



# Securitization Accounting

May 12, 2003

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# Agenda

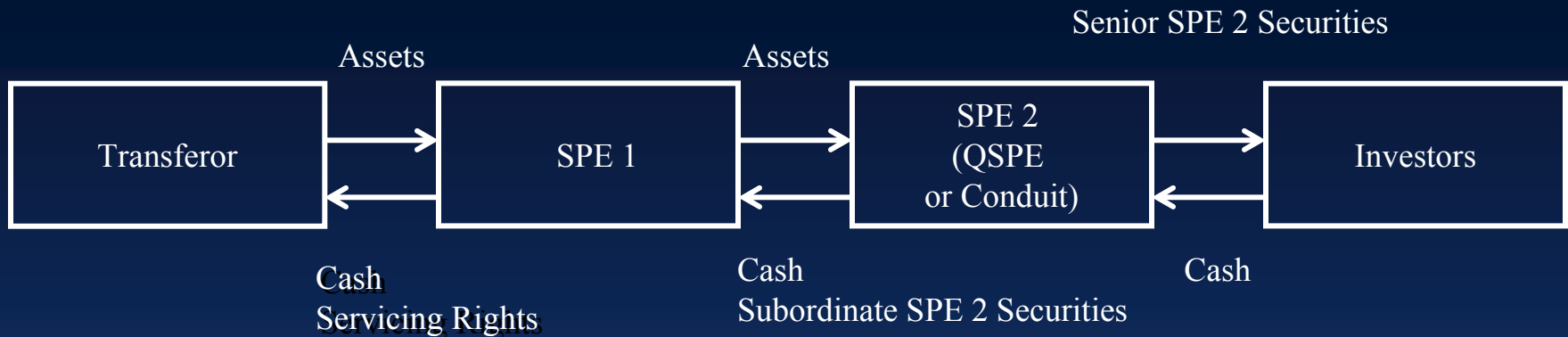
- Securitization Basics
- Sale Criteria
- Consolidation
- Gain on Sale
- Sample Transaction

# Securitization Basics

# What Securitization Is?

- Transformation of predictable cash flows into securities
- Structure to protect investors from originator credit (bankruptcy) risk

# Typical Structure



- Bankruptcy-remote SPE 1 acquires assets in “true sale”
- SPE 1 transfers assets to SPE 2 for cash and subordinate SPE 2 interest
- Transferor services assets
- Asset cash flows allocated to SPE 2 securities based on waterfall

# Benefits

- Lower cost of funds
- Risk transfer
- Alternative funding source
- GAAP presentation

# GAAP Presentation

- Remove assets from balance sheet
- Profit recognition
- Increase ROA and ROE
- Reduce regulatory capital where based on GAAP assets

# Sale Criteria

Accounting for Transfers and Servicing of  
Financial Assets and Extinguishments of Liabilities

SFAS 140

# Financial Assets

- Cash, evidence of ownership interest in an entity
- Contract that contractually conveys right to:
  - Receive cash or another financial instrument, or
  - Exchange financial instrument on potentially favorable terms

# Financial Assets

- Auto loans
- Credit card receivables
- Debt
- Equity
- Home equity loans
- Mortgage loans
- Minimum lease payments under capital leases
- Mortgages
- Trade receivables

# Non-Financial Assets

- Future revenues
- Operating leases
- Unguaranteed capital lease residuals
- Whole business

# Non-Financial Asset Transfers

- Other GAAP literature applies
- Generally follow “risks and rewards” model
- Not covered today

# SFAS 140 Sale Criteria

- Paragraph 9(a) – Legal isolation
- Paragraph 9(b) – Buyer can sell, or pledge, transferred financial assets or QSPE beneficial interests
- Paragraph 9(c) – Only limited calls on transferred financial assets
- Criteria discussed on subsequent slides
- If all not met, transaction is secured borrowing

# Paragraph 9(a)

- Transferred financial assets:
  - Isolated from transferor and affiliates,<sup>1</sup> and
  - Beyond reach of transferor, affiliates,<sup>1</sup> and their creditors
- Legal true-sale and substantive non-consolidation opinion required

<sup>1</sup> Other than SPEs designed to be bankruptcy remote.

# Paragraph 9(b)

- Transferee not QSPE:<sup>1</sup>
    - Transferee has right to pledge or exchange transferred assets, and
    - No condition:
      - Constrains transferee from that right, and
      - Provides more than trivial benefit to transferor or affiliates, or
- (continued)

<sup>1</sup> Described on subsequent slides.

# Paragraph 9(b) (continued)

- Transferee is QSPE:
  - QSPE beneficial interest holders have right to pledge or exchange beneficial interests, and
  - No condition:
    - Constrains beneficial interest owners from that right, and
    - Provides more than trivial benefit to transferor or affiliates

# Paragraph 9(c)

- Transferor and affiliates do not maintain effective control over transferred financial assets through agreement that:
  - Entitles and obligates repurchase of “readily obtainable” transferred assets, or
  - Entitles repurchase of non-“readily obtainable” transferred assets other than a “clean-up call”

# Clean-Up Call

- Option held by servicer or affiliate:
  - To purchase transferred financial assets or beneficial interests
  - Exercisable when servicing costs become burdensome relative to servicing benefits

# Qualifying SPE

- Demonstratively distinct from transferor
- Limits on:
  - Permitted activities,
  - Assets held, and
  - Asset sales, exchanges, and distributions
- Requirements discussed on following slides

# Demonstrably Distinct

- Transferor, affiliates, or agents cannot unilaterally dissolve QSPE
- Either:
  - At least 10% of fair value of QSPE beneficial interest held by parties other than transferor, affiliates, or agents, or
  - Transfer is “guaranteed mortgage securitization”

# Guaranteed Mortgage Securitization

- Mortgage loan securitization:
  - Within scope of FASB Statement No. 65, Accounting for Certain Mortgage Banking Activities
  - Includes substantive third party guarantee

# QSPE Permitted Activities

- Significantly limited
- Specified in legal documents that:
  - Establish QSPE, or
  - Create QSPE beneficial interests
- Change only with approval of majority of beneficial interest holders unaffiliated with transferor

# QSPE Assets

- Passive:
  - Transferred financial assets
  - Derivatives pertaining to third party beneficial interests
- Financial assets that reimburse for failure to:
  - Adequately service QSPE assets, or
  - Receive payment on QSPE assets
- Servicing rights related to QSPE assets

(continued)

# QSPE Assets (continued)

- Temporary, nonfinancial assets obtained upon assets collection
- Cash collected from:
  - Transferred financial assets, and
  - Investments purchased with cash pending distribution to beneficial interests that:
    - Are relatively risk-free, and
    - Mature no later than expected distribution date

# QSPE Asset Sales

- Only upon events:
  - Specified in legal documents that:
    - Establish QSPE, or
    - Create QSPE beneficial interests,
  - Not controlled by transferor or affiliates, and
  - Cause asset value to decline by specified amount below value when transferred to QSPE

(continued)



# QSPE Asset Sales (continued)

- Exercise of:
  - Beneficial interest put, or
  - Removal of account provision (“ROAP”)
- QSPE termination or beneficial interest maturity on fixed or determinable date

# ROAP

- Transferor repurchase option on QSPE assets
- Contingent ROAP does not preclude sale until contingency removed
- Unilateral ability to reclaim specific assets precludes sale

# FASB QSPE Project

- Exposure Draft late May or early June
- Final statement by year end
- Will add restrictions, principally on beneficial interest roll over and liquidity

# Consolidation

Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities – SFAS 140

Consolidation of Majority-Owned Subsidiaries – SFAS 94

Consolidation of Variable Interests Entities – FIN 46

# QSPEs

- Not consolidated by:
  - Transferor or affiliates (SFAS 140 paragraph 46 and FIN 46 paragraph 4(c))
  - Other parties, unless have unilateral ability to cause QSPE to liquidate, or change so no longer QSPE (SFAS 140 paragraph 46 and FIN 46 paragraph 4(d))
- Otherwise, evaluate under SFAS 94 or FIN 46, as applicable

# SFAS 94

- Majority-owned subsidiary:
  - Parent has controlling financial interest through direct, or indirect, voting interest of more than 50%
  - Consolidated by parent
- FIN 46 (discussed later) addresses when SAS 94 applies

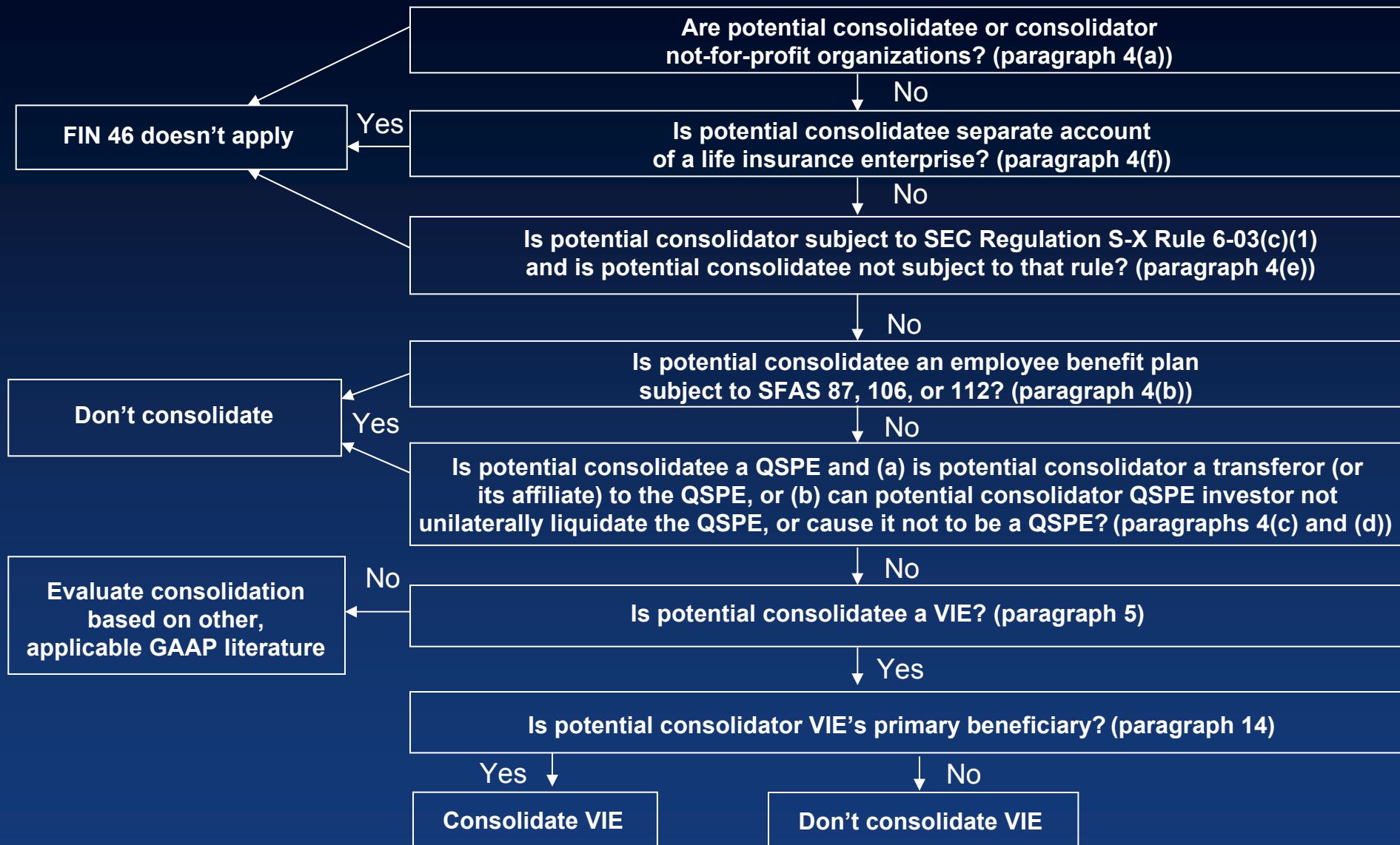
# FIN 46

- Response to Enron
- Issued January 2003
- Relatively new and controversial
- Covers all entities, not just SPEs
- Effective almost immediately
- Principles based?

# VIE

- New concept
- Consolidation not covered by SFAS 94
- Consolidated by primary beneficiary (discussed later)

# Schematic



# VIE paragraph 5

- By design:
  - At risk equity not sufficient (see next slide) (5(a)), or
  - Equity investors do not have-
    - Direct, or indirect, ability to make entity decisions through voting or similar rights (5(b)(1))
    - Obligation to absorb expected entity losses (5(b)(2))
    - Right to receive entity residual returns (5(b)(3))

# At Risk Equity paragraph 5(a)

- Classified as equity in VIE's GAAP financials (footnote 2)
- Participates significantly in profits or losses, even if no voting rights (5(a)(1))

# Not At Risk Equity paragraph 5(a)

- Equity issued in exchange for VIE subordinated interest (5(a)(2))
- Unless provider or financier in same consolidated financials as investor, amounts:
  - Provided directly, or indirectly, by entity or other parties involved with entity (5(a)(3)), or
  - Directly financed by entity or other parties involved with entity (5(a)(4))

# Sufficient Equity paragraph 9

- At least expected losses (discussed later)
- At least 10% of assets, unless:
  - Entity can finance activities without non-equity subordinated financial support (9(a))
  - Entity has at least as much equity as other entities with similar assets that operate without non-equity subordinated financial support (9(b)), or
  - Investment exceeds expected entity losses based on reasonable quantitative evidence (9(c))

# Subordinated Financial Support

- Variable interests that absorb some expected loss, if they occur

# Anti-Abuse Clause paragraph 5(b)

- Equity not sufficient if:
  - Voting disproportionate to obligation to absorb losses and receive residual returns, and
  - Substantially all activities involve, or conducted on behalf of, investor with disproportionately less voting rights

# Variability Example

Possible Cash Flows After One Year	Probability	Probability Weighted Cash Flows (a) *(b)	Present Value of Possible Cash Flows (d) = (a)/(1+RF Rate)	Variability	
				Expected Losses [(d)-(c)]*(b)	Expected Residual Returns
\$ 650,000	5%	\$ 32,500	\$ 619,048	\$ (6,905)	\$ -
700,000	10%	70,000	666,667	(9,048)	-
750,000	25%	187,500	714,286	(10,714)	-
800,000	25%	200,000	761,905	-	1,190
850,000	20%	170,000	809,524	-	10,476
900,000	15%	135,000	857,143	-	15,000
	<u>100%</u>	<u>\$ 795,000</u>		<u>\$ (26,667)</u>	<u>\$ 26,667</u>

Risk free rate 5%

Present value of probability  
weighted cash flows, discounted  
at risk free rate (fair value) \$ 757,143 (c)



# Variable Interest paragraph 2(c)

- Contractual, ownership, or other pecuniary interests that change with change in VIE net assets

# Primary Beneficiary paragraph 14

- Holds variable interests entitled to more than 50% of expected:
  - Losses, or
  - Residual returns
- If held by different parties, losses take precedence

# Interest in Specified Assets paragraphs 12 and 13

- Not VIE variable interests unless:
  - Fair value of specified assets more than 50% of fair value of all VIE assets, or
  - Held by investor with other, non-insignificant, interests in entire VIE that do not have little or no variability

# Expected Loss and Return

- Derived from expected cash flows, discounted and adjusted for market factors and assumptions (paragraph 2(b))
- Includes:
  - Expected variability in:
    - Net income or loss, and
    - Fair value of assets if not included in prior item, and
  - Fees to:
    - Decision makers, and
    - Guarantors of substantially all VIE assets or liabilities (paragraph 8)

# Decision Maker paragraph 14

- Directly or indirectly makes decisions that significantly affect VIE results

# Related Parties paragraphs 16 and 17

- Variable interest holder treats variable interests held by related parties as its own
- Related parties:
  - Defined in SFAS 57, and
  - De facto agents (see next slide)
- Only one party (related or not) can be primary beneficiary

# De Facto Agent paragraphs 16 and 17

- Cannot finance operations without subordinated financial support from party considering consolidation
- Received variable interest as contribution, or loan, from party considering consolidation
- Officer, employee, or member of board of party considering consolidation

(continued)

# De Facto Agent (continued)

- Party with:
  - Agreement not to sell, transfer, or encumber variable interest without approval of party considering consolidation, or
  - Close business relationship with party considering consolidation

# Silos paragraphs 3 and 13

- Divide VIE into, and analyze as, separate VIE (a “Silo”) if Silo assets are essentially only source of payment for specified VIE liabilities or other specified interests
- Silo can be:
  - Asset pool
  - Branch
  - Division
  - Department

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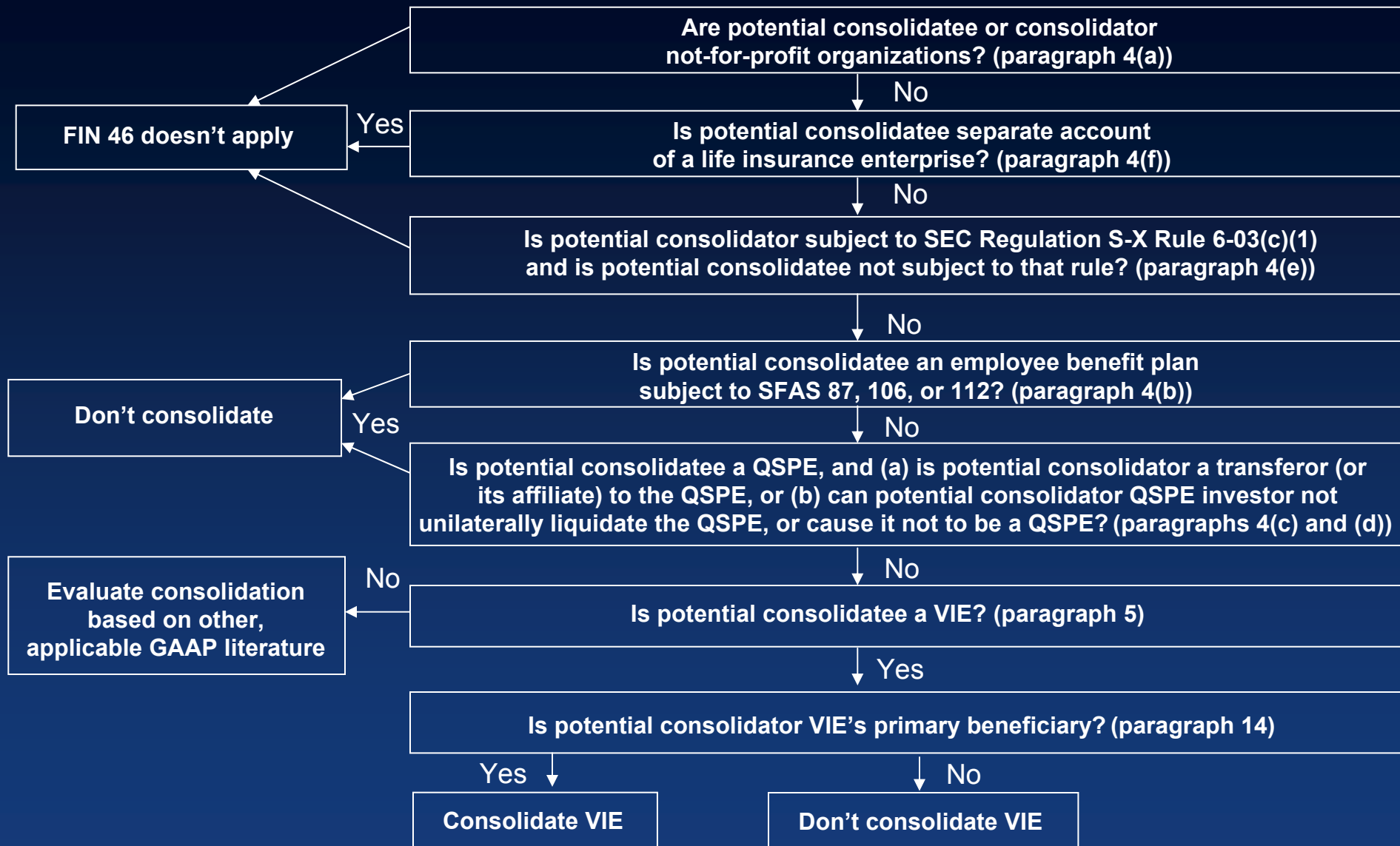
# Silos (continued)

- Separate consolidation decision by Silo
- Consolidated Silo not part of larger VIE

# FIN 46 Timing

- Variable Interest Entities (“VIEs”) created after January 31, 2003 – Immediate
- VIEs created before February 1, 2003 whose primary beneficiary is:
  - Public – First quarter beginning after June 15, 2003
  - Private – First year beginning after June 15, 2003

# Schematic



# Gain On Sale

# Basis Allocation

- Allocate pre-transfer asset carrying value between portions:
  - Sold, and
  - Retained
- Based on relative fair value

# Gain or Loss

- Difference between:
  - Sales proceeds (net of expenses), and
  - Basis allocated to sold portion

# Residual Valuation

- Market quotes
- Discounted cash flow model

# DCF Model

- Project cash flows:
  - Schedule contractual asset cash flows
  - Subtract:
    - Ongoing costs
    - Estimated losses
    - Estimated prepayment impact
    - Payments due senior interest holders
- Market discount rate

# Retained Interest

- Security:
  - Available for sale, or
  - Trading
- Like available for sale or trading security if:
  - Can be prepaid or otherwise settled so holder does not recover substantially all recorded investment

# Available for Sale

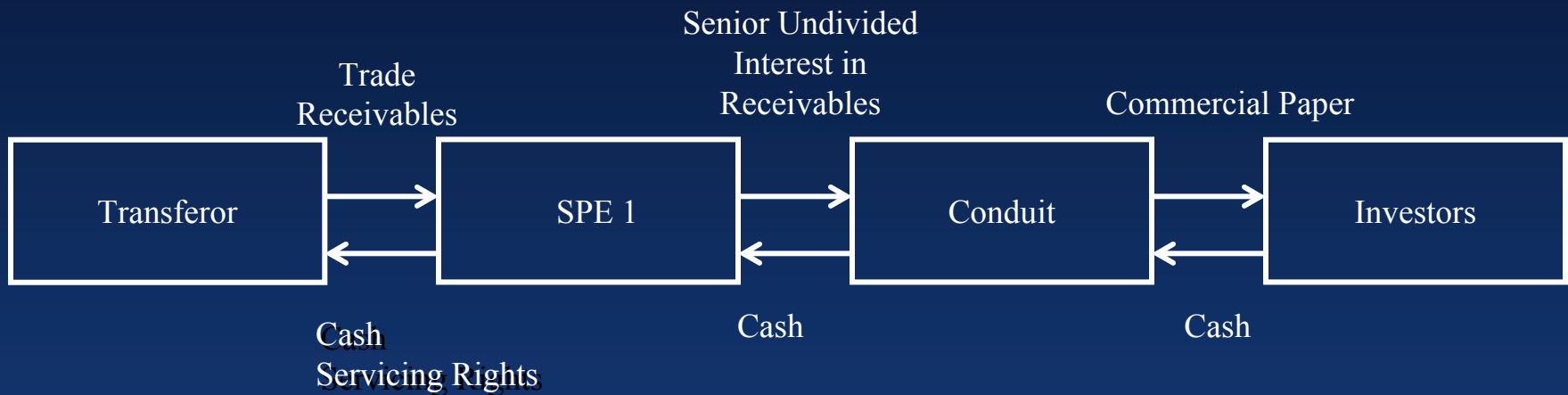
- Mark to market
- Change in fair value in “Other Comprehensive Income”

# Trading

- Changes in fair value recorded in income
- Tends to create earnings volatility

# Sample Transaction

# Typical Structure



# Pre-Transaction Balance Sheet

Cash	\$	100
Receivables		100
Allowance for Loan Loss		(5)
	\$	<u>195</u>
Existing Debt	\$	100
Equity		95
	\$	<u>195</u>

# Fair Value of Retained Interest

Gross Receivables	\$ 100	
Sold Receivables	<u>(85)</u>	\$ 15.00
Gross Receivables	\$ 100	
Expected Loss Rate	<u>5%</u>	(5.00)
Interest on Sold Receivables <sup>1</sup>		(0.51)
Servicing Fees <sup>1</sup>		(0.13)
Other Ongoing Costs <sup>1</sup>		<u>(0.06)</u>
Future Value of Retained Interest		<u>\$ 9.30</u>
Discounted for 45 <sup>2</sup> days at 10% <sup>3</sup>		<u>\$ 9.19</u>

<sup>1</sup> Calculated on next slide.

<sup>2</sup> Assumed average time to Receivable collection.

<sup>3</sup> Assumed of market discount rate.



# Expenses

## Ongoing Expenses:

	<u>Interest</u>	<u>Servicing</u>	<u>Other</u>
Sold Interest	\$ 85		
Gross Receivables		\$ 100	\$ 100
Rate	4.80%	1.00%	0.50%
Expense for 45 days <sup>1</sup>	<u>\$ 0.51</u>	<u>\$ 0.13</u>	<u>\$ 0.06</u>

## Upfront Expenses:

Rate		0.25%
Gross Receivables		<u>\$ 100</u>
Upfront Expenses		<u>\$ 0.25</u>

<sup>1</sup> Assumed time to Receivable collection.

# Basis Allocation

	<u>FMV</u>	<u>% FMV</u>	<u>Allocated Basis</u>	<u>Loss</u>
Sold Interest	\$ 85.00	90%	\$ 85.73	<u>\$ 0.73</u>
Retained Interest	<u>9.19</u>	<u>10%</u>	<u>9.27</u>	
	<u>\$ 94.19</u>	<u>100%</u>	<u>\$ 95.00</u>	

# Journal Entries

## On Balance Sheet – Debt

## Off Balance Sheet – SFAS 140 Sale

### Upon Securitization:<sup>1</sup>

			1	Receivables from SPE	85.00	
				Allowance for Loan Loss	5.00	
				Investment in Conduit Equity/Debt - Eligible Receivable	9.27	
				Investment in Conduit Equity/Debt - Ineligible Receivable	-	
				Loss on Sale of Eligible Receivables	0.73	
				Receivables		100.00
				Sale of Receivables		
				(see supporting calculations)		
2	Cash	85.00	2	Cash	85.00	
	New Debt			Receivable from SPE		85.00
	New Debt issuance	85.00		Receivable paid		
3	Deferred Debt Issuance Costs	0.25	3	Loss on Sale	0.25	
	Cash			Cash		0.25
	Capitalize all transaction costs	0.25		Expense all transaction costs		
4	Existing Debt	84.75	4	Existing Debt	84.75	
	Cash			Cash		84.75
	Repay Existing Debt	84.75		Repay Existing Debt		

<sup>1</sup> Same entries on each revolving sale date, except transaction costs are only expenses once under SFAS 140 sale.

# Journal Entries (continued)

## On Balance Sheet – Debt

## Off Balance Sheet – SFAS 140 Sale

### From Securitization to Day 45:

5	Interest Expense on New Debt	0.51		5	Investment in Receivables	0.04	
	New Debt		0.51		Interest Income/Dividend		0.04
	Interest expenses (for 45 days)				Accrete Retained Interest (10% for 45 days)		
6	Interest Expense on New Debt	0.06		6	Other Receivables	0.13	
	New Debt		0.06		Servicing Income		0.13
	Ongoing Deal Costs				Servicing Income Earned		
7	Debt Issuance Expense	0.25					
	Deferred Debt Issuance Costs		0.25				
	Amortize Old Debt issue costs						

# Journal Entries (continued)

## On Balance Sheet – Debt

## Off Balance Sheet – SFAS 140 Sale

### Day 45:

			8 Cash	0.13	
			Other Receivables		0.13
			Servicing Income received		
9 Cash	95.00		9 Cash	9.30	
Allowance for Loan Loss	5.00		Receivables		9.30
Receivables		100.00	Receivable collections		
Receivable collections					
10 New Debt	85.57		10 Existing Debt	9.43	
Existing Debt	9.43		Cash		9.43
Cash		95.00	Debt repayment		
Debt repayment					

# Comparison

## On Balance Sheet – Debt

### Net Pre-Tax Income (Expense):

Interest Expense	\$	(0.51)
Interest Expense - deal costs		(0.06)
Debt Issuance Cost		(0.25)
	\$	<u>(0.82)</u>

### Debt:

	<u>Existing</u>	<u>New</u>
Beginning Balance	\$ 100.00	\$ -
Issuance of New Debt		85.00
Repayment at Securitization	(84.75)	
Accrual of Interest Expense		0.57
Repayment on Day 45	(9.43)	(85.57)
Ending Balance	<u>\$ 5.82</u>	<u>\$ -</u>

## Off Balance Sheet – SFAS 140 Sale

Loss on Sale of Receivables	\$	(0.73)
Deal Costs		(0.25)
Income on Retained Interest		0.04
Servicing Income		0.13
	\$	<u>(0.82)</u>

	<u>Existing</u>
Beginning Balance	\$ 100.00
Repayment at Securitization	(84.75)
Repayment of cash from servicing income	(0.13)
Repayment of cash from investment in SPE	(9.30)
Ending Balance	<u>\$ 5.82</u>