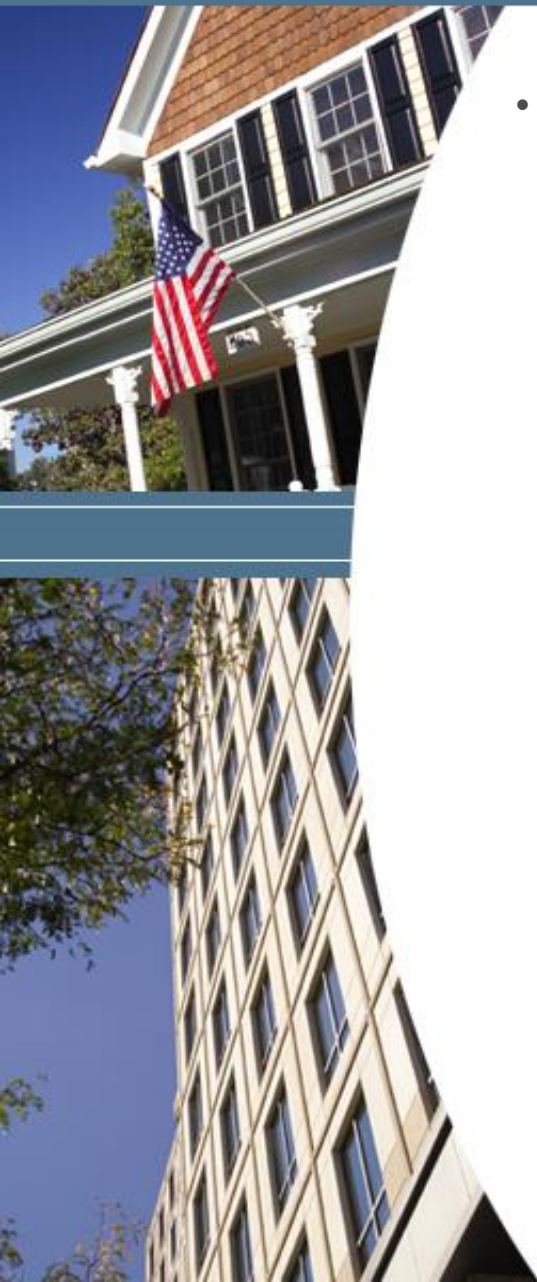


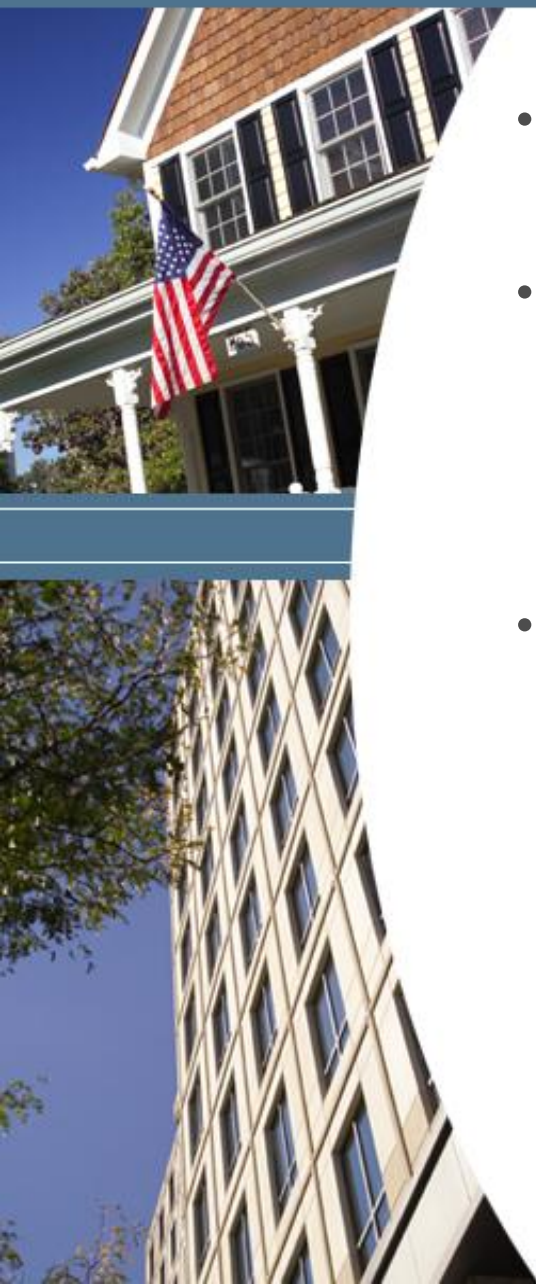


# Accounting for Securitizations and Special Purpose Entities – Overview

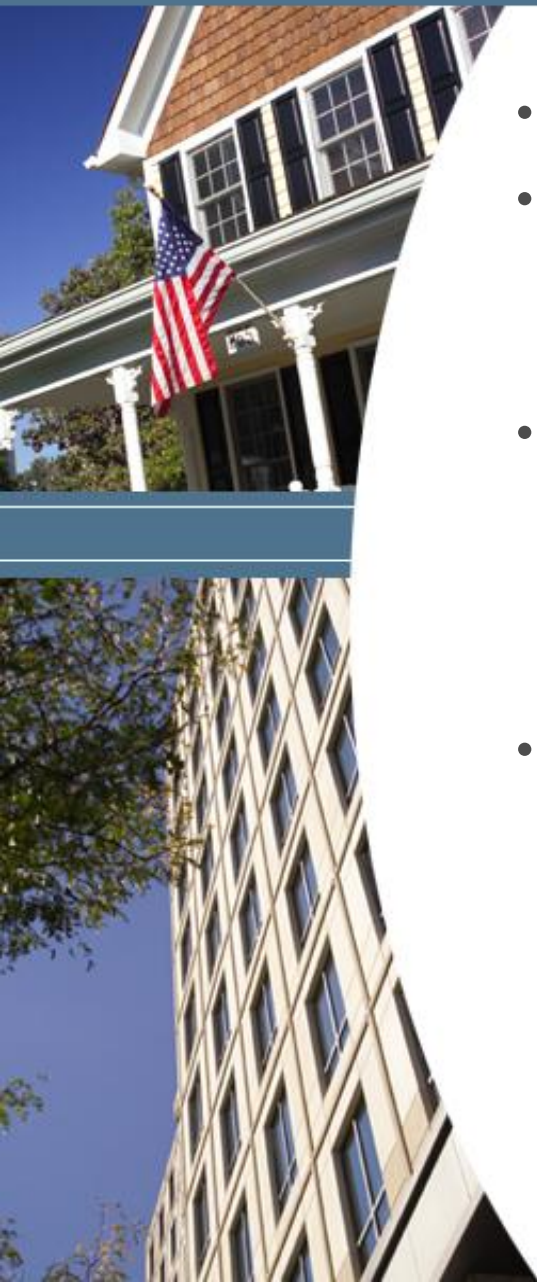
Variable interest entities

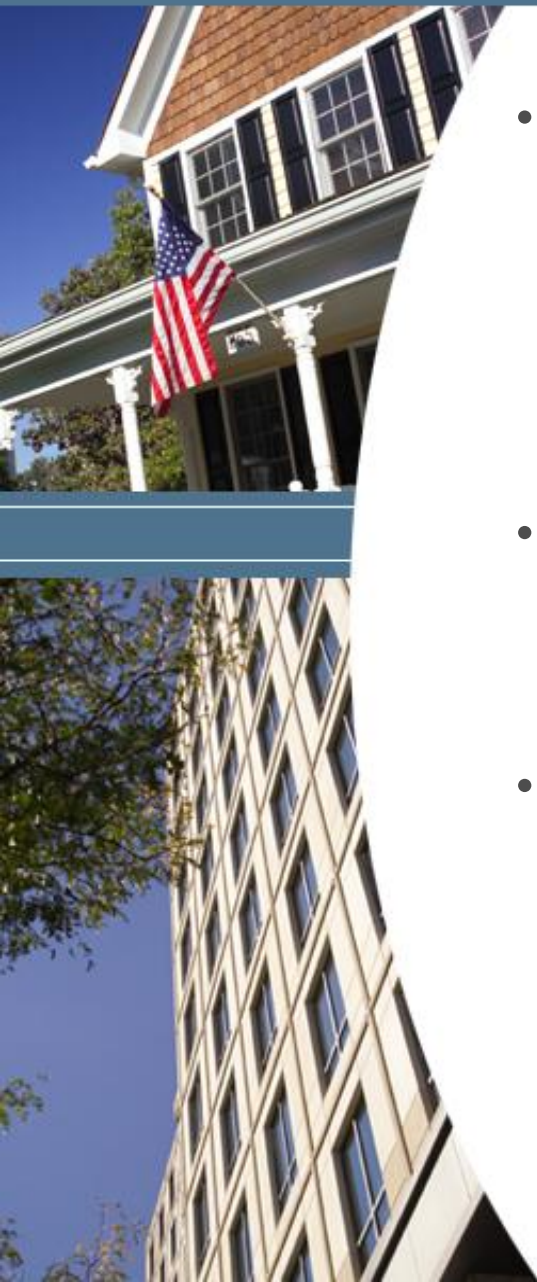
November 12, 2009

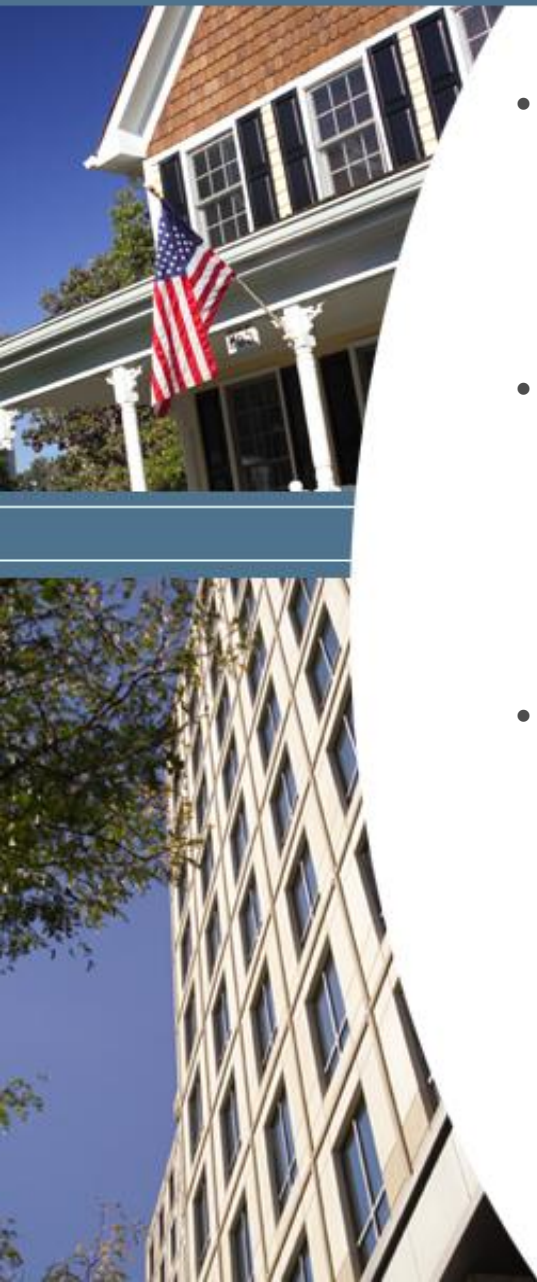
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- The information in this document and oral discussion is intended to provide only a general outline of the subjects covered. It should not be regarded as comprehensive or sufficient for making decisions, nor should it be used in place of specific advice. This presentation is accurate, to the best of our knowledge and belief, as of the date hereof; however, it is based on general concepts and terms, and the existing or proposed accounting and other literature summarized herein may be amended or may change before it is issued in final form, and accordingly, appropriate research and or professional consultation should be performed and or obtained before applying the current or proposed GAAP literature to any specific transaction or specific business facts and circumstances. The presentation expresses the author's views and is not intended to be accounting, legal, or other professional advice.

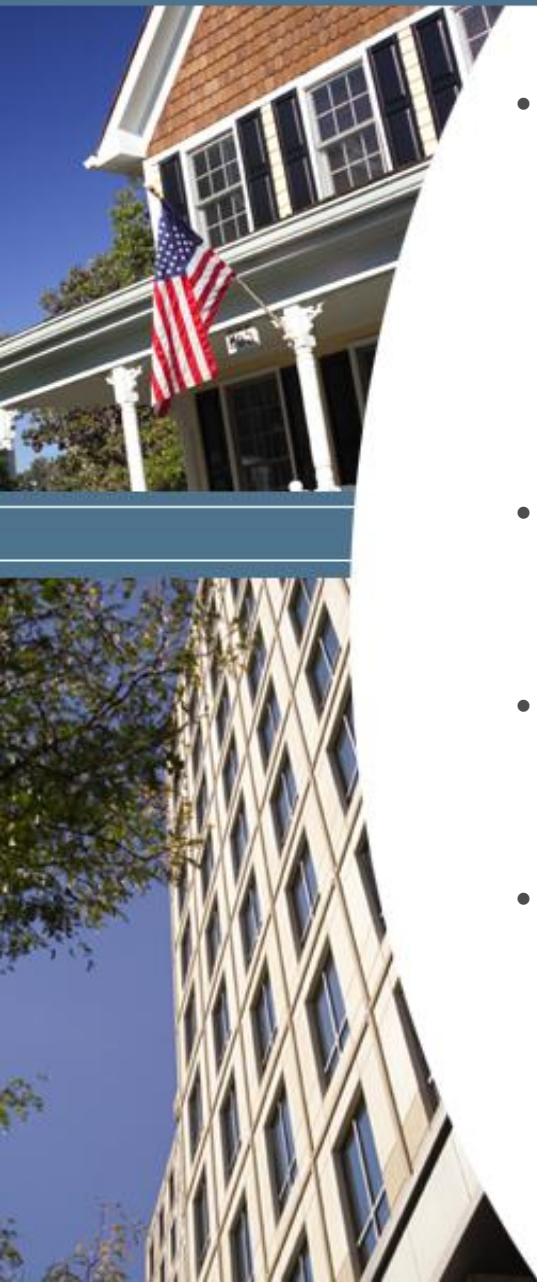


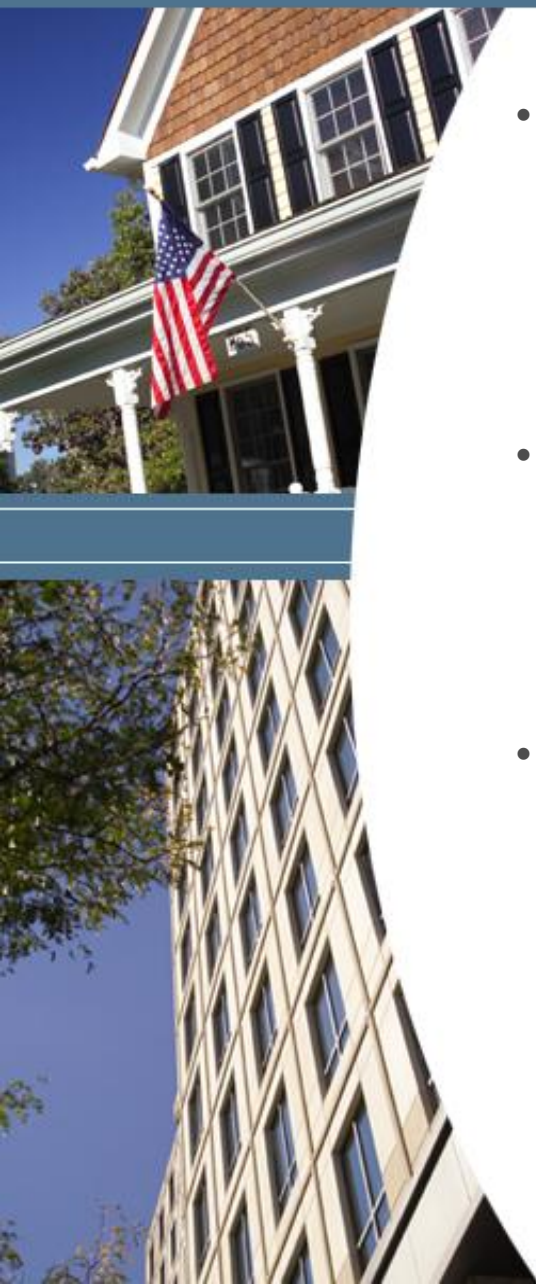
- The accounting for securitizations (particularly, QSPEs) challenged by several constituents
- Changes in the accounting for transfers of financial instruments amended the accounting for securitizations, eliminating the Q concept, among other things
- VIE / SPE amendments were in response to:
  - » Need to eliminate the QSPE scope exception
  - » Overly complex existing guidance did not result in timely, useful information about a company's involvement with VIEs

- 
- Scope changed only to eliminate QSPE exception
  - Variable interest definition remains substantially the same, except for fees paid to decision makers / service providers
  - VIE criteria modified:
    - » The at-risk equity holders generally must have power to direct the entity's activities that *most significantly* impact its economic performance
    - » Kick-out rights generally not considered
  - Primary beneficiary (PB) determined qualitatively
    - » Quantitative-based primary test eliminated
    - » Primary beneficiary has power and benefits, as defined

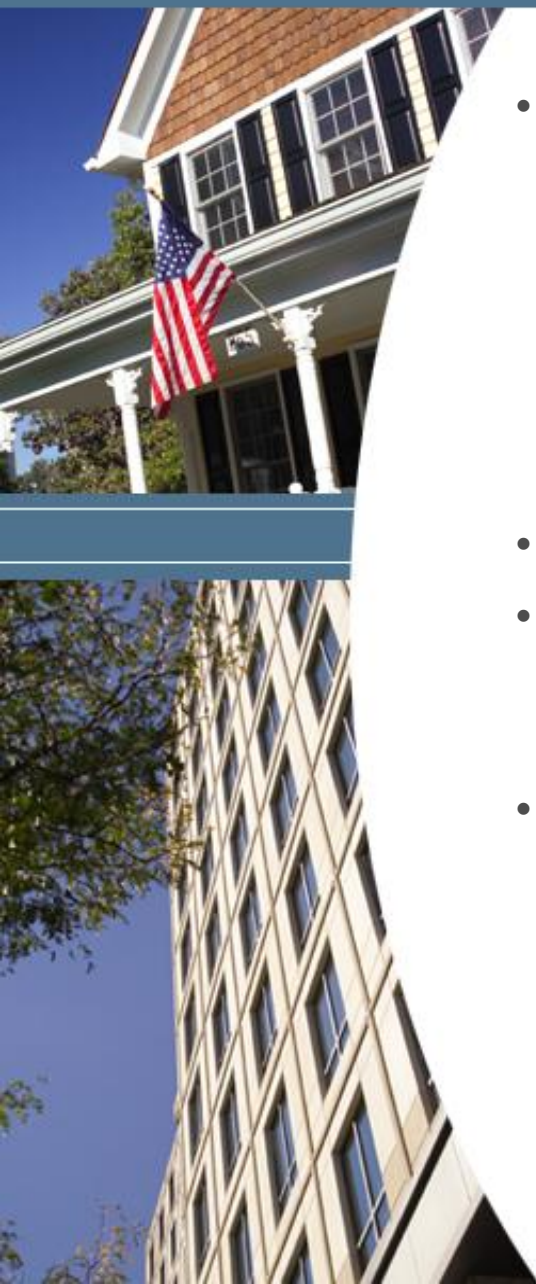
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- Reconsideration events modified
    - » For entity, upon occurrence of specified events (event added)
    - » For primary beneficiary, determination is continuous
    - » Exception eliminated for troubled debt restructurings (TDR)
  - Requires deciding who should consolidate an entity before deciding whether assets transferred have been “sold”
  - Enhanced disclosures required
    - » Generally consistent with previously-issued disclosure FSP

- 
- Variable interests continue to be absorbers or receivers of the variability the entity was designed to create and to distribute
    - » Current practice not expected to significantly change, except for the fees paid to decision makers / service providers
  - Fees paid to a decision maker / service provider are variable interests, unless they are:
    - » Customary and market-based
    - » Senior in payment
    - » Insignificant on both a total dollar and variability basis relative to the entity's economic performance
  - For fees not to be variable interests, neither the decision maker nor its related parties / de facto agents can have other variable interests that individually or in the aggregate absorb more than an insignificant amount of the entity's variability

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- Whether fees are variable interests can be determinative in applying the literature:
    - » Without holding any variable interest, a decision maker cannot be required to consolidate a VIE
    - » Whether the service contract is a variable interest can significantly affect whether the at-risk equity holders have substantive decision making (VIE determination)
    - » The service contract may require consolidation of the VIE
  - An administrator or servicer who earns fees of  $>0.5\%$  of assets under management is unlikely to have a variable interest
  - A general partner who is eligible to receive a carried interest of 20% of the entity's profits is likely to have a variable interest
  - Variable interests are identified based on the individual facts and circumstances



- The only VIE criterion amended is the decision making ability of the at-risk equity holders
  - » Entity must still have sufficient at-risk equity whose group of holders are subject to first dollar risk of loss without a cap on their returns not to be a VIE
- Not to be a VIE, the group of at-risk equity holders generally must have power, through voting rights or similar rights, to direct the activities of an entity that most significantly impact the entity's economic performance
- Substantive kick-out or participating rights not considered unless a single enterprise has the unilateral ability to exercise them



- Identify the activities that most significantly affect the entity's performance and determine whether the group of at-risk equity holders can direct them. Activities include, but not limited to:
  - » Establishing budgets and making the operating and capital decisions
  - » Appointing the manager / servicer of assets and or liabilities of a securitization
- Virtually every entity has some required decision making
- Kick-out rights guidance in the VIE literature is now inconsistent with the partnership accounting literature; FASB intends to resolve in a future project
- The amendment to the VIE guidance will require more consolidation by certain general partners and decision makers / service providers

- Example 1 – Joint venture

### Facts

- » Homebuilder A and mortgage company B form a joint venture. Each party has a substantive at-risk equity investment. The board of directors – which makes all significant decisions affecting the entity's economic performance – is comprised of 4 members, two from each venturer.

### Analysis

- » The group of at-risk equity holders has the power to direct the activities that most significantly affect the entity's performance

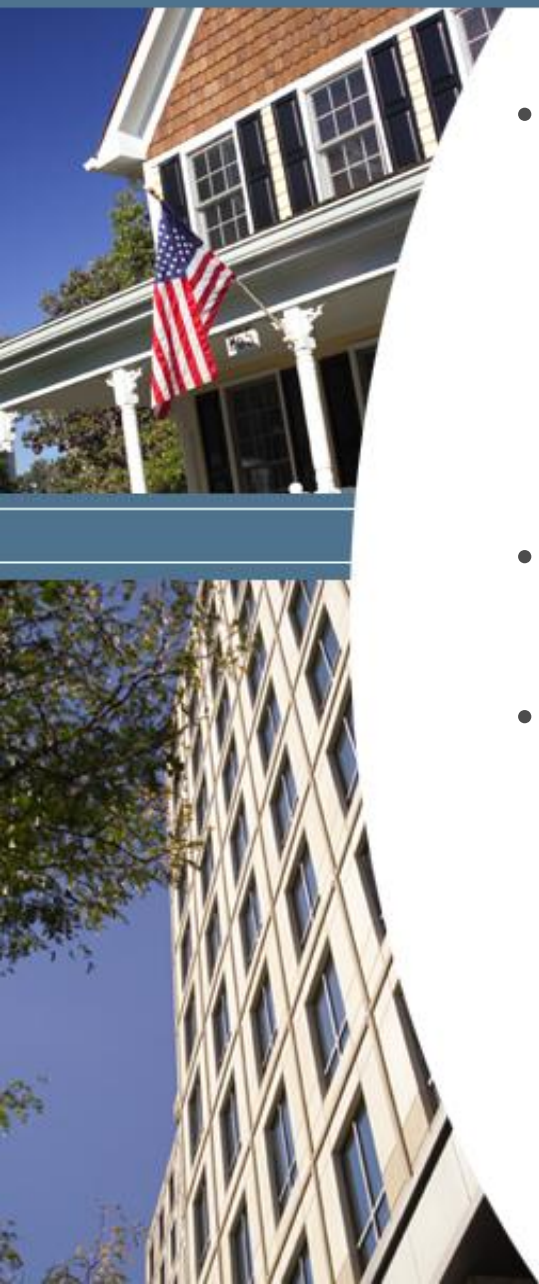
- Example 2 – Investment partnership

### Facts

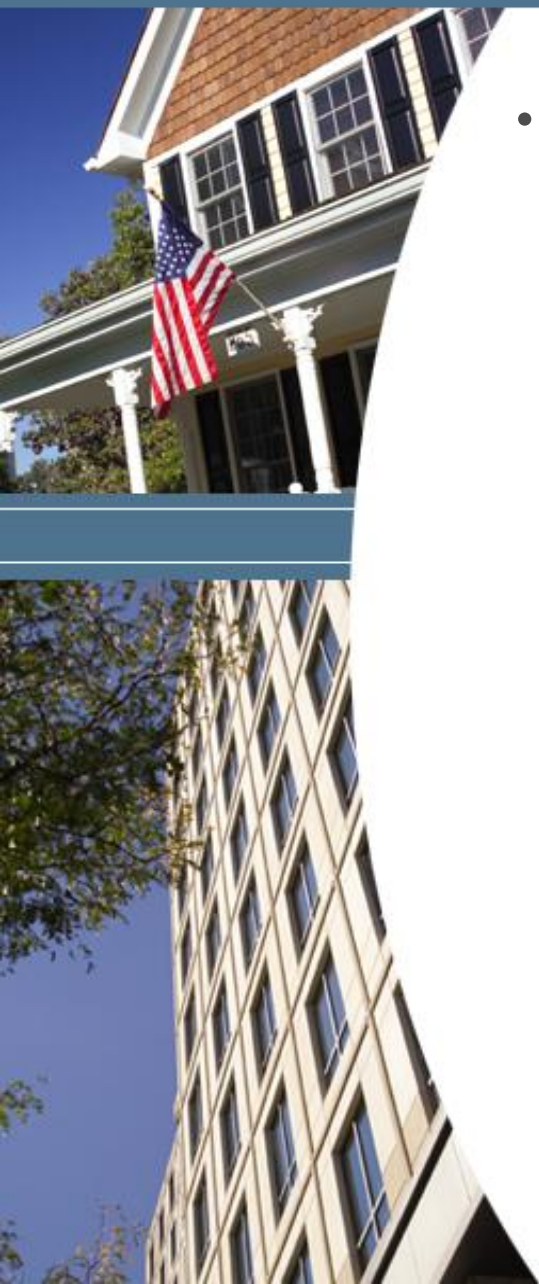
- » Real estate investment partnership is funded by multiple limited partners (LPs) unrelated to the general partner (GP). GP does not make an equity investment and is entitled to a carried interest of 20 percent of profits. The group of limited partners has substantive kick-out rights.

### Analysis

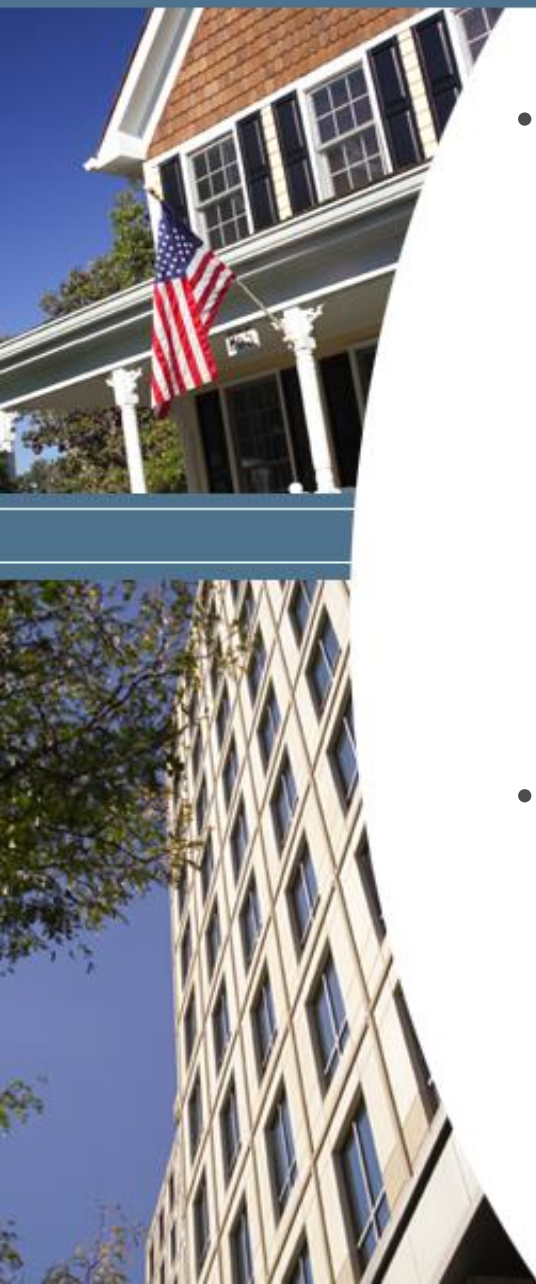
- » Partnership is a VIE under the amended literature because the at-risk equity holders (the LPs) do not have the power to direct the partnership's activities. The GP has a variable interest. Under current practice, the partnership is not a VIE because the LPs are concluded to have decision making authority through their substantive kick-out rights.



- Primary beneficiary (PB) is determined qualitatively and has:
  - » Power to direct activities that most significantly impact VIE's economic performance (power)
  - » Obligation to absorb losses or right to receive benefits from the VIE that could potentially be significant (benefits)
- An entity can – but is not required to – have only one PB
- Significance in the benefits criterion is to be measured in relation to the VIE without regard to probability of occurrence
  - » Can have power without currently exercising it



- Primary beneficiary (PB) considerations:
  - » Identify the most significant activities – including contingent activities – impacting the VIE’s economic success / performance
  - » A PB has unilateral ability to direct these activities
  - » Participating rights enable blocking of actions over significant activities but are not considered unless held by a single party (and its related parties and de facto agents)
  - » Protective rights are not considered



- PB additional considerations:
  - » If the same and most significant activities are directed by multiple parties, the party with power over majority of activities, if any, consolidates
  - » If different significant activities are directed by multiple parties, the most significant activities must be identified
    - The party that has the power over those most significant activities is the party with powers over the VIE and would be the PB (assuming it also has a variable interest that gives it benefits as defined)
- Determining the PB is a matter of facts and circumstances requiring the use of professional judgment

- Example 3 – Joint venture

## Facts

- » Homebuilder A and mortgage company B are unrelated and form a joint venture that is determined to be a VIE. The board of directors – which makes all significant decisions affecting the entity's economic success / performance – is comprised of 4 members, two from each venturer.

## Analysis

- » No single party has the ability to direct the activities significantly impacting VIE's economic performance. Accordingly, the VIE has no primary beneficiary.

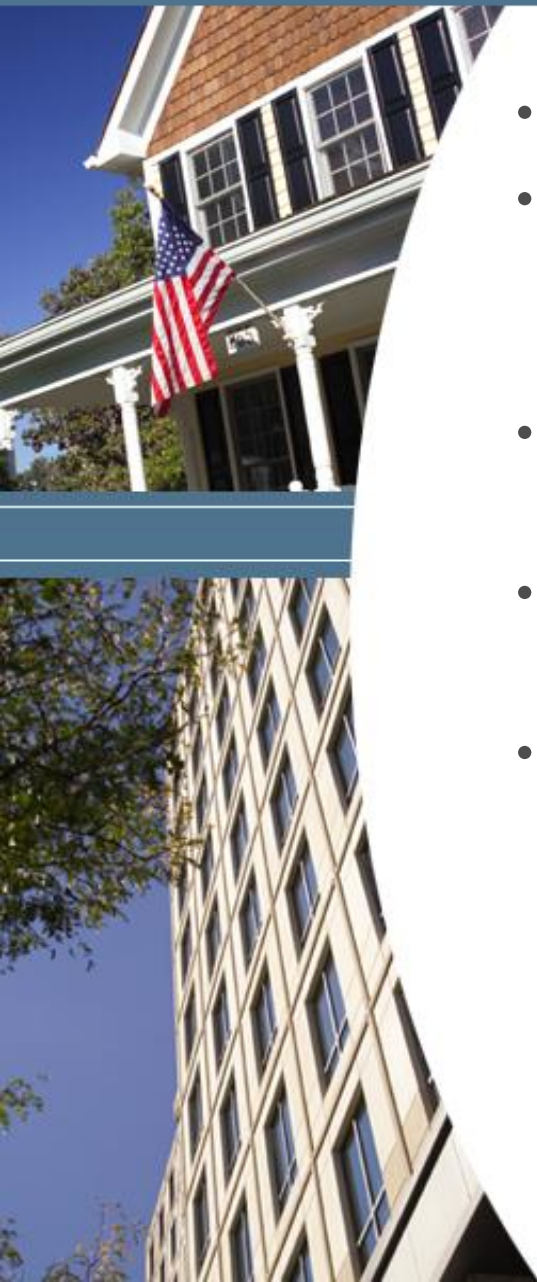
- Example 4 – Investment partnership

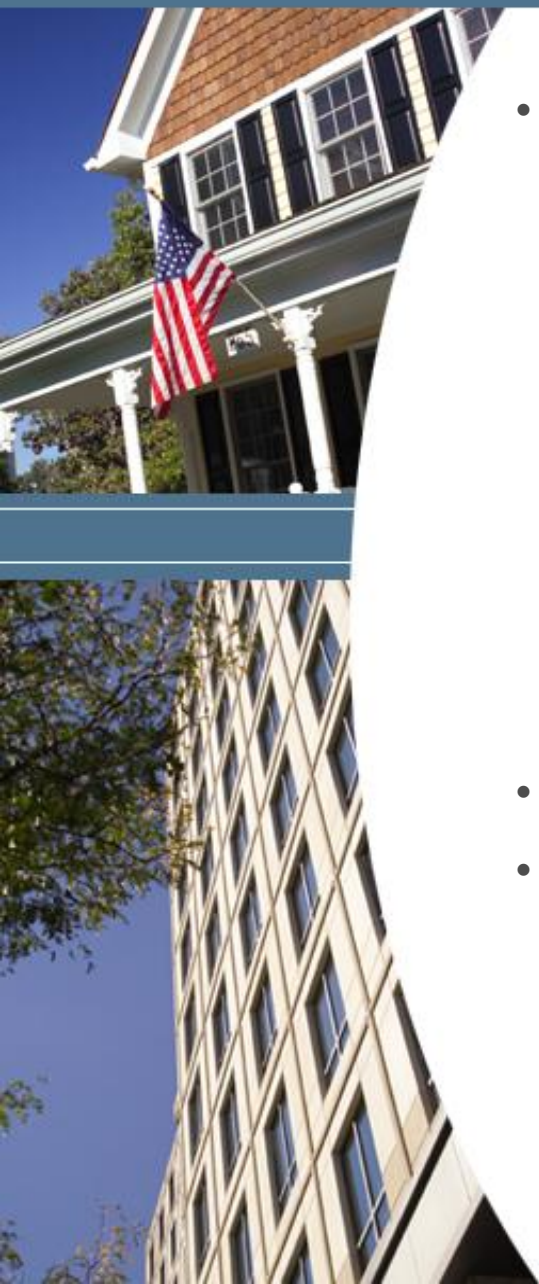
## Facts

- » Real estate investment partnership is funded by multiple limited partners (LPs) unrelated to the general partner (GP). GP does not make an equity investment and is entitled to a carried interest of 20 percent of profits. The group of limited partners has substantive kick-out rights.

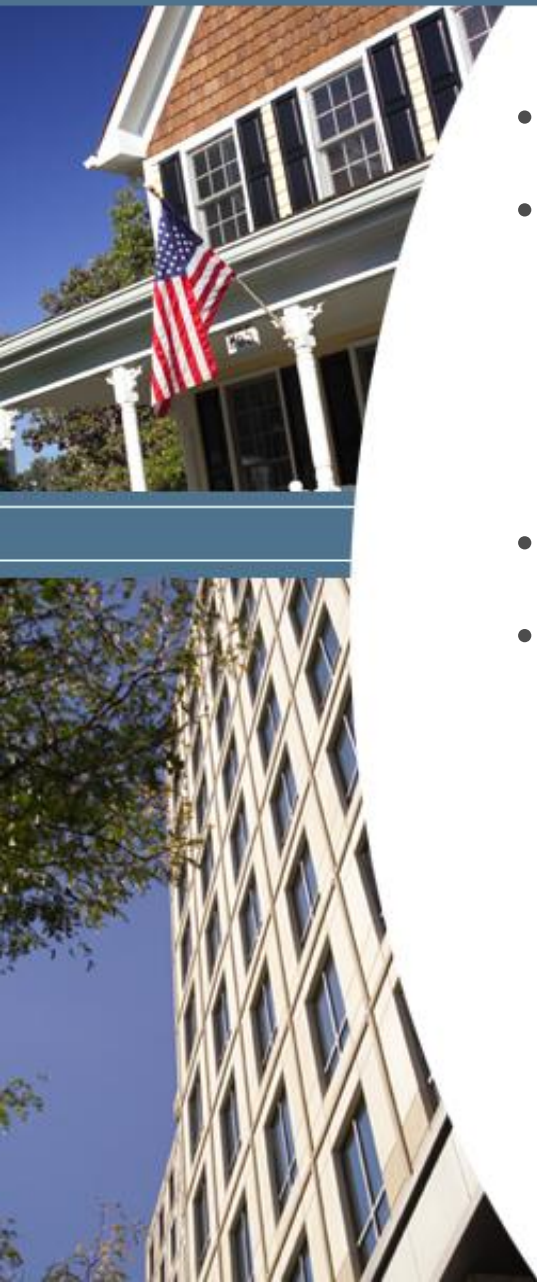
## Analysis

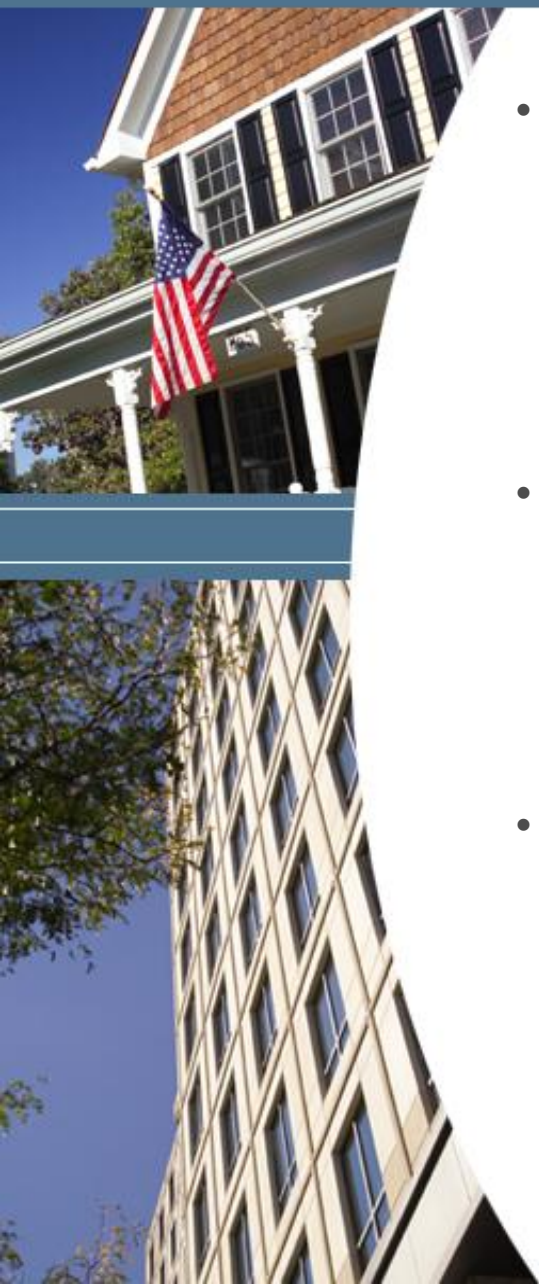
- » GP is the primary beneficiary because it has the power to direct activities that most significantly affect the VIE and has benefits. Kick-out rights are not considered in the analyses because they are not held by a single party.

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- Continuous PB determination
  - VIE reconsideration only on specific events (one event added, which is if the group of at-risk equity holders lose power)
  - Troubled debt restructuring VIE reconsideration exemption removed
  - Disclosures are extensive but generally consistent with the existing requirements (f.k.a. FSP 46(R)-8)
  - Separately present on the face of the balance sheet VIE's (1) assets if they can be used to settle only VIE's liabilities and (2) liabilities if VIE's creditors do not have recourse to consolidating PB

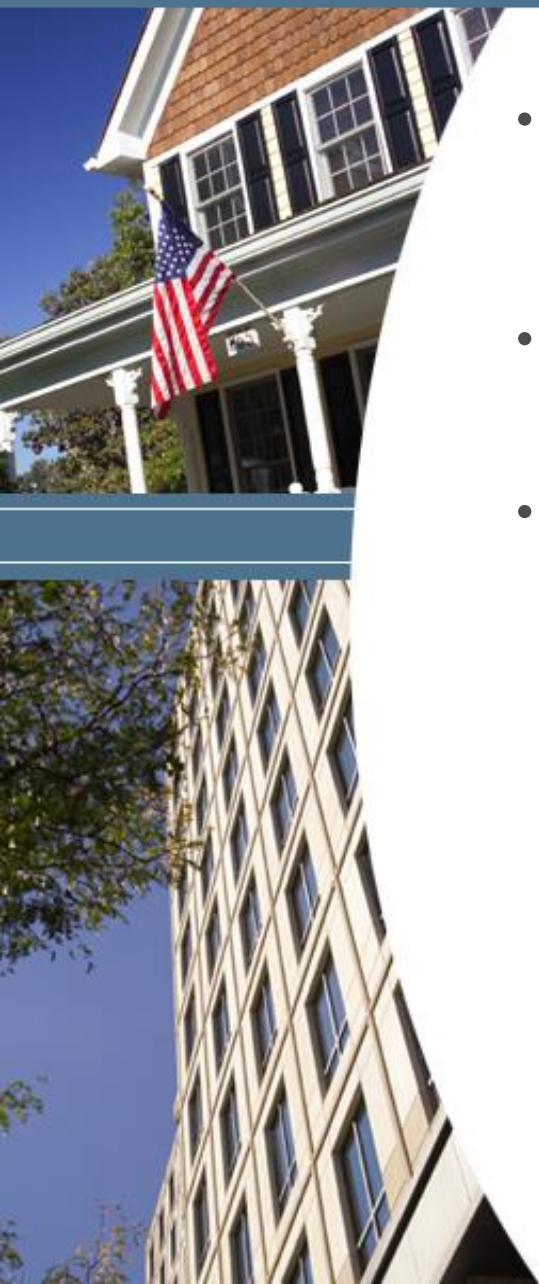


- Transition performed as if the new literature had always been applied
  - » VIE's assets, liabilities and noncontrolling interests are measured at the value at which they would have been at the adoption date had the new literature / guidance always been applied
  - » Exception if VIE carrying value determinations are impracticable, in which case the determinations and calculations are made using the adoption date fair values
  - » Additional exception if impracticable per above for entities that are primary asset-backed financings, which are permitted to use unpaid principal balance and accruals at the effective date
- VIE's retroactive application permitted but not required
- Changes to structures in anticipation of adopting the new VIE guidance must be substantive to be considered

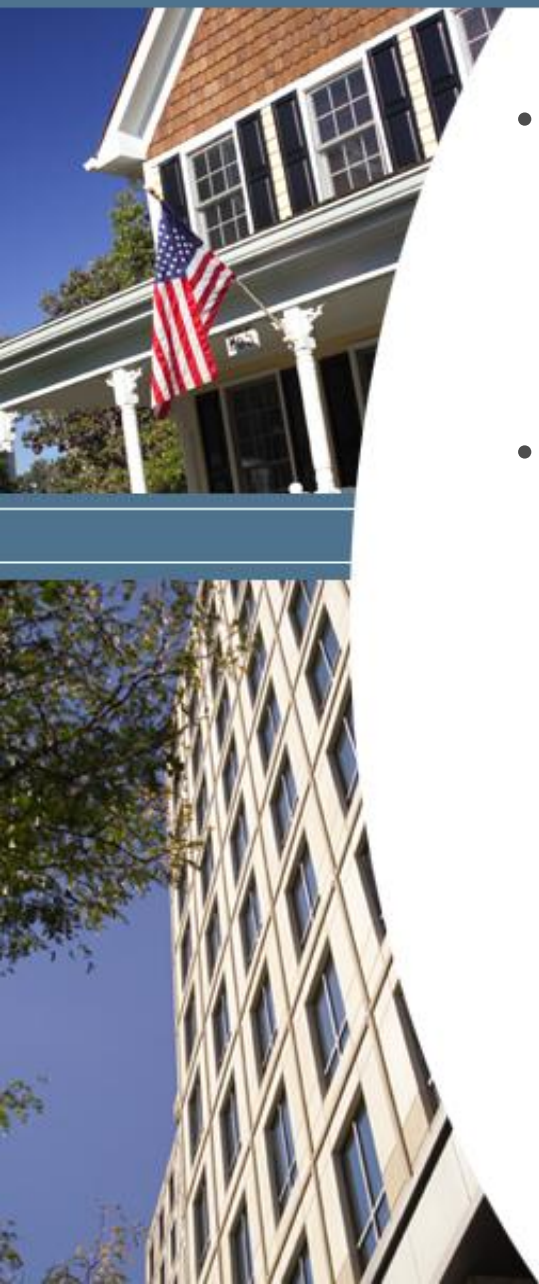
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- Applies to all new and existing entities
  - Effective as of the beginning of reporting entity's first annual reporting period that begins after November 15, 2009 (i.e., for calendar year companies – January 1, 2010)
  - Early application prohibited
  - Cumulative effect adjustment to retained earnings for any difference between the newly recognized net asset amount and the amount of any previously recognized interests



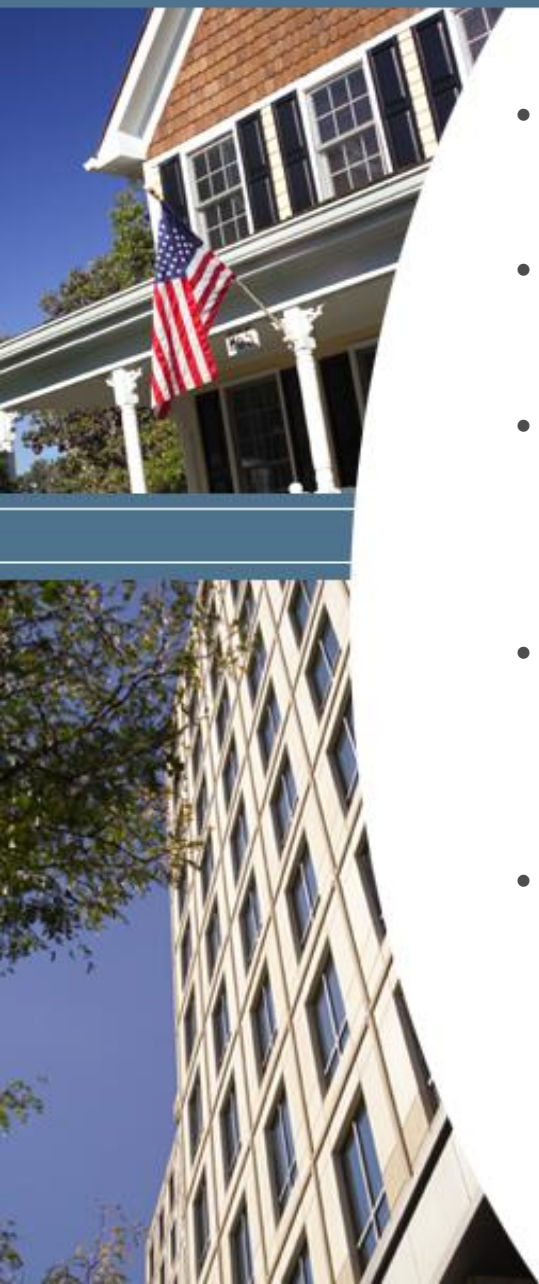
- New guidance will result in more consolidation accounting
  - » Elimination of the QSPE concept and scope exception
  - » Elimination of the TDR scope exception
  - » Variable interest definition
  - » Effect of kick-out rights on both the VIE and the PB determinations
- Basic approach to the VIE accounting has not changed
  - » Is there a variable interest?
  - » Is the entity a VIE?
  - » Who is its primary beneficiary?
  - » What, if any, disclosures are required?
- New VIE guidance did not amend the partnership accounting (f.k.a. EITF 04-5) or the evaluation of voting interest entities for consolidation



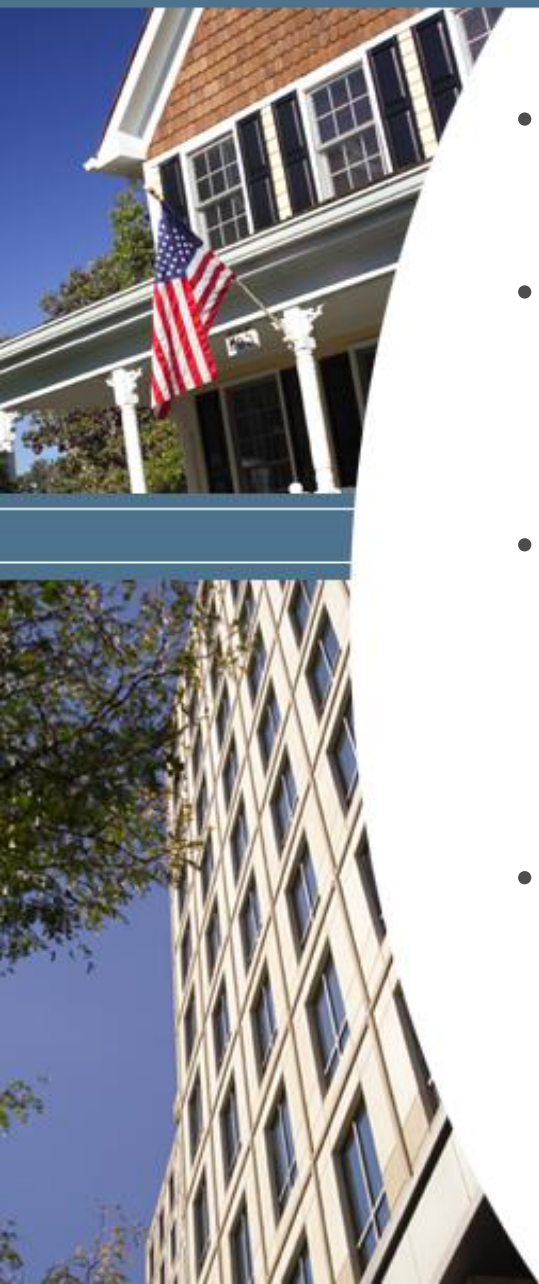
- New guidance eliminates TDR scope exception
  - » As such, lender must evaluate borrower entity for potential consolidation
- Borrower may be a VIE (because equity is not sufficient or for other reasons)
- PB determination based on specific facts and circumstances
  - » Which party, if any, has power (the right to direct the activities that most significantly affect VIE's economic performance)
  - » Specific rights held by lender



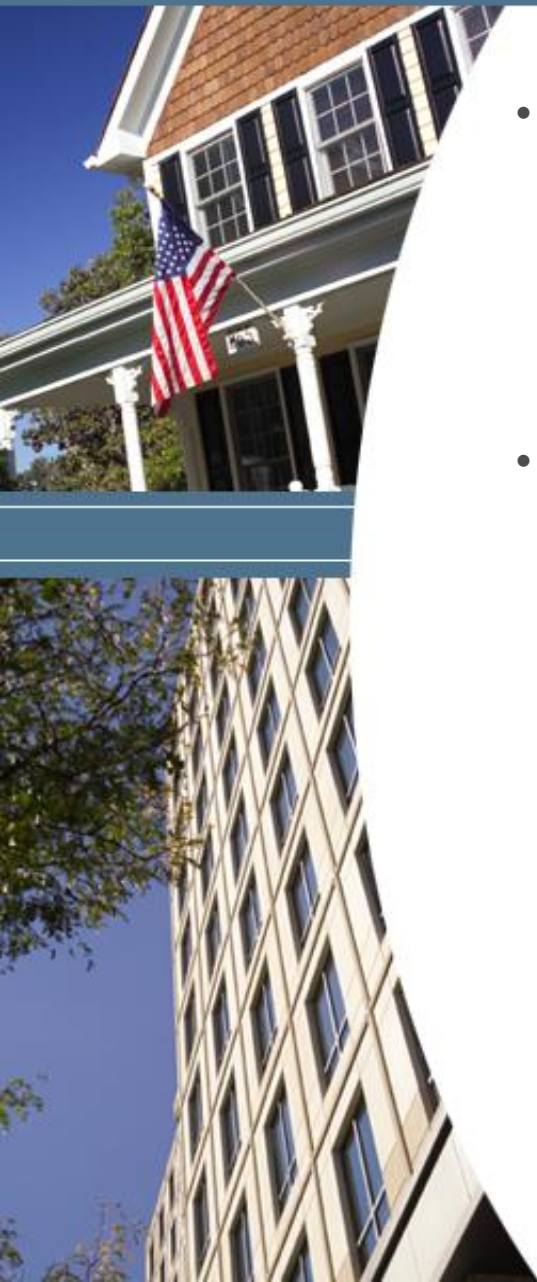
- TDR s that involve only a modification of terms (e.g., reduction in interest rate, extension of terms, principal forbearance), but no granting of power may not require consolidation by lender
- TDRs in which the lender obtains decision-making rights may lead to consolidation
  - » > 50% equity in full or partial satisfaction of the debt
  - » Ability to hire / fire management, establish operating and capital budgets
  - » Is decision-making protective in nature?

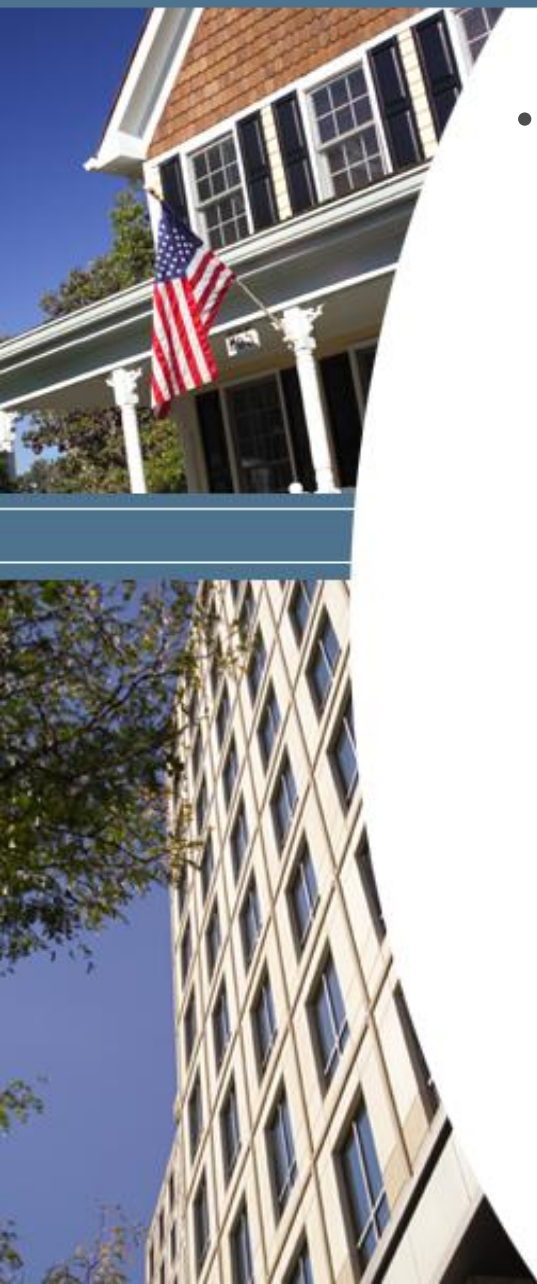


- VIE is financed with debt and proceeds used to purchase residential mortgage loans
- VIE enters into a guarantee with a GSE that absorbs any credit losses on the assets of the VIE
- Assets acquired by VIE underwritten by the originating / selling mortgage bankers in accordance with GSE guidelines
- All activities of the entity are prescribed by the trust agreement and servicing guide, both of which are established by the GSE
- No decisions generally required until default of an underlying asset is reasonably foreseeable or occurs



- GSE is a master servicer, and primary servicers can be removed only for material breach
- GSE hires the mortgage banker (transferor/seller of mortgage loans) to perform the primary servicing activities under its supervision
- GSE has the power to approve, reject, or require another course of action proposed by a primary servicer when a loan becomes delinquent or reasonably foreseeable of becoming delinquent
- Primary servicer receives a fee for its service as the primary servicer

- 
- Variable interest holders:
    - » Debt holders
    - » GSE (via its guarantee)
    - » Transferor's servicing fee is likely not a variable interest
  - GSE is the likely primary beneficiary
    - » Has the power to direct the activities of the VIE that most significantly affect the entity's economic performance
      - Ability to manage defaulted assets as Master Servicer
      - Ability to establish guidelines on activities of the entity
    - » Has an obligation to absorb potentially significant losses through its guarantee



- CMBS
  - » Special servicer
  - » Mezzanine debt holder
  - » Affordable housing partnerships
    - Banks' involvement is typically either as LPs or lenders to the operating partnership
    - Evaluate powers and benefits criteria

# Questions?

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