumer finance industry. Among these areas are the application of the effective yield method of amortization for pools of similar assets and the classification of fees and costs for loans held for sale.

Amortization and Accretion of Premiums and Discounts

Many companies have experienced difficulty applying Paragraph 19 of FAS 91 as it relates to incorporating estimated future prepayments in the calculation of a constant effective yield on pools of assets or liabilities that are subject to the scope of FAS 91. Estimates of future prepayments frequently differ from actual prepayment activity; therefore, FAS 91 permits companies to recalculate the effective yield to reflect actual payments to date and anticipated future payments. The recalculated effective yield is to be applied retroactively as if it existed at the acquisition date of the loans, resulting in a “catch up” entry in order to accurately reflect the net investment in the loans. Because future prepayment patterns are difficult to predict, large variances between estimated prepayments and actual prepayments are not uncommon, resulting in volatile periodic “catch up” adjustments that often have a material impact on earnings.

Upon scrutiny of the methods by which companies have performed these calculations, problems have frequently been observed in the application of consistent assumptions, affects on prepayment speed of variable rate resets, data consistency related to historical cash flow information and others. As a result of these complexities, many companies are reconsidering their application of Paragraph 19 in favor of a contractual method of amortization. These companies are discovering that, although the contractual method does not incorporate prepayment estimates in the amortization calculation, it is inherently simpler to maintain and control, and more closely aligns the income realization with actual prepayment activity. Because the contractual method writes off prepayments as they occur, the method is subject to potentially greater P&L volatility; however, the volatility is derived from actual prepayment activity as opposed to inaccurate prepayment estimates.

Classification of Premiums and Discounts for Loans Held for Sale

An area of continuing scrutiny relates to the classification of fees and costs received in the acquisition and origination of consumer loans. Paragraph 6 of FAS 91 states that “direct loan origination costs of a completed loan shall include only (a) incremental direct costs of loan origination incurred in transactions with independent third parties for that loan and (b) certain costs directly related to specified activities performed by the lender for that loan.” The Paragraph further states that “specified activities” shall include activities related to loan counselling/negotiations, application processing, appraisals, initial credit analyses, initial credit investigations, quality control reviews performed during the underwriting period, direct approval processing, loan evaluations and approval committee review (all activities included in origination decision), and loan closing.

Paragraph 6 goes on to read that employee costs related to these activities shall be capitalized, but the deferral is limited to “only that portion of the employees’ total compensation and payroll-related fringe benefits directly related to time spent performing those activities for that loan and other costs related to those activities that would not have been incurred but for that loan.” The phrase “total compensation and payroll-related fringe benefits” includes expenses related to employee salaries/wages, payroll taxes, dental and medical insurance, group life insurance, retirement plans, 401(k) plans, stock compensation plans and overtime meal allowances. It is important to keep in mind that only the expenses incurred on completed or successful originations are to be capitalized. Employee costs for unsuccessful origination attempts must be expensed as incurred and recognized in income immediately. This can be an issue

where the principal form of compensation to a loan officer is purely commission based (the view being that some portion of the commission received is compensating the loan officer for time spent on unsuccessful efforts).

Upon the successful implementation of Paragraph 6 in deriving an accurate standard cost per loan amount, it is important to apply the calculation to the correct population in order to arrive at an appropriate amount to be capitalized. Frequently, companies in the consumer finance industry utilize so-called standard cost amounts for purposes of estimating the deferral on these origination fees and costs. Given the dynamic nature of the marketplace over the past several years, we have noted that in some cases the information behind these standard costs may be stale. As such, as companies approach the year-end reporting cycle, consideration should be given to the reliability and reasonableness of the estimates used in complying with this Standard.

Another area of frequent confusion relates to the treatment of the deferred fee/cost balance upon sale of the underlying loans. Because the FASB concluded that origination fees and direct loan origination costs should be accounted for as components of a loan's acquisition cost (fees and costs are embedded in the basis of the loan), when these loans are sold, the net deferred fees/costs should be a consideration in the calculation of the loan's gain or loss from sale. Companies should ensure that they do not utilize a "book-and-reverse" method as it relates to the deferral of the original net premium/discount. This method can result in the incorrect classification of the origination fees and expenses.

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