



**FAS 140 – Part II, QSPEs –  
Their Present and Future Accounting**  
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# Why Securitize?

**Mortgage bankers will sell loans in a securitization for the following reasons:**

- ◆ Mortgage-backed securities may be more appealing to investors
- ◆ Mortgage-backed finance can provide a lower cost of funds
- ◆ Appropriately recognizing the transaction as a sale removes assets from B/S

**Mortgage bankers will retain most of the BIs in a securitization for the following reasons:**

- ◆ Securities often bear a lower capital charge than loans
- ◆ Liquid securities are easier to use as collateral in other transactions
- ◆ The accounting model for securities is different from the loan model



## Two Key Accounting Questions in a Securitization

1. Does the transfer of assets to an SPE qualify as a sale?
2. Must the transferor, sponsor, or investor in the BIs of the SPE consolidate the assets and liabilities of the SPE (thereby putting them (back) on the transferor's balance sheet)?



## Why Use a QSPE?

1. In a properly designed transaction, the transferor does not consolidate. Instead, transferor accounts for any interests it retains according to their new form
2. FIN 46R broadened the exemption from consolidation to other parties
3. QSPEs play critical role where transferor's goals is to:
  - a. Remove the assets from the balance sheet
  - b. Account for the interests that continue to be held according to their new form, or
  - c. Both

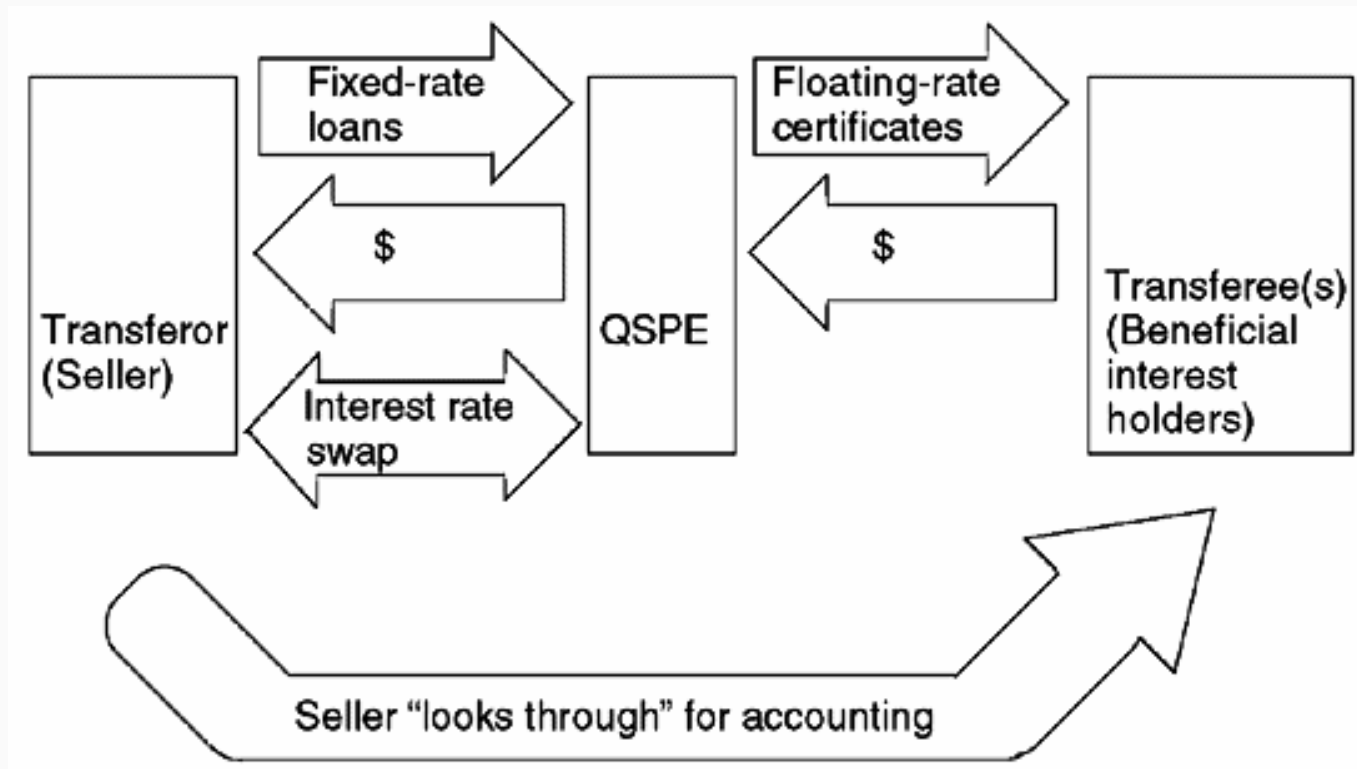


# Background of QSPEs

1. Concept first introduced in FAS 125 (superseded by FAS 140) as a vessel to facilitate de-recognition
2. Principle in FAS 125/FAS 140 was that in order to derecognize, you must give up control and have no continuing involvement. Continuing involvement includes:
  - a. Continuing to service a financial asset that has been transferred
  - b. Providing recourse to the buyer of the transferred asset
  - c. Sharing in the revenues from the transferred asset
  - d. Providing collateral to the lender
  - e. Converting the interest rate or currency on the transferred asset
  - f. Retaining an option to repurchase the transferred asset
3. Prior to FAS 125, there was a risk and rewards paradigm, so no need for QSPEs



# Diagram of Typical Mortgage Backed Securitization Involving QSPE





# Attributes of a Qualifying Special Purpose Entity (QSPE)

1. Legally distinct
2. Activities are prescribed and significantly limited
3. Holds only passive financial instruments
4. Sales of assets may only occur automatically and in response to specified events



# Attribute 1: The SPE is Demonstrably Distinct from the Transferor

1. The SPE cannot be unilaterally dissolved by any transferor, its affiliates and
2. Either:
  - a. At least 10 percent of the fair value of its BIs are held by outside entities  
or
  - b. The transfer is guaranteed mortgage securitization.



## Attribute 2: Prescribed and Limited Activities

1. Significantly limited means only those actions that are necessary to collect cash flows and remit to beneficial interest holders
2. Permitted activities must be specified in legal documents
3. Servicer may exercise discretion to work out a loan, initiate foreclosure, and dispose of foreclosed assets that it temporarily holds, provided there is prescribed and limited discretion
4. Servicer may not initiate new lending to the borrower or to a new borrower
5. Servicer may not subcontract for another entity to perform non-permitted activities



## Attribute 3: Limits on Holdings of a QSPE

A QSPE may hold only:

1. Financial assets transferred that are passive in nature
2. Passive derivative financial instruments that pertain to 3<sup>rd</sup> party beneficial interests
3. Servicing rights related to financial assets that it holds
4. Temporarily, non-financial assets obtained through foreclosure
5. QSPE may not hold American or Bermudan options or forwards, but can hold European options



## Attribute 4: Limited and Automatic Sales

### Permissible QSPE Activities

1. Servicer may dispose of defaulted loans if that power is specified in the servicing agreement and is limited.
2. Servicer may retain the right to purchase defaulted loans.

### Non-permissible QSPE Activities

1. QSPE or QSPE servicer may not have power to determine which loans to sell in response to adverse changes.
2. QSPE may not have servicing agreement that requires servicer to exercise significant judgment in disposing of defaulted loans.



# Servicer Activities that FASB is Challenging

1. The ability to waive a due-on-sale provision
2. The substitution of collateral with respect to a loan held by a qualifying SPE
3. The permitted activities in connection with a sale of real estate temporarily held by a qualifying SPE



# The Ability to Waive Due on Sale Provision

1. Impacts both residential and commercial servicers
2. More important in commercial because most loans are not pre-payable
3. Commercial loan PSA stipulates transferee must meet certain criteria
4. Criteria is intended to ensure that replacement borrower will be able to manage commercial property
5. Borrower-initiated transfer and waiver request must be evaluated by rating agencies for commercial waivers



# Substitution of Collateral

1. Generally exist in connection with loans secured by pools of properties owned by a single borrower
2. Mortgage agreement specifies criteria that borrower must meet in order to exercise its unilateral right to substitute collateral



# Servicers of Foreclosed Collateral

1. Commercial Servicer is constrained by both PSA as well as REMIC rules
2. PSA requires commercial servicer to sell REO property as soon as practicable in order to minimize losses to BI holders
3. At September 30, 2005, .44% of commercial securitized loans were in foreclosure. 56% sold in one year, 88% sold within two years
4. Residential servicer is constrained by Fannie Mae and Freddie Mac guidelines
5. This issue affects both commercial and residential, but residential to a lesser degree