Welcome to the Spring 2008 edition of PwC’s Consumer Finance Group Accounting Considerations, where we bring you insights into the complexity of the accounting and reporting issues that are affecting your industry.

The events of the second half of 2007 relative to the credit crisis and the turmoil within the overall U.S. markets as a result of the subprime mortgage issues have been at the forefront of the news. This edition contains an article that is focused on the impact that the credit crisis has had on accounting matters as well as several topical and emerging accounting and reporting technical issues that will most likely be of importance to the financial reporting and accounting staff of consumer finance companies. These topics include the difference between IFRS and US GAAP, new developments in hedge accounting, recent SEC guidance for management, regulation AB compliance, lessons learned from implementing FAS 157 and 159 among others.

As with previous issues of this publication, we hope that you find the collection of issue summaries relevant and helpful as well as timely. The volume of literature and rules changes from standard setters continues to be unprecedented; however, we are both excited and optimistic about these changes. We are committed to keeping you informed of industry accounting and regulatory issues and we encourage you to reach out to the authors of the articles about a particular or related topic.
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SEC guidance for management

The following discussion describes several key areas of focus for management in performing an assessment of a company's internal control over financial reporting for the current year in accordance with the SEC’s new management guidance.


In addition, on May 23, 2007, the SEC approved and released interpretive guidance regarding management’s report on ICFR. The SEC expects AS 5, in combination with the SEC’s new management guidance, will make Section 404 audits and management evaluations more risk-based and scalable to company size and complexity.

The proposed guidance consists of two broad principles. The first principle is that management should evaluate whether it has implemented controls that adequately address the risk that a material misstatement in the financial statements would not be prevented or detected in a timely manner. The guidance describes a top-down, risk-based approach, including the role of entity-level controls, in assessing financial reporting risks and the adequacy of the controls. The second principle is that management’s evaluation of evidence about the operation of its controls should be based on its assessment of risk. The guidance provides an approach for making risk-based judgments about the evidence needed for the evaluation.

Embedded within these two principles are several areas of focus management should consider when implementing the new guidance. These areas are listed below and then presented in greater detail in the following sections:

- Identifying financial reporting risks
- Identifying controls that adequately address financial reporting risks
- Consideration of entity-level controls
- Role of information technology general controls
- Determining the evidence needed to support the assessment
- Implementing procedures to evaluate evidence of the operation of ICFR
- Evidential matter to support the assessment

Identifying financial reporting risks

Financial reporting risks are defined as risks of misstatement that could, individually or in combination with others, result in a material misstatement to the financial statements. Identifying financial reporting risks requires an understanding of how the requirements of GAAP apply to the company’s business, operations and transactions. Management then uses its knowledge and understanding of the business and its organization, operations and processes to consider the sources and potential likelihood of misstatements to the financial statements. Internal and external risk factors that impact the business, including the nature and extent of any changes in those risks, may give rise to a risk of misstatement. Risks of misstatement may also arise from sources such as the initiation, authorization, processing and recording of transactions and other adjustments that are reflected in financial reporting elements.

Management’s evaluation of financial reporting risks should consider the vulnerability of the entity to fraudulent activity (e.g., fraudulent financial reporting, misappropriation of assets and corruption) and whether any such exposure could result in a material misstatement of the financial statements. Management should recognize that the risk of material misstatement due to fraud ordinarily exists in any organization, regardless of size or type.
Identifying controls that adequately address financial reporting risks

Management should identify controls that adequately address the financial reporting risks previously identified. A control consists of a specific set of policies, procedures and activities designed to meet an objective. Controls within a process may consist of financial reporting controls (those that provide reasonable assurance regarding the reliability of financial reporting) and operational controls (those designed to achieve operational objectives). It is not necessary to identify all controls that exist or identify redundant controls, unless redundancy itself is required to address the financial reporting risks. Management may also consider the efficiency with which evidence of the operation of a control can be evaluated when identifying the controls that adequately address the financial reporting risks. In other words, when more than one control exists that adequately addresses a financial reporting risk, management may decide to select the control for which evidence of operating effectiveness can be obtained more efficiently, such as automated controls. Management may also determine that an entity-level control adequately addresses an identified financial reporting risk.

Consideration of entity-level controls

It’s important to note that some entity-level controls, such as the control environment, have an indirect effect on the likelihood that a misstatement will be prevented or detected on a timely basis. While important to consider in determining the nature, timing and extent of testing, these types of controls are not designed to fully address the related financial reporting risk. It will be important for management to carefully consider the design of entity-level controls, including the level of precision at which they operate, to determine whether the controls operate with the level of consistency and rigor necessary to prevent or detect material misstatements on a timely basis. Management may determine that it is necessary to modify or enhance the design of these controls to achieve this objective.

Role of information technology general controls

Controls that management identifies as addressing financial reporting risks may be automated, dependent upon IT functionality, or a combination of manual and automated procedures. Management’s evaluation process generally considers the design of such controls and the relevant IT general controls over the applications providing IT functionality. The identification of risks and controls within IT should not be a separate evaluation; it should be an integral part of management’s top-down, risk-based approach to identifying risks and controls.

Determining the evidence needed to support the assessment

Management should consider the characteristics of the controls identified that adequately address financial reporting risk as well as the financial statement amounts and disclosures to which the controls relate (collectively, “ICFR risk”) when determining the evidence needed to support the ICFR assessment. In other words, the higher the risk of material misstatement for a given financial amount or disclosure and the greater the risk of control failure, the more evidence needed to support the assessment.

The risk of material misstatement is impacted by both the materiality of the financial statement amount or disclosure and the susceptibility of the underlying account balances, transactions or other supporting information to a misstatement that could be material to the financial statements. For example, risk of material misstatement would be higher (requiring more sufficient evidence) for a financial statement amount or disclosure that involves significant judgment in determining the recorded amounts (e.g., allowance for loan losses). The consideration of entity-level controls may influence management’s determination of the evidence needed to sufficiently support its assessment of ICFR.
Implementing procedures to evaluate evidence of the operation of ICFR

The methods and procedures management uses to gather evidence about the effective operation of controls are based on its assessment of the company’s financial reporting risk. Therefore, the methods and procedures, including the timing of when they are performed, are a function of the evidence that management considers necessary to provide reasonable support for its ICFR assessment based on the risk. The methods management uses to gather evidence for its evaluation include ongoing monitoring activities (including management self-assessments), direct testing of controls or a combination of both. As ICFR risk increases, management will ordinarily adjust the nature of the evidence that is obtained. When ICFR risk is assessed as high, management’s evaluation would ordinarily include evidence obtained from direct testing or ongoing monitoring activities performed by individuals who have a higher degree of objectivity. For lower-risk areas, management may conclude that evidence from ongoing monitoring activities is sufficient and that no direct testing is required. Management’s evaluation would ordinarily consider evidence from a reasonable period of time during the year, including the fiscal year-end.

Evidential matter to support the assessment

Management must maintain reasonable support for its assessment. Documentation of the design of the controls management has placed in operation to adequately address the financial reporting risks is an integral part of the reasonable support. The form and extent of the documentation will vary depending on the size, nature and complexity of the company. Also, management’s assessment must be supported by evidential matter that provides reasonable support for its assessment. The nature of the evidential matter may vary based on the assessed level of ICFR risk of the underlying controls and other circumstances.

Conclusion

The guidance from the SEC provides management with a risk-based approach in making judgments about evidence needed to support its assessment of ICFR. Further, this new guidance from the SEC allows management to align the nature and extent of its evaluation procedures with those areas of financial reporting that pose the greatest risks to reliable and accurate financial statements.

The successful implementation of this new guidance should allow management to bring its own experience and informed judgment to bear when designing an evaluation process that meets the needs of its company and provides a reasonable basis for its annual assessment of whether ICFR is effective. This should allow management sufficient and appropriate flexibility to design such an evaluation process.
Adapting to global accounting rules: IFRS vs. US GAAP

Since 2002, the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) have been committed to converging International Financial Reporting Standards (IFRS) and US generally accepted accounting principles (GAAP). On June 20, 2007, the US Securities and Exchange Commission took a milestone step when it unanimously voted to advance a proposal that would allow non-US companies to file their financial statements using IFRS without reconciling the figures to US GAAP.

The SEC further said it would take another step this summer to move toward global accounting rules, exploring the possibility of allowing US companies to report their financial results either under US GAAP or IFRS. One day, perhaps, US GAAP may be replaced by a single set of globally accepted financial reporting standards that allows companies worldwide to speak a single financial language.

While the SEC eliminated the requirement that foreign private issuers who file their financial statements using IFRS also must file a reconciliation of those financial statements to US GAAP, the Commission now requires those foreign issuers to highlight the differences between the two methods. As US GAAP is commonly thought of as a rule-based approach and IFRS is considered more of a principle-based approach, IFRS gives companies more leeway in their financial reporting.

The following sections underscore a few main differences between IFRS and US GAAP as they relate to the consumer finance industry. It will be important to focus on and assess the impact of these differences as the SEC further explores enabling US-based companies to report under IFRS.

Use of the fair value option

Under IFRS, the fair value option applies only to financial instruments within the scope of IAS 39, Financial Instruments: Recognition and Measurement. For example, the fair value option would not apply to:

- An entity’s obligation to settle a liability in connection with a product warranty
- Insurance contracts that do not meet the definition of a financial instrument or contain a discretionary participation feature

Under US GAAP, the fair value option can be applied to financial instruments, and it can also be applied to certain insurance and warranty contracts that do not meet the definition of a financial instrument.

In addition, under IFRS, certain criteria must be met in order to apply the fair value option. Specifically, the fair value option may be used provided one of these conditions is satisfied:

- It eliminates or significantly reduces a measurement or recognition inconsistency.
- A group of financial assets or liabilities (or both) is managed and performance is evaluated on a fair value basis.
- The contract contains one or more embedded derivatives.

Under US GAAP FAS 159, applying the fair value option is unrestricted, and it may be used for any item within the scope of FAS 159.
Derecognition of financial assets

Under IFRS, an entity first needs to address the issue of consolidation of all subsidiaries in accordance with IAS 27 and SIC 12 and then apply the derecognition principles in IAS 39 at the consolidated level. One of the key questions in applying IAS 39 derecognition principles is to determine whether there has been a transfer. A transfer can occur in either a transfer of contractual rights or a pass-through arrangement (refer to IAS 39, par. 19, for the “pass-through tests”). If the transaction qualifies as a transfer of legal rights or as a pass-through arrangement, then the risks and rewards of the transferred assets must be assessed further to determine if the assets can be derecognized under the derecognition criteria:

- If the entity has transferred substantially all the risks and rewards, the entity derecognizes the asset.
- If the entity retains substantially all the risks and rewards, the entity continues to recognize the asset.
- If the entity has neither transferred nor retained substantially all the risks and ownership, the entity has to determine if it has retained the control of the asset.

Under US GAAP, the derecognition model is governed by three key tests:

- Legal isolation of the transferred asset from the transferor—assets have to be isolated from the transferor and beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.
- The ability of the transferee to pledge or sell the asset—the transferee has to be able to pledge or exchange the transferred asset free from constraint.
- No right or obligation of the transferor to repurchase—the transferor cannot maintain effective control through a right or obligation to repurchase or redeem assets or a right to purchase or the ability to unilaterally cause the holder to return specific assets (except for “clean-up” call).

Loan origination and fees and cost recognition

The criteria for capitalization of acquisition costs for loans are more restrictive under IFRS than under US GAAP.

IAS 39 does not consider certain internal costs as incremental costs directly attributable to the origination of financial instruments and, therefore, they are expensed as incurred and excluded from effective interest yield calculations. To be part of the initial cost of a financial asset, the transaction costs must be directly attributable to the acquisition of the financial asset (i.e., only incremental costs). Examples include: (a) fees and commissions paid to agents, advisers, brokers and dealers; (b) levies by regulatory agencies and securities exchanges; and (c) transfer taxes and duties. Examples of costs that would not qualify under IFRS to be part of the initial cost of a financial asset include: (a) internal administrative or holding costs; (b) financing costs; and (c) costs to exit or sell the asset.

SFAS 91 under US GAAP requires nonrefundable fees and costs associated with lending, commitment to lend, or purchasing a loan or a group of loans to be deferred and recognized over the life of the related loan through amortization using effective yield method. FAS 91 permits the following to be included in the initial cost of originated or acquired loans:

- Incremental direct costs of loan origination or acquisition incurred in transactions with independent third parties for that loan
- Certain costs directly related to specified activities performed by the lender of that loan, such as:
  - Evaluating the prospective borrower’s financial condition
  - Evaluating and recording guarantees, collateral and other security arrangements
  - Negotiating loan terms
  - Preparing and processing loan documents
  - Closing the transaction
FAS 91, par. 6, also states that, “The costs directly related to those activities should include 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.” IAS 39 does not consider those costs as incremental costs directly attributable to the origination or acquisition of the loan and, therefore, they are expensed as occurred.

The other key divergence between IAS 39 and FAS 91 is how to measure the effective interest rate. For financial assets that are carried at the amortized cost, the calculation of the effective interest rate under IFRS is generally based on the estimated cash flows over the expected life of the asset, while under US GAAP it is generally based on contractual cash flows over the asset’s contractual life.

Under IFRS, the effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset. When calculating the effective interest rate, an entity estimates cash flows considering all contractual terms of the financial asset (for example, prepayment, call and similar options) but must not consider future credit losses (IAS 39, par. 9). Contractual cash flows over the full contractual term of the financial asset are used only in those rare cases when it is not possible to estimate reliably the cash flows or the expected life of a financial asset.

Under US GAAP, the effective interest rate is generally calculated based on the contractual cash flows through the contractual life of the financial assets, although certain exceptions exist for certain financial assets. The expected life can only be used for (a) loans if the entity holds a large number of similar loans and the prepayments can be reasonably estimated, (b) certain structured notes, (c) certain beneficial interests in securitized financial assets and (d) certain loans or debt securities acquired in a transfer.

Derivatives and hedge accounting

Under both IFRS and US GAAP, derivatives are measured at fair value on the acquisition date and recognized as either financial assets or liabilities on the balance sheet. Subsequent changes in fair value are recognized in the income statement as they arise, unless the derivatives satisfy the criteria for hedge accounting.

The differences between IFRS and US GAAP in hedge accounting are summarized in the table on the next page:
As illustrated above, significant differences exist between US GAAP and IFRS. As the SEC explores the option of allowing US-based companies to report under IFRS, companies interested in exploring this option will need to begin to assess where the differences in the current accounting exists and prepare an analysis and report under IFRS.

<table>
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<tr>
<th>Accounting Topic</th>
<th>Under IFRS</th>
<th>Under US GAAP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basis adjustments under cash flow hedges</td>
<td>A “basis adjustment” commonly refers to an adjustment of a non-financial asset or non-financial liability subject to a cash flow hedge. That is, the initial carrying amount of the hedged item recognized on the balance sheet (i.e., the basis of the hedged item) is adjusted by the cumulative gains or losses on the hedging instrument’s fair value changes that were recorded in equity. IFRS gives companies a choice to either “basis adjust” the hedged non-financial assets or liabilities or release amounts to profit or loss as the hedged item affects earnings. The basis adjustment is not permitted for financial assets or liabilities.</td>
<td>The term “basis adjustment” commonly refers to the method by which the hedged item is adjusted for changes in its fair value attributable to the hedged risk under a fair value hedge. Under a cash flow hedge, the basis adjustment to the hedged item is not permitted. All gains and losses are subsequently released to the income statement concurrent with the deferred recognition of the hedged item.</td>
</tr>
<tr>
<td>Non-derivative financial instruments and combination of derivatives and non-derivatives for foreign currency risk</td>
<td>Two or more non-derivatives or proportions of them, or a combination of derivatives and non-derivatives or proportions of them, can be viewed in combination and jointly designated as the hedging instruments for foreign currency risk. Non-derivatives can be used as hedging instruments for foreign currency risk.</td>
<td>Considering a separate derivative and a non-derivative as a single synthetic instrument is prohibited for hedge accounting purposes. US GAAP provides that a non-derivative can hedge foreign currency risk only for a net investment in a foreign entity or a fair value hedge of an unrecognized firm commitment.</td>
</tr>
<tr>
<td>Internal derivatives for foreign currency risk</td>
<td>Internal derivatives do not qualify for hedge accounting in the consolidated financial statements because they are eliminated in consolidation.</td>
<td>Internal derivatives are permitted for hedge accounting for foreign currency risk provided specific criteria are met.</td>
</tr>
<tr>
<td>Hedging more than one risk</td>
<td>IFRS permits designating a single hedging instrument to hedge more than one risk in two or more hedged items.</td>
<td>Hedging more than one risk with a single hedging instrument is not permitted.</td>
</tr>
<tr>
<td>Designated risks for financial assets or liabilities</td>
<td>A portion of a specific risk is qualified as a hedged risk as long as effectiveness can be reliably measured.</td>
<td>Designating a portion of a specific risk as a hedged risk is not allowed.</td>
</tr>
<tr>
<td>Fair value hedge of interest rate risk in a portfolio of dissimilar items</td>
<td>A fair value hedge of interest rate risk in a portfolio of dissimilar items designated as an amount of a currency rather than a designation of individual assets or liabilities is permitted.</td>
<td>Such a strategy is not allowed. The US guidance requires that a “similar asset” assessment be made regularly.</td>
</tr>
<tr>
<td>Firm commitment to acquire a business</td>
<td>IAS 39 permits companies to hedge a firm commitment to acquire a business in a business combination with respect to foreign currency risk.</td>
<td>The hedged item cannot be related to a business combination, acquisition or disposal of a subsidiary, minority interest or investments using the equity method.</td>
</tr>
<tr>
<td>Servicing rights</td>
<td>Servicing rights may be hedged only for foreign currency risk or for the entire change in fair value.</td>
<td>Servicing rights can be hedged for the benchmark interest rate in a fair value hedge.</td>
</tr>
<tr>
<td>Effectiveness measures and testing</td>
<td>IAS 39 does not specify a single method for assessing hedge effectiveness prospectively and retrospectively. The most commonly used methods are critical term comparison, dollar offset method and regression analysis. Under IFRS, an entity has to measure ineffectiveness and is not allowed to assume perfect effectiveness.</td>
<td>Similar to IFRS, FAS 133 does not specify a single method for assessing hedge effectiveness prospectively and retrospectively. The methods described under IAS 39 are generally acceptable under US GAAP. However, US GAAP allows, assuming stringent conditions are met, a “shortcut” method that assumes perfect effectiveness for a fair value or cash flow hedge involving interest-rate swaps.</td>
</tr>
<tr>
<td>Effectiveness testing frequency</td>
<td>IAS 39 only requires effectiveness testing once a year if a company only reports results on an annual basis.</td>
<td>FAS 133 requires effectiveness testing at least every quarter.</td>
</tr>
</tbody>
</table>
Lessons learned from the early adopters of FAS 157/159 and from the current implementation wave

In the march to a fair value measurement basis for financial statements, the FASB has issued FAS 157, Fair Value Measurements, and FAS 159, the Fair Value Option for Financial Assets and Financial Liabilities. FAS 159 permits the election of the fair value measurement method for certain financial assets and liabilities, and FAS 157 defines and establishes a framework for measuring fair value and expands fair value disclosure requirements. Early adoption of these standards was available for institutions that had not issued interim financial statements for their current fiscal years. The standards must be adopted for financial statements for fiscal years after November 15, 2007.

Subsequent to the issuance of the first quarter 2007 Form 10-Qs for SEC registrants, we had an opportunity to see what the early adopters actually did and ascertain what lessons there are for those still working through adoption of FAS 157 and FAS 159. To develop this information we looked at the financial statements of 10 early adopters. Of the 10, they were evenly split between investment banks and non-investment banks.

In looking at the available information, there is a wide dispersion of the assignment of similar financial instruments into the FAS 157 hierarchy as seen in the disclosure of level 1, 2 and 3 inputs. The election of FAS 159 also seems to be tactical with no one electing to use the fair value model for all eligible items. Further, entities applying benchmark rate hedge methodology under FAS 133 are more reluctant to apply the fair value model as they are required to record the financial asset or liability at full fair value (credit risk would be in the valuations and P&L).

In looking at the FAS 157 valuation disclosures, we summarized them in the following table:

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<table>
<thead>
<tr>
<th>FAS disclosure levels (1–3)</th>
<th>Early adopters examined</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset classes</td>
<td>Investment bank 1</td>
</tr>
<tr>
<td>Government agency securities</td>
<td>1</td>
</tr>
<tr>
<td>Other mortgage securities</td>
<td>1,2,3</td>
</tr>
<tr>
<td>Trading securities</td>
<td>N/A</td>
</tr>
<tr>
<td>Mortgage whole loans</td>
<td>N/A</td>
</tr>
<tr>
<td>Derivatives</td>
<td>1,2,3</td>
</tr>
<tr>
<td>Resale/repurchase agreements</td>
<td>2</td>
</tr>
<tr>
<td>Short securities</td>
<td>2</td>
</tr>
<tr>
<td>Debt/collateral (on balance sheet securitizations)</td>
<td>2</td>
</tr>
<tr>
<td>Debt</td>
<td>N/A</td>
</tr>
<tr>
<td>Mortgage servicing rights</td>
<td>N/A</td>
</tr>
<tr>
<td>Other retained interests</td>
<td>N/A</td>
</tr>
</tbody>
</table>

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1 FAS 159 scope exceptions include demand deposits, leases, investments in subsidiaries or VIEs, convertible debt with a beneficial conversion feature, pension and other deferred compensation arrangements.

2 All of the financial statement information was obtained through the public Form 10Q filings of these companies.
The disclosures of the early adopters contain some inconsistencies related to where certain items fit into the fair value hierarchy as proscribed by FAS 157. For example, we see mortgage securities and residential mortgage loans disclosed as having valuations in all of the fair value hierarchy levels as outlined in FAS 157. As a reminder, Level 1 valuation inputs are observable inputs that reflect quoted prices for identical assets or liabilities in active markets; Level 2 inputs are inputs other than quoted prices included in Level 1 that are observable for the asset or liability through corroboration with observable market data; and Level 3 inputs are inputs that do not have an observable market as they may reflect a company’s own data. The level of detail in the disclosures does not provide the data to ascertain which mortgage securities or whole loans had a quoted market verses which ones were predominately based on modeled valuations. We may have expected to see these categories at a Level 2 due to the illiquidity of the markets, and the element of servicing that needs to be incorporated into residential mortgage loan valuation.

Also, the election of the FVO seems to be different across the nine institutions that adopted that standard as can be seen in this table with an “X” indicating an election (Investment Bank #3 did not adopt 159):

<table>
<thead>
<tr>
<th>Financial instruments</th>
<th>Early adopters examined</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Investment bank 1</td>
</tr>
<tr>
<td>Mortgage loans held for sale</td>
<td>X</td>
</tr>
<tr>
<td>Securities (previously AFS)</td>
<td></td>
</tr>
<tr>
<td>Resale and repurchase agreements</td>
<td>X</td>
</tr>
<tr>
<td>Borrowings/structured notes</td>
<td>X</td>
</tr>
<tr>
<td>Securitization warehouse</td>
<td></td>
</tr>
</tbody>
</table>

What was most interesting is that the FVO was almost universally elected for some portion of mortgage loans held for sale. This may be attributed to the complexity of managing the FAS 133 hedging relationship for those assets. However, not all mortgage loans were necessarily elected for the FVO. It appears that the emphasis is on the prime conventional mortgages, loans where the valuation process is more mature and there was a hedging program that qualified for hedge accounting under FAS 133.

For many early adopters, the logic surrounding the use of the FVO was consistent. They typically stated that the FVO provided an opportunity to mitigate volatility in reported earnings caused by economic hedging programs and the measuring of the hedged assets and liabilities reported at an amount other than fair value. The adopters now report related economic hedging instruments at fair value with changes recorded in current period earnings.

On the liability side of the balance sheet, the results also were interesting. In most cases, the elections to apply the FVO were tied to the more complex transactions that may have been difficult to hedge in qualifying FAS 133 hedging relationships. However, one bank did migrate some of its fixed-rate debt into the FVO with the express intent of eliminating the complexities surrounding compliance with FAS 133.

In the next table, we can see the bias to the asset side of the balance sheet for the FVO:
We are aware that the early adopters came to the realization that the implementation of these standards is not a simple exercise, and that is being confirmed by the current wave of adopters. Implementation is at least a six-month process due to the need to address the systems-related issues in tracking the FVO election and compliance with the increased FAS 157 disclosure requirements. These systems issues are still being worked through and may be currently addressed with spreadsheet applications.

In the current wave of adoption, there are some recurring themes that appear to be challenges for early adopters. These include, but are not limited to, the valuation of derivative credit/nonperformance risks, the use of valuation services, the lack of strong valuation policies/practices and Level 3 roll-forwards.

In FAS 157, there is the expectation that the fair value measurement will include all elements of the fair value. Derivatives in an asset position should include an adjustment for the credit risk of the counterparty. Derivatives in a liability position should include an adjustment for the risk of non-performance of the entity that owns the derivative position. However, it is common practice for derivative models to perform valuations without such adjustments. To further complicate this, the markets do not typically trade with “visible” credit adjustments due to the use of standardized master netting agreements and credit support annexes (CSAs or collateral posting agreements). At this time, there is no clear consensus as to how this valuation dilemma will be addressed and how the netting agreements/CSAs factor into that valuation.

For valuation services, the situation also presents some challenges. At first pass, many early adopters were of the opinion that the use of a valuation service automatically resulted in a Level 2 valuation and they would be able to avoid the Level 3 disclosure requirements. As these firms finalized their implementation conclusions, many concluded that there was a need to dig further into what specific inputs were being used by the services and what was the corresponding level. The byproduct of this process was the realization that to value some...
securities, even the valuation services need to use a level of judgment or Level 3 inputs.

On the valuation policy front, many adopters are learning that they do not have robust valuation policies and procedures. With the implementation of FAS 157, we see a merging of what would normally be an accounting policy with the valuation policies. To the extent that the valuations are documented, the development of the new accounting policy is greatly facilitated. However, a valuation policy that says, for example, “download the Bloomberg price” will not be sufficient to support the FAS 157 requirements.

While much of the current effort still centers on correctly allocating instruments to the correct “buckets” and identifying the starting position, many systems are not designed to track by level. This is complicated by the possibility that an instrument, for example, a CMO, was a Level 2 but now has moved to Level 3 status due to changes in the market environment. This change in level will need to be identified and tracked with valuations at the transition point captured in the system of record. Additionally, there currently is no consensus that clearly defines the realized and unrealized gains/losses for the Level 3 items.

The implementation of these new standards was challenging for the early adopters, and it is no less challenging for the current adoption wave. As the adoption process continues, we expect to see diversity in FAS 157 level identifications, a bias to the asset side of the balance sheet for the FVO election under FAS 159, and ongoing development of processes to comply with the disclosure requirements of the standards.
Published in June 1998, Statement of Financial Accounting Standards 133, Accounting for Derivative Instruments and Hedging Activities (FAS 133), was intended to develop a comprehensive accounting framework for derivative instruments. Since then, the standard has been deferred, amended twice and interpreted in more than 100 FASB staff implementation questions and answers. Even with all of its changes and interpretations, FAS 133 has been criticized by the investment and accounting communities for the lack of guidance around transparent disclosures for reporting entities from both quantitative and qualitative perspectives. As a result, actions were undertaken by FASB to address certain questions around hedge accounting.

An example of one such action was the issuance of an exposure draft by FASB staff on disclosures about derivative instruments and hedging activities in late December 2006. As of the end of November 2007, FASB continued to deliberate several of the disclosure requirements currently set forth in the exposure draft. Specifically, the items to be discussed in future meetings relate to contingent features, notional amounts and leverage factors, frequency of disclosure and effective date considerations. Currently, the final release of this draft is expected to be issued in the first quarter of 2008.

During a January 2007 meeting, FASB also directed its staff to research issues causing difficulties in the application of hedge accounting and potential approaches to accounting for hedging activities. Based on research performed, the following seven issues were identified as causing significant difficulties in applying hedge accounting:

1. Strictness of documentation requirements
2. A lack of clarity regarding when de-designation and re-designation are necessary
3. Which hedged items or hedged transactions could be included in a group
4. How should effectiveness be assessed and what should be included in the effectiveness testing
5. How should cash flows and different aspects of the discount rate be incorporated into the measurement of a hedged item whose change in value is attributable solely to an individual hedged risk
6. How should ineffectiveness be measured in a cash flow hedge and what features should be included in a perfect hypothetical derivative
7. What should be the consequences for failing to meet the criteria for hedge accounting

Further, in response to inquiries related to shortcut hedge accounting, the Board proposed Implementation Issue E23 (DIG E23), “Issues Involving the Application of the Shortcut Method under Paragraph 68,” in late July 2007. DIG E23 was released in January 2008 and is effective for all hedging relationships designated on or after January 1, 2008.

This article highlights the key issues addressed by FAS 133-related guidance from the FASB.

**Exposure draft, disclosures about derivative instruments and hedging activities in late December 2006**

In December 2006, the FASB issued the exposure draft for comments and questions. The objective of the proposed exposure draft is to improve disclosures about derivatives and hedging activities that are accounted for in accordance with the FAS 133. Specifically, the project is expected to amend and expand the disclosure requirements in FAS 133 with the intent to provide an enhanced understanding of:

- How and why an entity uses derivative instruments
- How derivative instruments and related hedged items are accounted for under Standard and its related interpretations
- How derivative instruments affect an entity’s financial position, results of operations, and cash flows

Specifically, the proposed draft would require entities (public and private) to:
FAS 133 update project—accounting for hedging activities

There have been numerous discussions during FASB’s meetings around this proposed revision. The topics primarily include bifurcation by risk; the shortcut method; critical terms match; the requirement to quantitatively assess effectiveness in order to qualify for hedge accounting; and the accounting for an entity’s own existing recognized debt within the fair value hedge accounting approach for both fair value hedges and cash flow hedges.

The current proposed approach for the standard is the fair value approach. This approach would eliminate bifurcation by risk, the shortcut method, critical term match, and assessing effectiveness. The approach also would not require any entry or ongoing tests to qualify for hedge accounting and would require independently measuring the hedging instrument and hedged item for all changes in value. It is clear that the Board is taking active steps to remove the shortcut hedge accounting option and provide entities with some relief around hedge documentation and effectiveness assessment. At this time, there has been no clear indication of when this draft will be finalized and effective.

DIG E23 “Issues Involving the Application of the Shortcut Method under Paragraph 68”

In addition to the exposure draft discussed for derivative disclosures and the FAS 133 update project, the FASB has issued Implementation Issue DIG E23. The objective of DIG E23 is to clarify and amend certain requirements under paragraph 68 of the standard related to application of shortcut accounting because there have been practice issues associated with such applications. Specifically, DIG E23 addresses the following:

- Settlement of hedged item occurs subsequent to swap trade date. For financial reporting purposes, an interest rate swap is recorded on a trade date where an interest-bearing asset or liability is not recognized until issued several days later on its settlement date. Consequently, if a hedging relationship is designated on the trade date, the hedged item is not yet a recognized asset or liability. The Board decided that
these narrow market realities should not disqualify the use of the shortcut method, provided that the difference between the trade date and the settlement date are in accordance with normal market terms and conventions.

- **Application of Paragraph 68(b) when the transaction price of interest rate swap is zero.**

  Paragraph 68(b) of FAS 133 requires the fair value of an interest rate swap at the inception of the hedging relationship to be zero. However, upon adoption of SFAS 157, Fair Value Measurements (FAS 157), the fair value of an interest rate swap at initial recognition would be based on an exit price, as discussed in paragraph 31 of FAS 157, which likely would be other than zero due to the existence of a bid-ask spread. DIG E23 indicates that when a company enters into an interest rate swap with a transaction price of zero in its principal (or most advantageous) market, a difference between transaction price and fair value that is attributable solely to differing prices within the bid-ask spread between the entry transaction and a hypothetical exit transaction would not preclude application of the shortcut method.

Upon adoption, entities will be required to assess their existing hedging relationships. If the shortcut method is disallowed as a result of implementing DIG E23, an entity will be required to redesignate the hedging relationship prospectively. No prior period adjustments related to these hedges designated either under fair value or cash flow hedges shall be reversed.

In light of the new guidelines related to FAS 133 hedge accounting, companies may consider the need to reassess current hedge strategies and disclosures surrounding derivatives and hedge activities.
An argument could be made that current accounting considerations in the mortgage industry are the result of past occurrences, mainly the housing boom that occurred between 2000 and 2005. During this period, the price of real estate increased and lenders became more willing to lend on riskier terms. This was partly due to speculation that real estate prices would continue to rise, which would give borrowers an option to refinance their loans at more favorable terms in the future. As a result, there was an increase in the number of two- and three-year adjustable rate mortgage loans issued by borrowers.

The loans issued during the housing boom included home mortgage purchase loans along with refinanced home mortgage loans. Due to rising real estate prices, these refinanced loans allowed many homeowners to use the appreciated value of their homes to refinance first mortgages and receive additional cash to make home improvements, refinance other debt, etc. Many of the loans included common features such as teaser rates (i.e., artificially low interest rates during the fixed interest rate period of the loan) or other features that permitted the borrower's mortgage payments to be lower in the early years of the loan with an expected increase as the interest rates reset at the end of the fixed-rate period. However, as the housing boom reversed and home values decreased, the borrower's refinance options became limited. As a result, it is expected that a number of the borrowers who entered into the two- and three-year adjustable rate mortgage loans will not have sufficient income to pay their mortgage payments upon the reset date of the mortgage note or have the ability to refinance into a more affordable mortgage loan. These loans are commonly referred to as subprime mortgages.

Generally, lenders securitized these loans by selling them to a special-purpose entity (SPE). The SPE sold securities to various investors including pension funds, institutional investors and other qualified investors using the loans as the cash repayment source and collateral for the securities. The process generally also included the lenders maintaining a residual interest in the loans.

Since fall 2006, delinquencies and foreclosures in the subprime mortgage industry have been rising, and future problems are anticipated as more than $200 billion of subprime mortgages loans are scheduled to have their interest rates reset within the next year. As described above, there is a general expectation that some of the borrowers will not have the ability to meet their increased payment obligations when interest rates reset. Additionally, the refinance options available are now limited as home prices have stabilized or decreased in many parts of the country and lenders have begun tightening their underwriting standards. As such, refinancing will likely not be an option for many subprime borrowers facing dramatically higher payments. Consequently, losses on subprime loans have been vast with an expectation of further loan defaults and losses.

The result of the above market conditions has been widespread losses posted by various mortgage originators and/or servicers, extensive subprime loan valuation decreases, large valuation losses to companies holding mortgage-backed securities, bankruptcies of several subprime loan originators, widening securitization spreads throughout the industry and increased sensitivity to early payment defaults. With demand decreasing, there has been a large reduction in the number of subprime mortgage-backed collateralized debt obligations (CDO) issuances, an all-time low ABX index (a popular tool for hedging subprime mortgage risks), increasing yields required to issue subprime mortgage paper and the widespread shorting of the mortgage market (largely through the purchases of credit default swaps).

This has drawn the attention of investors, the media, and regulatory and congressional bodies. The national banking regulators published OCC Bulletin 2007-14, which encouraged financial institutions to work constructively with residential borrowers who are financially unable to make their contractual payment obligations on their home loans. The bulletin noted that prudent workout arrangements that are consistent with safe and sound lending practices are generally in the long-term best interests of both the financial institution and the borrower, and these arrangements could increase the potential for financially stressed residential borrowers to keep their homes.

The accounting considerations as a result of the above conditions have included valuation considerations in
regards to the servicing assets, loans held for investment, security valuations, guaranty obligations incurred by the lenders as part of the securitization process, and other investments linked to subprime mortgages. Companies and servicers should continue to place a great deal of diligence and scrutiny in evaluating the valuations and classification of investments they hold. In addition, questions have been raised as to the impact of loan modifications in a qualified SPE and to loans held for investment.

**Loan Modifications in a qualifying special-purpose entity**

This maelstrom of economic activity creates various accounting implications, including increased procedures over the validity and market transparency of assumptions used in valuations for various assets from prime loan portfolios to subprime residual assets. However, another accounting implication discussed has been the potential impact of Statement of Financial Accounting Standards No. 140, Accounting for Transfers and Servicing of Financial Assets & Extinguishments of Liabilities (FAS 140), which guides securitizations on mortgagors’ and/or servicers’ abilities to make loan modifications to forbear foreclosures. The concern mainly focuses on the ability of lenders or servicers to restructure loans that have been sold to a securitization trust in which the trust has been determined to be a qualifying special-purpose entity (QSPE) as defined in FAS 140.

An important feature of a QSPE is that it is not required to be consolidated into another entity; however, there are also limitations as to the type of activities allowed in the QSPE. Specifically, the guidance in paragraph 35(b) of FAS 140 states that a qualifying SPE is a trust or other legal vehicle whose permitted activities (1) are significantly limited; (2) were entirely specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds; and (3) may be significantly changed only with the approval of the holders of at least a majority of the beneficial interests held by entities other than any transferor, its affiliates and its agents. A violation of this provision may cause the entity to no longer meet the requirements of a QSPE and require a lender to consolidate the trust into its financial statements.

As a result, lenders and/or servicers have been hesitant to initiate mortgage loan modifications, fearing the activity would violate the QSPE rules and require a consolidation of the securitization trust by the transferor of the loans. Those who expressed their concern over this matter include the chairman of the US House of Representatives Committee on Financial Services, who issued a letter to Securities and Exchange Commission Chairman Christopher Cox asking for clarification on loan modifications allowed within a QSPE. Chairman Cox responded by issuing a letter to the House chairman that indicated the SEC’s professional staff believes that no additional interpretive guidance is necessary.

However, Chairman Cox did indicate that the SEC professional staff believes that, consistent with general agreement in practice, modifications to mortgage loans when default is “reasonably foreseeable” would not result in a requirement for entities to consolidate the securitization trusts. The SEC professional staff further indicated that it would expect the modifications undertaken to be consistent with the nature of modifications permitted if a default of the loans had occurred.

In December 2007, the American Securitization Forum issued the “Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans” (the ASF Framework), which provides guidance to servicers to streamline borrower evaluation procedures and to facilitate the effective use of all forms of foreclosure and loss prevention efforts. The ASF Framework is applicable to loans originated between January 1, 2005, and July 31, 2007, loans that are included in securitized pools and loans with an initial reset between January 1, 2008, and July 31, 2010. They have segmented these loans into three categories. One category has been labeled “Segment 2,” which would include current loans that a borrower is unlikely to be able to refinance into any readily available mortgage product. These loans are further defined by these categories: being less than 30 days delinquent or having not been 60 days delinquent at any point in the last 12 months (both
under the OTS method); having a loan-to-value ratio on
the first lien greater than 97%, and not being FHA Secure
eligible. If the Segment 2 loans are owner-occupied,
have a reset payment that will be greater than 110% of
the current payment, and the borrower's FICO score is
less than 660 and is less than a score 10% higher than
the FICO score at origination, the borrower is considered
eligible for a “fast-track” loan modification. The fast-track
loan modification allows the servicer to offer to keep the
interest rate on the loan at the existing rate, generally for
five years following the first reset date. An agreement to
accept the modification should be requested from the
borrower, however an assumption can be made that the
borrower accepts the modification if the borrower makes
two payments under the modified loan after receiving the
modification notice.

On January 8, 2008, the SEC staff issued a letter to the
Center for Audit Quality (http://sec.gov/info/accountants/
staffletters/hanish010808.pdf) stating that the staff “will
not object to continued status as a QSPE if Segment 2
loans are modified pursuant to the specific screening
criteria in the ASF Framework.” The SEC staff stated
that it believes “that it would be reasonable to conclude
that Segment 2 subprime ARM loans are ‘reasonably
foreseeable’ of default in absence of a modification
based upon a qualitative consideration of the expectation
of default.”

Additionally, the SEC staff stated that it “expects
registrants to provide sufficient disclosures in filings
with the Commission regarding the impact that the ASF
Framework has had on the QSPEs that hold subprime
ARM loans.” An overarching principle in the ASF
Framework is that servicers would not take any action
that either is prohibited by the applicable governing
securitization documents, would violate applicable laws
and regulations, or would alter the accounting treatment
of any securitization that was treated as a sale under FAS
140.

Loans that do not qualify for the fast-track modification
may still be eligible for a loan modification; however,
an analysis will be required on a case-by-case basis or
the application of an additional framework consistent
with the applicable servicing standard in the transaction
documents for a loan modification or other loss mitigation
outcome will need to be established. In addition, servicers
are not required to adopt the ASF Framework and have
the option of establishing their own framework. As no
additional guidance is expected from the standard
setters in regards to loans that are outside of Segment 2
loans, each servicer will need to determine what type
of loan modifications they believe is acceptable within
a securitization trust that has been determined to be a
QSPE. We believe there are several key items servicers
should consider in their analyses.

Loan modification considerations in a qualifying SPE
The first and foremost consideration should be reviewing
what is permitted within the corresponding deal
documents (i.e., pooling and servicing agreement, trust
agreement, offering circular, etc.). There may be explicit
limitations on the amount of modification activities
allowed as well as the type of modification efforts
permitted. An explicit violation of the corresponding deal
documents would result in failing the QSPE status and/
or violating servicing obligations, which may trigger legal
complications. Another consideration is that the servicer
should make a determination of what type of loan they
consider to be a “subprime” loan. Currently, there is no
specific definition of a “subprime” loan. If a servicer were
to establish a framework outside of the Segment 2 loans,
the framework should apply only to loans where it is
reasonably foreseeable that the borrower will default on
their loan. Beyond these considerations, lenders should
strongly consider the following factors to ensure they do
not violate the QSPE rules:

• Ensure that the expected loan modifications are
inherent in servicing activities.
  – The lender should ensure any contact being initiated
    with the borrower is made to prevent a potential
default of a loan versus a marketing effort.

• Ensure that the loan modifications would not be
considered “new lending.” Questions to determine
whether loan modifications would be considered new
lending should include:
  – Does the modification result in any new money
  being advanced?
Would the loan modification qualify as a new loan by analogizing to existing accounting literature, i.e., EITF 01-7, EITF 96-19 and FAS 15?

Ensure that the loan modifications are in the best interest of the investors of the QSPE. The goal of the modifications should be to minimize losses and not to maximize gains. If borrowers are in a financial position that would allow them to refinance their loans or continue to timely pay their existing loans, the general expectation is that these loans would not be eligible for an established framework. Under this concept, we would expect that the loans would be considered to be in one of the following states:

- In default
- In imminent default
- In default in the reasonable foreseeable future due to various factors (i.e., there is expected to be considerable payment shock once a loan resets to a new interest rate)

In summary, servicers will need to determine a methodology to apply to determine what loans are to be modified prior to default. Much of the consideration should go toward applying a consistent approach that would not include loans that may be profitable given the specific circumstances. Therefore, the process of defining “reasonably foreseeable” should be well thought out prior to implementing a widespread modification effort. This would help ensure that loan characteristics identified for the current circumstances remain consistent in other circumstances. The result would be a consistent and sound approach to servicing the loan portfolios and properly working with distressed borrowers without impacting the determination that a securitization trust meets the requirements of a QSPE.

Loan modifications for loans held for investment

Additional accounting considerations exist for modified loans which are on lenders’ balance sheets. Residential mortgage loans that are modified should be assessed to determine whether or not the modification is considered a troubled debt restructuring (TDR) under Statement of Financial Accounting Standards No. 15, Accounting by Debtors and creditors for Troubled Debt Restructuring (FAS 15). Loans that are modified in a TDR should be measured for impairment in accordance with the provisions of Statement of Financial Accounting Standards No. 114, Accounting by Creditors for Impairment of a Loan (FAS 114). The TDR assessment and subsequent measurement of impairment are applicable for loans that are not accounted for at fair value (under Statement of Financial Accounting Standards No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (FAS 159) or other specialized industry guidance.)

Given the expected significant increase in loan modification volumes for subprime ARM loans over the next couple of years, companies should consider the ability of their current operational processes to meet the accounting requirements for loans which are modified in troubled debt restructurings and subject to impairment measurement under FAS 114.

On December 5, 2007, the Mortgage Bankers Association (MBA) submitted a letter to the Financial Accounting Standards Board (FASB) in response to operational concerns surrounding the application of FAS 114 accounting requirements expressed by some of its members. The letter asserted that it would be operationally difficult for some lenders that currently do not have systems capabilities in place to perform the required impairment assessments under FAS 114. The letter requested the FASB to issue guidance that provides relief from the measurement requirements of FAS 114 for smaller balance, homogeneous loans that are modified in a troubled debt restructuring. At its January 30, 2008 meeting, the FASB voted unanimously not to add a project to its agenda to address the MBA's request.

Companies should assess the impact of these additional FAS 140-related considerations on their business activities.

Repurchase agreement considerations

Consider the impact that the proposed FASB Staff Position FAS 140-d will have on future transactions that involve an initial transfer of financial assets and a
subsequent repurchase agreement of the same financial assets between the same counterparties. A typical arrangement contemplated by this proposed guidance occurs when a company (Entity A) transfers (through a sale) financial assets to another company (Entity B) and then contemporaneously or subsequently Entity B executes a repurchase agreement with Entity A on the same financial assets. Historical practice typically has been to account for the two transactions as separate transfers – if the initial transfer qualified as a sale under FAS 140, it would be recorded as such, and the repurchase agreement would be recorded as a financing. The FASB decided that the current industry practice of evaluating the initial transfer separately from the repurchase agreement for the purpose of determining whether the requirements for sale accounting are met is only appropriate if there is a valid and distinct business purpose for entering into the two transactions separately.

The proposed FSP would provide guidance on how to determine whether two transactions, as described above, should be evaluated as a single, linked transaction or as separate transactions for the purpose of assessing whether sale accounting is appropriate under FAS 140. If linkage is required under this proposed guidance and results in the requirements for sale accounting not being met, the combined transaction will essentially constitute a forward sales contract.

The scope of the proposed FSP is limited to transactions that were entered into contemporaneously or in contemplation of one another. For those transactions within the scope of the proposed FSP, the model in determining whether to link the two transactions (initial transfer and repurchase agreement) is based on a rebuttable presumption approach that presumes linkage unless all of the following factors are met:

- The initial transfer and repurchase agreement are not contractually contingent on one another. The pricing and performance of one transaction cannot be dependent on the terms and execution of the other transaction.
- The repurchase agreement provides the transferor with full recourse to the transferee.
- The financial asset that is the subject of the initial transfer and repurchase agreement is readily obtainable in the market and the initial transfer and the repurchase agreement are entered into at market rates.
- The initial transferee maintains rights to the collateral (is able to take control of the asset and substitute it with a different asset).
- The financial asset and the repurchase agreement are not coterminous (the maturity of the repurchase agreement is prior to that of the asset).

If the proposed FSP is approved, the guidance would be effective for fiscal years beginning after November 15, 2008. The FSP would be applied to new repurchase agreements entered into after the date of adoption and also to repurchase agreements that exist at the beginning of the fiscal year in which the FSP is initially applied. Any difference in how the initial transfer and repurchase financing would be accounted for on the balance sheet under FAS 140 as a result of this guidance would be reflected as a cumulative-effect adjustment to the opening balance of retained earnings.

**CDO/CLO considerations**

Questions have been raised about whether certain CDO/CLO transactions (static CDO/CLO) would meet the conditions for sale accounting described in FAS 140. Consider the example for a static CDO/CLO where a transferor sells loans to a transferee who then bundles the loans and sells collateralized bonds. The senior interest bonds are sold to third parties and the transferor retains a residual interest in the static CDO/CLO. The transferee is a variable interest entity (VIE) as defined in FIN 46(R), Consolidation of Variable Interest Entities, an interpretation of ARB No. 51. In addition, the VIE does not have the ability to sell or pledge the financial assets that are transferred to the VIE except in limited circumstances such as when its assets begin to decline in value or the underlying borrower's credit deteriorates. To the contrary, the VIE would not be able to sell an asset that has appreciated in value in order to realize a gain. The VIE is not considered a QSPE as a result of certain discretionary powers that are inconsistent with a QSPE's qualification (e.g., the structure provides the portfolio manager with
discretion on whether to sell or hold and work out assets that experience such credit issues).

In these transactions, the first consideration is that the ability to sell or pledge is not met through the VIE’s initial issuance of the bonds; this action is not typically a pledge (but is usually the granting of a security interest), and the pledge ability must be present beyond the initial transfer date as discussed in Q&A 140 – A Guide to Implementation of Statement 140 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (FAS 140 Implementation Guide), question no. 22.

As a result, the main question in these transactions is whether the transferor’s involvement would result in more than a trivial benefit to the transferor. The “more-than-trivial” guidance in FAS 140 is a very low threshold, indicated in the paragraph 29 example where the constraint on the ability to sell provides the transferor with knowledge of who holds the asset and, thus, benefits the transferor more than trivially.

In the above static CDO/CLO, the constraint is deemed to provide more than a trivial benefit to the transferor as indicated in FAS 140, paragraph 31, which describes that a condition imposed by a transferor that constrains the transferee presumptively provides more than a trivial benefit to the transferor. In addition, we understand that the SEC considers if there is a rebuttable presumption that a transferor is deriving more than a trivial benefit from a constraint if it is a party to the agreements that impose the constraint and the transferor has involvement in the structure on an ongoing basis.

However, even if that view were not held, the constraint above clearly benefits the transferor. For example, it impacts the rating agency view of the structure (as the assets are less risky because they are static), which lowers the funding rate, level of equity and/or credit enhancement needed. The transferor also benefits through its ownership of the residual interest of the static CDO/CLO.

Another potential constraint would result in the cases where there are tax, securities law or other benefits from the constraint that impact the overall economics of the transaction. The guidance in FAS 140, paragraph 106, also indicates that if a loan participation agreement constrains the transferees from pledging or exchanging their participations, the transferor presumptively receives a more-than-trivial benefit and, therefore, has not relinquished control over the loan and would account for the transfers as secured borrowings. While this guidance is in the context of a loan participation transaction, the guidance explicitly indicates that a transferor has not relinquished control if the transaction documents constrain the transferees.

For the above static CDO/CLO, the sale criterion in paragraph 9(b) would not be met as a result of the transferor benefiting more than trivially, as described above, and the constraint on the assets in the VIE. The key concept in analyzing static CDO/CLO transactions is that determining if a transferor’s continuing involvement provides more than a trivial benefit to the transferor is a low threshold that can be achieved in a variety of direct and indirect manners that entities should consider fully.

Another factor to consider in a CDO/CLO transaction is the impact to a transferor as a result of the transferor holding a portfolio manager role. Consider a CDO/CLO transaction (managed CDO/CLO) where the VIE has the ability to freely pledge or exchange the assets transferred to it in order to allow the VIE to actively manage the assets it holds. In situations where the transferor is the portfolio manager and also holds a residual interest in the VIE, it must be determined whether the pledge or exchange criterion in paragraph 9(b) has been met as a result of the transferor in its role as portfolio manager managing the assets.

In analyzing the guidance provided in footnote 15 to FAS 140, the overall effect of related rights and obligations must be considered when determining whether the transferor has relinquished control of the transferred assets. While the VIE has the contractual right to pledge or exchange the assets it received, the VIE can only exercise its rights through its agents, such as the portfolio manager. If the transferor is the portfolio manager, it has not relinquished control over such rights.
Further, the constraint provides more than a trivial benefit to the transferor. As portfolio manager, the transferor will have control over all asset disposition decisions, which may directly affect the value of any other interests the transferor has in the CDO such as equity ownership. Appointing the transferor as the portfolio manager should be viewed in the same context as allowing a transferee to pledge or exchange its assets only on terms agreed with the transferor. As discussed in FAS 140, paragraph 29, such a provision constrains the transferee and presumptively provides the transferor with more-than-trivial benefits. In addition, through its role as portfolio manager, the transferor would know who holds an asset (a prerequisite to repurchasing the asset) and could block the asset from finding its way into the hands of a competitor, both of which provide the transferor with more-than-trivial benefits. As such, the pledge or exchange criterion in paragraph 9(b) has not been met if the transferor, or an affiliate of the transferor, is appointed as portfolio manager.

Additional consideration is needed if the third-party investors hold substantive rights to “kick out” the transferor as the portfolio manager or are provided with rights that direct the portfolio manager to sell individual assets. These rights would need to be considered substantive. For example, providing the senior beneficial interest holders with the right to sell or pledge if a sufficient vote is achieved, in many cases, would not overcome the issue because such investors would likely have limited incentive to exercise this right (as they would not participate in gains), and the process could be onerous (such as when there are a large number of senior beneficial interest holders that would be required to vote).

Finally, if the portfolio manager, who is the transferor, holds a residual interest and is not precluded from putting an asset up for sale and then bidding on it or participating in an auction of the assets at the termination date of the transaction, the criteria for sale accounting under paragraph 9(c) would not be met based on paragraph 53 and Q&A 49 of the FAS 140 Implementation Guide.

Future of qualifying special-purpose entities
As part its January 8, 2008, letter to the Center for Audit Quality, the SEC noted that the Office of Chief Accountant (OCA) has requested the FASB immediately address the various issues that had arisen in the application of the QSPE guidance in FAS 140. The results of this project are expected to result in a dramatic change in regards to the evaluation of a sale of a financial asset under paragraph 9(b). The general expectation is that the definition of a QSPE will be changed or the concept of a QSPE will be eliminated altogether. The OCA has requested that the FASB complete this project addressing the guidance in paragraph 9(b) and paragraphs 35-55 of FAS 140 to allow for the amendment to be effective no later than years beginning after December 31, 2008.

Summary
In order to fully understand and properly account for the situations described above, companies should consider the particular facts and circumstances present in their own business operations. With adequate insight into these types of accounting considerations, companies should be better prepared to answer the challenge of one of the more complex accounting issues facing the mortgage industry today.
Regulation AB — one year later

Regulation AB became effective January 1, 2006, for all public asset-backed securitizations (ABS) registered with the Securities and Exchange Commission (SEC) on or after January 1, 2006. This regulation represented a complete overhaul of both the Securities Act of 1933 and the Securities Exchange Act of 1934 rules that govern the registration, disclosure and ongoing reporting requirements for public ABS. Two rules in particular required significant cooperation, coordination and interpretation among ABS service providers. These two rules are the Report on Assessment of Compliance with Servicing Criteria (as required by Section 1122) and the Servicer Compliance Statement (as required by Section 1123). These two rules require ABS service providers to report on their compliance with 30 potentially applicable performance criteria and report on their contractual compliance with the related servicing agreements. Both of these reports are filed with the SEC within the securitization trust’s annual Form 10-K. These reports were intended to provide investors a mechanism for assessing the performance of the servicer and to provide assurance that an independent party was checking some aspect of the servicing function.\(^1\)

As with any first-year implementation of new reporting or regulatory requirements, there are going to be some bumps in the road, and Regulation AB was no different. So, with year one behind us, how did everyone fare and what changes are companies contemplating? Although many criteria presented challenges to asserting parties, this article will focus on three common challenges: trigger monitoring; asserting on behalf of vendors; and waterfall testing. These challenges were most acute because the related criteria were not part of prior compliance programs such as the Uniform Single Attestation Program (USAP) issued by the Mortgage Bankers Association. First, 1122(d)(1)(i), monitoring events of default and trigger events, posed a challenge for some companies for two primary reasons: 1) understanding and interpreting the criterion took tremendous effort and coordination among servicing staff and legal counsel; and 2) a large platform makes this criterion extremely difficult and cumbersome to monitor. In order to monitor more effectively, companies may consider developing procedures to catalog the transactions and all related events of default and trigger events. Mapping all of these events to current policies and procedures also may help satisfy the requirement. In some cases, additional policies and procedures may be required to ensure the company satisfies this criterion.

Another common area of difficulty for many companies was monitoring vendors under 1122(d)(1)(ii), test servicing activities outsourced to third parties, which was further clarified by an SEC Telephone Interpretation 17.06 that was issued in February 2007. Some of the struggles surrounding this criterion focused on the following questions: Is the provider a servicer or a vendor? How should a vendor be described in management’s assertion? What constitutes monitoring? To answer these questions, we focused on Telephone Interpretation 17.06, the American Securitization Forum (ASF) Model, and the criteria applicable to the vendor. First, a vendor is “engaged by a servicer to perform specific and limited activities or to perform activities scripted by the servicer that would not be viewed as a party participating in the servicing function separate and apart from the servicer.”\(^2\) Second, a company’s management assertion should clearly show that a vendor is being utilized in a specific criterion, the servicer is taking responsibility for the vendor, and “the servicer engaging the vendor has policies and procedures in place designed to provide reasonable assurance that the vendor’s activities comply in all material respects with the servicing criteria applicable to the vendor.”\(^3\) Finally, a company should examine the criterion in which the vendor is performing servicing and ensure the monitoring in place is sufficient to state that the company is materially in compliance with the criterion in question. For example, if a lockbox provider is utilized in payment processing, the company should monitor and test the lockbox provider to ensure all mail is processed in sufficient time for the company to receive the transmission and post it within two business days from receipt at the lockbox. Management may consider consulting its internal auditors and external

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auditors to ensure the appropriate samples are selected for monitoring lockbox providers.

The third common challenge deals with investor reporting functions and waterfall calculations, which is the method for calculating the payment to investors based on the investor priority as described in the Pooling and Servicing Agreement. The most prevalent snag servicers encounter when making this assertion is materiality. Many asserting parties try to apply both quantitative and qualitative judgments to investor report differences. One common way of understanding the frequency of errors is to test a sample of the investor reports – by statistically applying the results of these substantive tests, asserting parties can estimate the error rate of the entire population of investor reports. While there was no fixed error threshold, accounting firms wanted to know the statistical error for the purposes of forming their opinions. The more difficult measurement of materiality was the qualitative assessment of errors. It may be easy for investors and service providers to agree that a $0.01 error on a million dollar bond payment is not material, but what about an error amount of $1,000 or $10,000? Consideration also must be given to nonpayment amounts included in investor reports. As the recent sub-prime mortgage market activities suggest, investors are concerned with pool performance data including delinquency, prepayments and losses. Questions of materiality will never fit neatly into a “one-size-fits-all” box. Management must make individual decisions based on the facts and circumstances of each error. Accountants also must consider the needs and expectations of the users of the report in forming an opinion on management’s assertion.

Finally, many management teams struggled to assess what level of evidence pursuant to the Regulation AB criteria was required to be obtained by management for purposes of enabling the signing of the 302, 1122 and 1123 certifications regarding Sarbanes-Oxley, Section 404. Without a process in place to obtain evidence there are no material instances of non-compliance, it is difficult for management to sign the required certifications. In this regard, some companies rely on their internal audit functions to work side by side with registered public accountants, while others rely on quality assurance teams built into the business units, and still others simply rely on the management reports they receive. With the material instances of noncompliance that were disclosed in a number of reports, the questions remain: Is management monitoring sufficient? Could processes be implemented to prevent some of the instances of noncompliance being raised to a material level with early detection? These are questions many companies are now pondering. A suggestion for monitoring exceptions is to ensure any exception is addressed and escalated to the appropriate person in a timely manner. Management should ask for exception reporting on each of the criteria from the business units on a monthly basis.

Now that we have examined some of the pitfalls and difficulties of year one, what can companies expect for year two of Regulation AB? Investors and companies alike may expect to see a decrease in material instances of noncompliance; however, when the exceptions were identified and when the corrective action was in place will drive this expectation. For example, if the corrective action was not in place at December 31, 2006, for a material instance of noncompliance, the company begins year two with the exception. Also, with year one reports filed, the SEC review of these reports is currently under way. Therefore, SEC comments and possible further interpretations could spring from these reviews, which, in turn, may trigger additional discussions within the industry.
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