



**WILARY WINN LLC**

Advice to Strengthen Financial Institutions

## Accounting for Sales of Seasoned Loans

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### INTRODUCTION

Accounting for the transfer of loans where the consideration received includes an interest only strip can be extremely complex. Did the transfer meet the requirements of “true sale” accounting?

The question is first whether the interest only strip meets the definition of a “participating interest.” In cases where it does not, then can a sale still be recorded? The answer depends on the unit of account. Did the financial institution transfer the entire loan, which can be accounted as a sale, or did it sell a participation, retaining an interest only strip which would preclude sales accounting?

#### KEY TAKEAWAY

Wilarity Winn provides valuations of mortgage servicing rights and turnkey advice on how to properly account for them.

#### HOW CAN WE HELP YOU?

Founded in 2003, Wilarity Winn LLC and its sister company, Wilarity Winn Risk Management LLC, provide independent, objective, fee-based advice to nearly 600 financial institutions located across the country.

#### We provide the following services:

##### CECL & ALM

Holistic solutions to measure, monitor and mitigate interest rate, liquidity, and credit risk on an integrated basis.

##### MERGERS & ACQUISITIONS

Independent, fee-based determinations of fair value for mergers and acquisitions.

##### VALUATION OF LOAN SERVICING

Comprehensive and cost-effective valuations of servicing arising from the sale of residential mortgage, SBA 7(a), auto, home equity and commercial loans.

##### ADDITIONAL SERVICES

Services to support our CECL, ALM, Fair Value and Loan Servicing product offerings.

# Accounting for Sales of Seasoned Loans

## Background

This white paper summarizes the accounting and reporting for the sale of loans to a Government Sponsored Enterprise (GSE) and purchasing a Mortgage-Backed Security ("MBS") in return. Given the recent changes in market interest rates, financial institutions generally receive an interest-only strip in addition to the customary servicing fee of .25%

We note that this transaction is not unusual and is commonly undertaken in order to minimize credit risk and lower required regulatory capital. By selling loans to Freddie Mac or another GSE, and purchasing an MBS in return, the seller shifts the credit losses to the GSE and benefits from 20% risk weighting on the MBS compared to 50% for the loans. These transactions are accounted for under special provision in FASB Statements Nos. 140 and 65 which allows sellers to record the loans as a sale. In June 2009, FASB issued *SFAS 166 – Accounting for Transfers of Financial Assets an Amendment of FASB Statement No. 140*. Among other changes, FAS 166 eliminated the special provision regarding guaranteed mortgage securitizations by requiring these transactions be treated the same way as any other transfer of assets under FAS 140.

FAS 140 and 166 are extremely complex and this paper is not designed to be an exhaustive summary of the accounting. It is instead intended to address only the items we believe relevant to the proposed transaction. We note further that the accounting references are to the FASB Accounting Standards Codification ("ASC").

The issue is whether the sale of the loans to a GSE can be treated as a sale for accounting purposes. The potential results are:

1. The transaction qualifies as a sale and the financial institution removes the loans from its books, records the purchase of an asset backed security, records the fair value of the servicing rights, and records the fair value of the interest-only strip; or
2. The transaction does not qualify as a sale. In this case, the loans remain on the books as loans, the servicing rights are not recorded, nor is the present value of the interest-only strip.

## Test for Sales Accounting

FAS ASC 860-10-40-5 sets for the criteria that must be met in order to record a sale. It provides that a transfer of an entire financial asset, a group of entire financial assets, or a participating interest in an entire financial asset in which the transferor surrenders control over those financial assets shall be accounted for as a sale if and only if all of the following conditions are met:

- a. The transferred financial assets have been isolated from the transferor – put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership ...
- b. Each transferee ... has the right to pledge or exchange the assets (or beneficial interests) it received, and no condition both constrains the transferee (or third-party holder of its beneficial interests) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor.
- c. The transferor ... does not maintain effective control over the transferred financial assets ...



We believe the sale of loans to a GSE meets the requirements of 860-10-40-5a. The requirements related to 860-10-40-5b and c are more complex. FASB has indicated that when determining whether control has been surrendered over transferred financial assets, the transferor ..... must consider its continuing involvement in the transferred financial assets and all arrangements or agreements made contemporaneously with, or in contemplation of, the transfer, even if they were not entered into at the time of the transfer. The financial institution will receive a servicing fee and an interest-only strip from the transaction. The first question is whether or not the servicing fee or interest-only strip would be a participating interest in order to ensure sales treatment.

ASC 860-10-40-6A indicates that a participating interest has all the following characteristics:

- From the date of transfer, it represents a proportionate (pro rata) ownership interest in an entire financial asset ...
- From the date of transfer, all cash flows received from the entire financial asset are divided proportionately among the participating interest holders in an amount equal to their share of membership. Cash flows allocated as compensation for services performed, if any, shall not be included in that determination provided those cash flows are not subordinate to the proportionate cash flows of the participating interest and are not significantly above an amount that would fairly compensate a substitute service provider, should one be required, which includes the profit that would be demanded in the marketplace. In addition, any cash flows received by the transferor as **proceeds** of the transfer of the participating interest shall be excluded from the determination of proportionate cash flows provided that the transfer does not result in the transferor receiving an ownership interest in the financial asset that permits it receive disproportionate cash flows.
- The rights of each participating interest holder .... have the same priority, and no participating interest holder's interest is subordinate to the interest of another participating interest holder.

**An interest-only strip is by then definition not a participating interest and would preclude sales treatment.**

The crux of the accounting issue related to the participating interest is the unit of account. The question is does the financial institution create an interest strip before it sells the loans, thus precluding sales treatment or is it selling the entire group of loans and receiving the interest-only strip as sales proceeds. We believe that the sale of the loans constitutes the transfer of a group of entire financial assets and meets the true sales test. Paragraph 860-10-55-17 of the codification provides guidance "a loan to one borrower in accordance with a single contract that is transferred to a securitization entity before securitization shall be considered an entire financial asset..... In contrast, a transferred interest in an individual loan shall not be considered an entire financial asset; however, if the transferred interest meets the definition of a participating interest, the participating interest would be eligible for sale accounting."

Further guidance is provided in FAS ASC 860-10-55 17 G, "In a transaction in which the transferor creates an interest-only strip from a loan and transfers the interest-only strip, the interest-only strip does not meet the definition of an entire financial asset (and an interest-only strip does not meet the definition of a participating interest; therefore, sale accounting would be precluded).

**In contrast, if an entire financial asset is transferred to a securitization entity that it does not consolidate and the transfer meets the conditions for sale accounting, the transferor may obtain an interest-only strip as proceeds from the sale.**

An interest-only strip received as proceeds of a sale is an entire financial asset for purposes of evaluating any future transfers that could then be eligible for sale accounting. It is also a financial asset that would likely be recognized and measured according to ASC 815, *Derivatives and Hedging*, or ASC 320-10,



*Investments—Debt and Equity Securities - Overall.* We recommend that it be accounted for in accordance with ASC 320-10. ASC 860-20-35-2 provides that “interest-only strips, other interests that continue to be held by a transferor in securitizations, loans, other receivables, or other financial assets that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment, shall be subsequently measured like investments in debt securities classified as available for sale or trading under Topic 320.

The remaining issue related to true sale concerns the servicing of the loans. As a part of the transaction, the financial institution will obtain the right to service the mortgages. Servicing rights are explicitly listed in the definition of "continuing involvement" and must therefore be examined for sales treatment viability. FAS 166 26E provides direct guidance “cash flows allocated as compensation for services performed, if any, shall not be included in that determination of participating interest provided those cash flows are **not subordinate** to the proportionate cash flows of the participating interest and are not significantly above an amount that would fairly compensate a substitute service provider, should one be required, which includes the profit that would be demanded in the marketplace.”

Since the financial institution would be compensated for servicing at market rates, and this compensation is senior (instead of junior) to all other cash flows of the mortgages, the presence of the servicing rights would not preclude sales treatment. Conversely, if the interest-only strip were included in the servicing fee, we believe the servicing would not meet this safe harbor test as it would exceed the rate required by a substitute servicer and the transaction could not be accounted for as a sale.