

2007 MBA Accounting, Tax and Financial Analysis Conference

Accounting Implications of Restructurings Mortgage Loans

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Presented by:

Aaron Netten, Wells Fargo & Company



Accounting Discussion

➤ Implications of Restructuring Securitized Loans

- Background
- The issue: What are servicers allowed to do under FAS 140?
- Accounting guidelines for servicers to follow when restructuring troubled loans

Emerging Issue: Impact of Modifying Non-Securitized Loans

- Accounting Guidance – FAS 15 and FAS 114
- Implementation issues

Restructuring Securitized Loans - Background

- Subprime mortgages – confluence of factors contributing to current conditions
 - Billions of dollar of ARM loans resetting (e.g., 2/28, 3/27 loans)
 - Weakening housing market
 - Tightening underwriting standards, elimination of certain programs
- Significant amount of recent loans in securitizations
 - Loans held by Trusts, designed to be FAS 140 QSPEs
 - QSPEs required for off-balance sheet (sales) treatment
 - QSPE thought of as on “auto pilot” by accountants, activities limited and pre-defined
- General agreement that minimizing foreclosures and keeping people in homes beneficial for both investors and borrowers
- Servicers fiduciary responsibility to service loans according to Pooling and Servicing Agreements (PSAs), acting in best interest of certificate holders and creditors (i.e., servicers) of the Trust.

Restructuring Securitized Loans – Background (Cont'd)

- Servicers typically employ several loss mitigation strategies before foreclosure, generally allowed by PSAs
 - Proactively contact borrower to assess situation
 - Temporary solutions – e.g., repayment plans, forbearance
 - Permanent solutions – e.g., loan modifications, short sales
- PSAs generally allow these strategies for loans in default or where default is **“reasonably foreseeable”**.
- Loan default is **Reasonably foreseeable** if all of the following occurs:
 - Servicer has contacted borrower,
 - Servicer has assessed borrower’s ability to continue to pay and
 - Servicer has reasonable basis for concluding borrower will be unable to make their mortgage payment in the near future.
- Loans modifications are *contractual* changes to the loan, including:
 - Interest rate changes – temporary and permanent
 - Principal forgiveness
 - Capitalizing or deferring delinquent payments
 - Term extension

Restructuring Securitized Loans – FAS 140 Practice Issue

- FAS 140 QSPE rules require its activities are “significantly limited” and “entirely specified in the legal documents”. Additionally, “new lending” by the QSPE is not allowed.
- Questions raised Q1/Q2 2007 whether servicer loan modification activities are consistent with QSPE rules
- Primary Issue: Is the servicer discretion/judgement allowed by the “reasonably foreseeable” standard too broad under QSPE rules (i.e., that QSPE activities are “significantly limited”)?
- Companies fearful of QSPE tainting
- Perceived as hurdle to proactively engaging in loan modification activities

Restructuring Securitized Loans – FAS 140 Practice Issue (Cont'd)

- Congressional, regulatory and industry efforts undertaken to provide clarification:
 - Banking Regulators announcement
 - MBA White Paper
 - American Securitization Forum Principles and Guidelines
 - Barney Frank letter to SEC Chairman Cox
 - FASB Education session June 22
 - Chairman Cox response to Barney Frank letter

Restructuring Securitized Loans – FAS 140 Practice Issue (Cont'd)

- Issue resolved: Servicing activities associated with troubled loans – including when loan default is reasonably foreseeable - are permissible activities of QSPE, so long as certain conditions met. Off-balance sheet treatment can continue.
- Consensus developed amongst preparers, investors, auditors, SEC, banking regulators and FASB.
- What is the technical rationale? MBA White Paper instrumental.
 - Loan modifications granted to borrowers where default is reasonably foreseeable are troubled debt restructurings (TDRs) under FAS 15 and EITF 02-4.
 - Existing FAS 140 implementation guidance states restructuring a loan *upon delinquency or default* is permissible activity. (i.e., TDRs performed on delinquent or defaulted loans are OK)
 - Servicer discretion required when default in reasonably foreseeable is similar to discretion required when loan is in default or delinquent.

Restructuring Securitized Loans – Accounting Guidelines to Follow

- Servicers should follow these guidelines when restructuring troubled loans:
 - Servicer has substantiated basis for concluding loan is in default or that default is reasonably foreseeable.
 - Servicer’s power to commence workouts of troubled loans is significantly limited and parameters of such discretion is described in QSPE’s legal agreements.
 - Each troubled loan workout is considered a TDR under FAS 15 and EITF 02-4.
 - Loan modification options available to troubled borrowers should not include “new lending” (e.g., refinance options, new borrower or new collateral)
- Failure to follow these guidelines could result in QSPE disqualification and consolidation of the loans by the transferor

Loan Modifications to Non-Securitized Loans

Accounting Guidance

- **What qualifies as a TDR?**
 - FAS 15 & EITF 02-4 applicable guidance
 - Both of the following conditions required to qualify for TDR:
 - Borrower experiencing financial difficulty
 - Lender grants *contractual* concession
 - Effective interest rate of modified loan < Effective interest rate of old loan, then determinative concession considered granted. *But* concession may occur otherwise.
 - FAS 15 provides loan modifications (as defined herein) as an example of a TDR
 - Judgment required, all facts and circumstances considered

Loan Modifications to Non-Securitized Loans (Cont'd)

Accounting Guidance (cont'd)

- **How are TDRs accounted for by lenders/creditors?**
 - FAS 114 provides accounting guidance for creditors of impaired loans, including but not limited to TDRs. Residential mortgage loans not subject to FAS 114, *unless* underwent a TDR.
 - Recognition principle: Loan is impaired when probable that all contractual principal and interest amounts due will not be collected.
 - Measurement principle: If impaired, amount of loss equal NPV of estimated future cash flows less than recorded investment in loan.
 - Measurement Methods: NPV future cash flows (most likely), observable market price and collateral value (if loan is collateral dependent).
 - Accounting: adjust allowance for loan losses, offset provision for loan losses.

Loan Modifications to Non-Securitized Loans (Cont'd)

Implementations Issues

1. Can loans in current payment status qualify as TDRs?
2. Can loan qualify as a TDR, but no impairment is recognized under FAS 114?
3. When is a TDR impairment recognized for residential mortgage loan?
4. What effective interest rate should be used when calculating NPV under FAS 114?
5. FAS 5 vs FAS 114 – is there a difference in amount recorded to ALLL reserves? If so, what is it and is it understood?

Loan Modifications to Non-Securitized Loans (Cont'd)

Example – Illustration of Effective Interest Rate

Assume:

- 2/28 loan originated March 2006 at 5% teaser rate scheduled to reset at LIBOR+200bps in March 2008.
- Its December 2007 and current LIBOR is 6%. Lender determines loan modification is appropriate, offering fixed-rate at 6% for remaining term, effective December 2007.

Q: What is the effective interest rate to calculate NPV under FAS 114?

- Effective rate of old loan recalculated at time of impairment
- Index assumed to be stay constant

A: Effective rate = blended rate (e.g., 7.875%), 5% for 3 months and 8% for remaining term.

Note: When performing NPV calculation, projected cash flows can be based upon contractual maturity or adjusted for expected prepayments pursuant to guidance in FAS 91.



Contact Information

Aaron P. Netten

Accounting Policy

Wells Fargo & Company

90 South 7th Street, MAC N9301-151

Minneapolis, MN 55401

aaron.p.netten@wellsfargo.com

(612) 667-4647

