



Servicer Related Accounting Issues

Today's Presenters

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Objectives

Agenda:

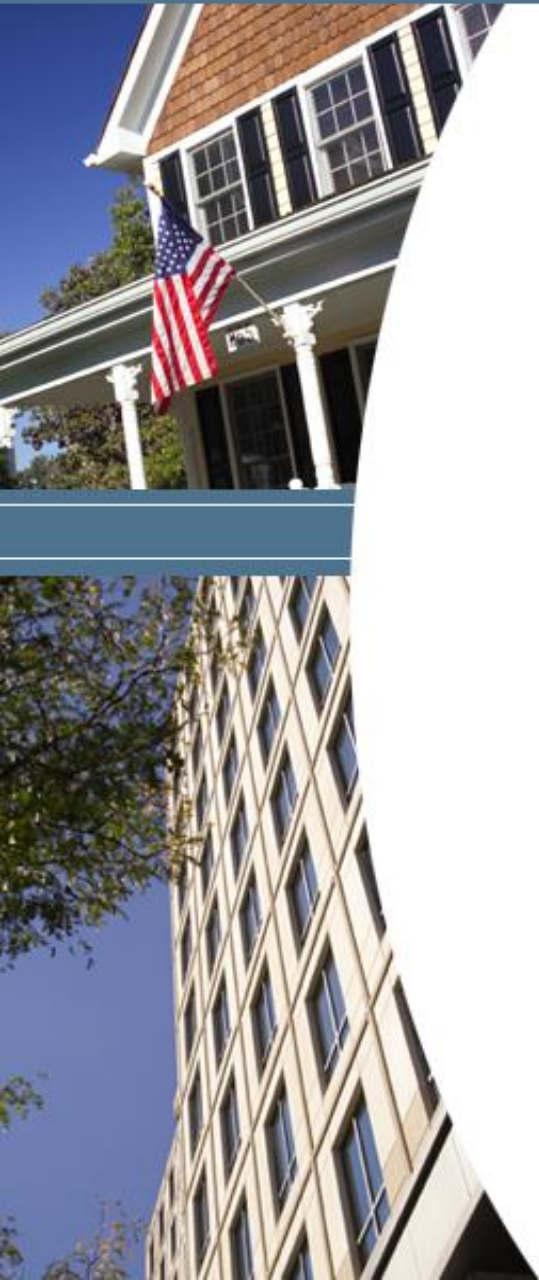
- Refresher on Accounting for Mortgage Loans
- Modification Strategies
- On-Balance Sheet Loan Modification Accounting
- Off-Balance Sheet Loan Modification Impact
- Accounting for Servicer Advances



Accounting For Mortgage Loans General Principles

- Loans classified as held for investment are recorded at amortized cost
- Loans are included in the entity's SFAS 5 valuation allowance methodology
 - As the loan seasons, its default probability increases which is applied to the loan's unpaid principal balance by origination vintage
 - Severity rate is applied to the defaulted principal balance
 - An increase in the collective loan loss allowance is made with a charge to bad debt expense

- At transfer, full-recourse and standard representations & warranty provisions require the transferor to record a non-contingent, stand ready obligation at fair value as a reduction of the gain on sale
- If a mortgage loan is reacquired at par plus accrued interest and fair value is a discount, then the loss is charged off against the off balance sheet liability
- Reacquired loans with credit deterioration between origination and acquisition may be subject to SOP 03-3



Modification Strategies

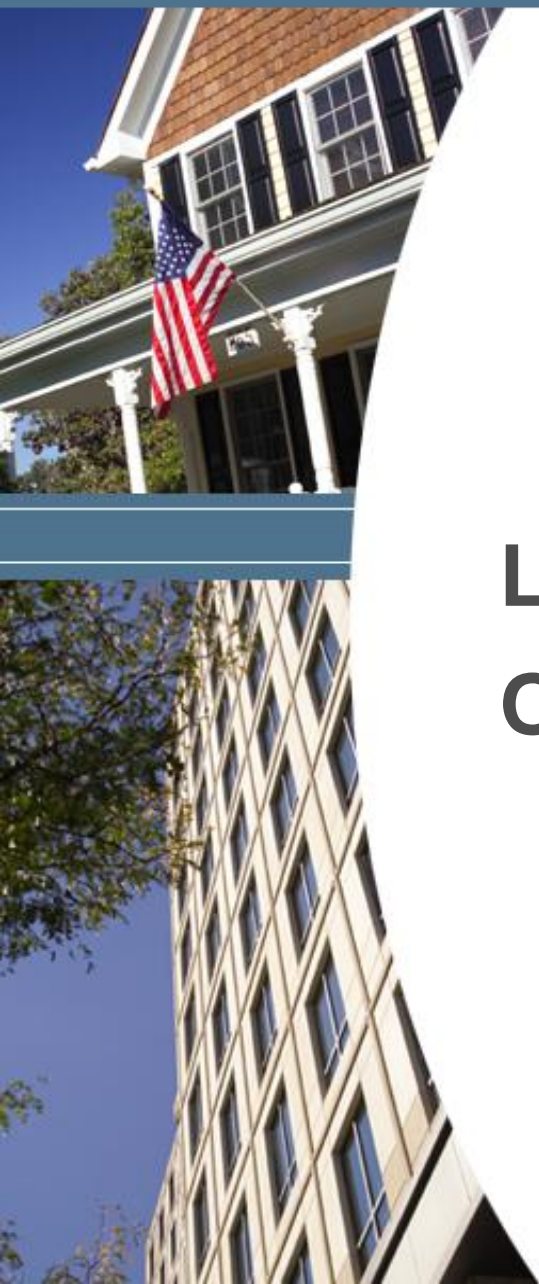
- When a mortgagor experiences financial difficulty and the loan becomes delinquent, servicing entities have several loss mitigation options available to provide the mortgagor relief from an expensive foreclosure.
- In the August 2007 inter-banking agency *Statement on Loss Mitigation Strategies for Servicers of Residential Mortgage Loans* -- servicing entities may use one or more of the following loss mitigation techniques
 - Loan modifications (i.e., contingent or permanent interest rate reductions)
 - Payment deferrals
 - Loan maturity extensions
 - Capitalization of past due amounts
 - Product conversions (i.e., convert an ARM loan to a FRM loan)

Servicing entities regularly monitor past due loans, and attempt workout arrangements if the borrower demonstrates an ability to honor the obligation under the arrangement

- For on balance sheet loans, instruments may be modified outright
- For off balance sheet loans, servicing entities may re-acquire the mortgage loan prior to modifying loans
 - In pool modifications must be written into the servicing and pooling agreement
 - Out of pool modifications are common as many securitization trusts do not have such modification provisions incorporated in the servicing and pooling agreement

Large Bank Announcements:

- **Proactive loan modifications of seriously or are likely to become serious delinquent borrowers**
 - A. Rate resets
 - B. Payment forecasts
- **Become more aggressive in modifications and foreclosure moratoriums**
- **“Preemptive measures” to keep borrower in their home**
 - A. Current borrowers qualify
 - B. Risk-based forecast versus “inability to pay”
- **FDIC plan**



Loan Modification Accounting On-Balance Sheet

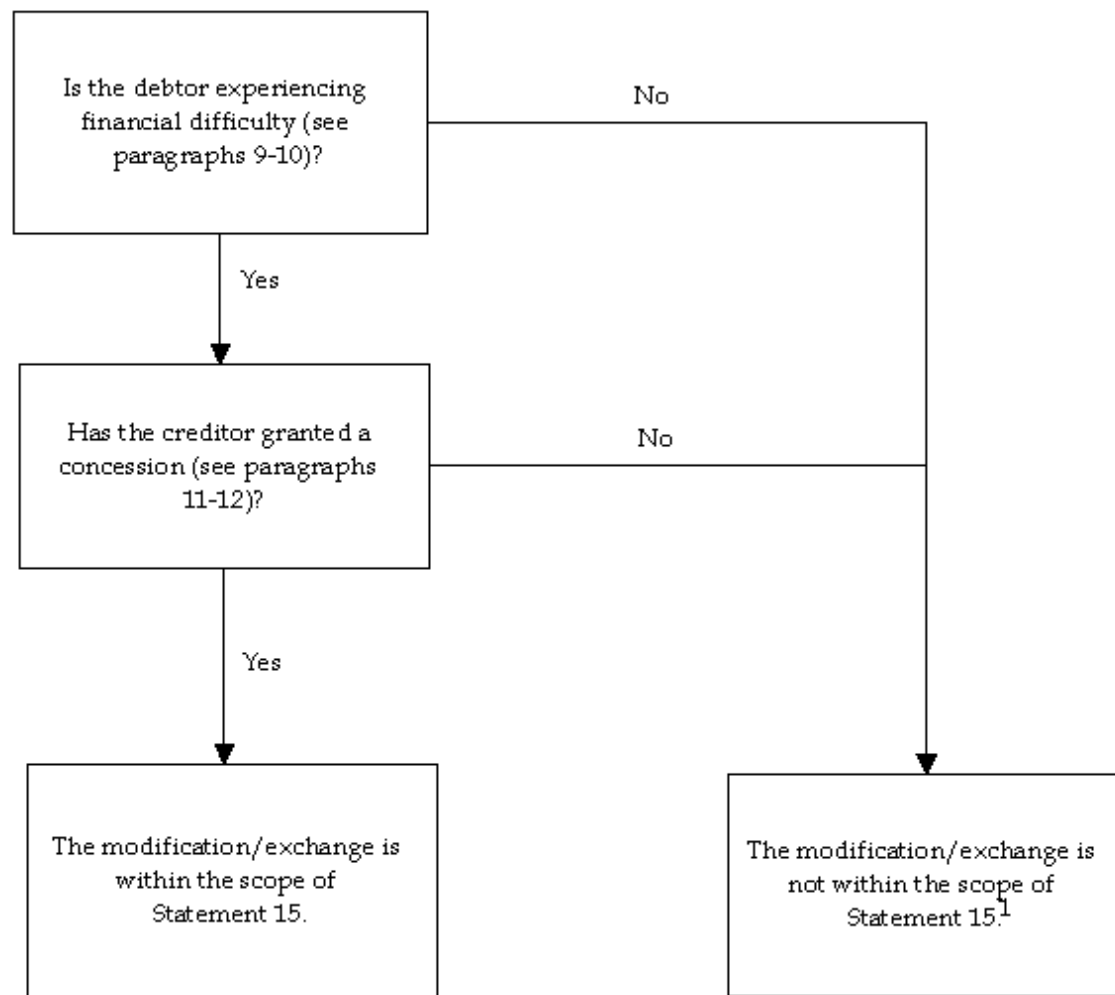
Troubled Debt Restructurings (TDR) / FAS 114 Interaction:

- Scope of FAS 114:
 - Paragraph 6 – All loans that are identified for evaluation, except:
 - a) Large groups of smaller-balance homogenous loans that are collectively evaluated
 - b) Loans measured at fair value or LOCOM
 - c) Leases as defined in FAS 13
 - d) Debt securities as defined in FAS 115
 - Paragraph 9 – Loans modified in TDRs, **including** those that were otherwise excluded from scope of FAS 114 under paragraph 6(a)
 - For example, certain residential mortgage loans modified in TDR
- TDR—Defined in FAS 15:

“the creditor for economic or legal reasons related to the debtor’s financial difficulties grants a concession to the debtor that it would not otherwise consider”

What is a TDR?

- EITF 02-4:
- Gateway to TDR determination!



EITF 02-4 provides accounting guidance as to whether a debtor is experiencing “financial difficulty”

- Indications of YES:
 - The debtor is currently in default on any of its debt.
 - The debtor has declared or is in the process of declaring bankruptcy.
 - Absent the current modification, the debtor cannot obtain funds from sources other than the existing creditors at an effective interest rate equal to the current market interest rate for similar debt for a nontroubled debtor.
- Indications of NO:
 - The debtor is currently servicing the old debt and can obtain funds to repay the old prepayable debt from sources other than the existing creditors (without regard to the current modification) at an effective interest rate equal to the current market interest rate for a nontroubled debtor, and
 - The creditors agree to restructure the old debt solely to reflect a decrease in current market interest rates for the debtor or positive changes in the creditworthiness of the debtor since the debt was originally issued.

EITF 02-4 provides accounting guidance as to whether a modified loan is a troubled debt restructuring

- If the post modification effective borrowing rate has declined below the original effective borrowing rate, then a concession is considered to have been made
 - Effective borrowing rate is calculated as projecting the newly modified cash flows and solving for the discount rate that equates the present value of the cash flows to the current carrying amount (i.e., an IRR)
- For multiple recent modifications, the new effective borrowing rate comparison should be made to the original debt's effective borrowing rate

Impairment Calculation

- Impairment measured as:
 - Present value of expected future cash flows
 - Discounted at the loan's original effective interest rate.
- Other measurement options (practical expedients):
 - Observable market price of the loan
 - Collateral value (if the loan is collateral dependent)

- Practical Considerations
 - Determining “expected future cash flows”
 - Include default and recovery assumptions?
 - Include prepayment assumptions?
 - Determining the “effective interest rate”

Loan Modifications – TDR Example

- A defaulted 30 yr FRM mortgage loan was modified in the 3rd year after origination. 10 months of past due interest was capitalized, the loan term was extended for an additional 34 months and the interest rate was permanently reduced by 300 bps. According to the lender’s non-accrual policy, 4 months of interest was recognized and all remaining contractual interest was suspended from income recognition.
- The impaired loan’s valuation allowance resulted in an impairment charge of \$76,000.

	Orig_Loan	Mod_Loan
Orig Pribal	\$250,000.00	
Int Rate	7.00%	4.00%
Term	360	360
Price	102.00%	101.82%
Pmt	\$1,663.26	\$1,168.41
Eff Yld	6.80%	3.85%
Mod Period		34
Balance at Mod Date		\$244,737.37
Unamortized Premium		\$4,446.63
Interest Capitalized		\$14,213.52
Deferred Income		<u>(\$8,511.26)</u>
Carry Amt		<u><u>\$254,886.26</u></u>
DCF @ 6.80%		<u><u>\$179,133.84</u></u>
Val Allowance		<u><u>(\$75,752.42)*</u></u>

* Note that the example assumes no default assumptions for illustrative purposes. In practice, default would need to be considered.

- System Requirements and Process Challenges
 - Identifying TDRs in Loss Mitigation for proper flagging
 - System functionality to capture the terms before and after modification
 - Capturing/calculating the proper effective yield for discounting
 - System feeds for future contractual cash flows
 - Incorporating estimated default and prepayment assumptions
 - System capability of accreting any NPV impact of impairment
 - Ensuring the TDR reserve isn't double counting FAS 5 or other reserves (e.g., FFIEC)

A TDR is a continuation of collection on the original loan

- Therefore, FAS 91 deferred fees and costs continue as part of the carrying amount of the loan
- “New” fees received related to TDR is a reduction of the recorded investment
- Additional costs should be expensed as incurred

- Loan modifications that do not result in a TDR and are not within the scope of SOP 03-3 are subject to the more than minor loan modification evaluation
- SOP 03-3 loan modifications – remain within the scope of SOP 03-3
- For loans within the scope of EITF 01-7, if the loan's modified cash flows discounted at the original effective yield is changed by 10% or more from its previous carrying amount, then the loan is considered to be a more than minor (i.e., a “major” modification)
 - Lender should perform the EITF 96-19 cash flow analysis
 - The old loan's unamortized fees and costs are recognized in full in current period earnings
 - New fees and costs are deferred and amortized according to the lender's income recognition policy

- Interaction between non-accrual policy and capitalization of past due interest
 - Lender capitalizes all past due interest on the loan balance
 - Unrecognized portion of past due interest becomes deferred income and is accreted over loan life according to the interest method
- If a loan is placed on forbearance, it may be impaired from a cash flow timing perspective - the lender should develop an accounting policy for such events taking materiality into consideration
- If a non-SOP 03-3 modified loan does not meet the 10% threshold, then the loan continues, but there may be a SFAS 91 cum adjustment to reflect a change in effective yield based upon the modification terms



Loan Modification Accounting Off-Balance Sheet

A Qualifying Special Purpose Entity (QSPE) is a trust or other legal vehicle that meets *ALL* of the following criteria:

- Demonstrably distinct from the transferor
- *Permitted activities are significantly limited and entirely specified*
- May hold only certain passive assets, and
- May only sell or dispose of noncash assets in certain circumstances

- QSPE's activities must be “significantly limited and entirely specified”
- ‘Work outs’ allowed for loans that are delinquent or in default (140 Q&A #28B)
- SEC interpretation expands this to ‘reasonably foreseeable’ default

Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime ARM Loans (ASF Framework)

- Scope limited to ARMs with specific terms and origination/ repricing dates held within securitization structures
- Aims to facilitate effective efforts to prevent foreclosures and losses
- Provides recommended framework to streamline the process of evaluating borrowers for possible loan modifications

Includes screening criteria for the purpose of categorizing loans into three segments:

- Segment 1: current loans where borrower is likely to be able to refinance into any readily available mortgage industry products
- Segment 2: current loans where the borrower is unlikely to be able to refinance into any readily available mortgage industry products
- Segment 3: loans where borrower is not current, demonstrating difficulty meeting the introductory rate

Segment 2 loans are only eligible for fast track loan modification if:

- Loan originated between January 2005 and July 2007
- The borrower currently occupies the property as a primary residence
- The borrower meets the FICO test (or qualifies using alternative analysis)
 - FICO test: current FICO score is less than 660 AND has not increased more than 10% from the FICO score at origination
- The servicer determines that, at the upcoming reset, the payment amount would go up by more than 10%

Borrowers in this segment may be offered a loan modification under which the interest rate will be kept at the existing rate, generally for 5 years following the upcoming reset

Fast track option is non-exclusive and does not preclude a servicer from using an alternative (more rigorous) analysis to determine if a borrower is eligible for loan modification (i.e., default is “reasonably foreseeable”)

- Fast track option allows servicers a “portfolio approach” to loan modification
 - No need to contact the borrower or consider/ confirm their current income, as objective criteria are used to make assessment instead

Trust Documentation

- Review of each type of trust to ensure discretion consistent with FAS 140
- Note: Consider all QSPE criteria

Modification Documentation

- Support that each modification is consistent with Trust documents



Accounting for Servicer Advances

Many times, a servicer is required to advance funds to a Trust/Investor

- Principal and interest
- Taxes and insurance
- Corporate advances (e.g., foreclosure expenses)

Advances recoverable from Trust assets

- First from proceeds on specific loan
- Second from proceeds on total trust assets
- Servicer can stop advancing on a specific loan when the expected proceeds do not support recoverability from that specific loan

Accounting considerations

- Collectibility of advances

Questions



- FASB Statement No. 5, *Accounting for Contingent Losses*
- FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*
- FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs with Originating and Acquiring Loans and Initial Direct Costs of Leases*
- FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*
- FASB Statement No. 118, *Accounting by Creditors for Impairment of a Loan – Income Recognition and Disclosures*
- FASB Interpretation No. 45, *Guarantor’s Accounting and Disclosure for Guarantees, Including Indirect Guarantees of Indebtedness of Others*

- AICPA Statement of Position 03-3, *Accounting for Certain Loans Or Debt Securities Acquired in a Transfer*
- Emerging Issues Task Force No. 92-2, *Measuring Loss Accruals by Transferors for Transfers of Receivables with Recourse*
- Emerging Issues Task Force No. 96-19, *Debtor's Accounting for a Modification or Exchange of Debt Instruments*
- Emerging Issues Task Force No. 01-7, *Creditor's Accounting for a Modification or Exchange of Debt Instruments*
- Emerging Issues Task Force No. 02-4, *Determining Whether a Debtor's Modification or Exchange of Debt Instruments Is Within the Scope of FASB Statement No. 15*
- Emerging Issues Task Force No. 02-9, *Accounting for Changes That Result in a Transferor Regaining Control of Financial Assets Sold*

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