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In This Issue:

- The Senator's Position on Subprime Loan Modifications
- Background
- The June Symposium and Chairman Cox's Letter

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Accounting Consequences of Subprime Loan Modifications

Senator Schumer Urges Wider Understanding

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The Senator's Position on Subprime Loan Modifications

New York Senator Charles Schumer recently wrote to the CEOs of the Big Four accounting firms, urging them to "assist this country's mortgage crisis by ensuring that your clients are aware of the recent SEC and FASB guidance on FAS 140, and by otherwise encouraging them to modify subprime loans at risk of default."

Senator Schumer's [letter](#) refers to a June educational forum hosted by the FASB and a follow-up letter from SEC Chairman Christopher Cox to House Financial Services Committee Chairman Barney Frank, discussed below.

Background

The crisis in subprime lending explains Congress's most recent interest in generally accepted accounting principles (GAAP). Senator Schumer is concerned that an overly narrow interpretation of GAAP would prevent loan servicers from renegotiating the terms of troubled mortgage loans — especially adjustable-rate subprime mortgages that soon are expected to reset to much higher rates of interest. Without a restructuring, many of these loans will default, leading to foreclosures and exacerbating the problems in the housing market.

Most subprime mortgage loans — in fact, most mortgages of any type — are sold by loan originators to specialized entities that issue mortgage-backed securities. The entity uses the cash it raises by issuing the bonds to buy the mortgages. The cash flows on the underlying mortgages service the classes of securities and pay the administrative expenses of the specialized entity. Loan originators rely on these sales as a fundamental source of liquidity that provides them with funds needed to originate more loans and to continue the origination and sale cycle.

What's the role of financial reporting? Typically, loan originators depend on off-balance-sheet sale treatment when transferring the mortgages to the specialized entity. To achieve this goal, the originator structures the transaction in accordance with FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, and related accounting guidance for the assets to be considered sold and derecognized; otherwise, the cash received by the loan originator upon selling the mortgages to the specialized entity is accounted for as a borrowing in the originator's consolidated financial statements. In other words, the mortgages remain on-balance-sheet (not off-balance-sheet), reported as assets.

Numerous factors come into play in applying Statement 140. Off-balance-sheet treatment is facilitated if, under Statement 140, the specialized entity is a qualifying special-purpose entity (QSPE). Some accountants worried that QSPE status and off-balance-sheet accounting would be jeopardized if a loan servicer, working on behalf of the investors in the specialized entity, actively sought to identify and restructure troubled mortgages before they became delinquent or went into default. Why? Because Statement 140 significantly limits the powers and decision-making abilities of a QSPE or its agents. Statement 140 implementation guidance issued by the FASB indicates that certain workout activities around assets that become delinquent or that default are consistent with the limited powers of a QSPE. However, no guidance directly addresses whether similar activities, conducted before the asset becomes delinquent or before it defaults (i.e. when default or delinquency is reasonably foreseeable), are consistent with the limited powers of a QSPE.

The June Symposium and Chairman Cox's Letter

To deal with this concern and at the request of the SEC staff, the FASB hosted an educational forum with 30 participants, including representatives of investors, preparers, auditors, servicers, and banking regulators. The consensus of the participants was that, within certain constraints, proactive loan renegotiations, designed to forestall defaults and foreclosures, do not violate off-balance-sheet treatment under Statement 140. According to Chairman Cox's [letter](#) to Chairman Frank:

Specifically, there appears to be a consensus in practice, and it is our view, that entering into loan restructuring or modification activities (consistent with the nature of activities permitted when a default has occurred) when default is reasonably foreseeable does not preclude continued off-balance sheet treatment under FAS 140.

While Chairman Cox's letter should allay fears of automatically losing off-balance-sheet treatment due to restructuring or modifying loans when a default is reasonably foreseeable, note that not all activities are consistent with QSPE status. Restructuring or modification activities must be consistent with the activities permitted pursuant to the legal documents of the QSPE and otherwise must be consistent with the provisions of Statement 140.

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Editor's Note: The views expressed in Chairman Cox's letter are consistent with (1) Deloitte & Touche LLP's May 4, 2007, Q&A FASB 140: 35(b)-1, Effect on QSPE Status of a Servicer's Ability to Initiate Workouts in the Absence of Default or Delinquency, which is available to subscribers of Technical Library: The Deloitte Accounting Research Tool, and (2) a [white paper](#) prepared by the Mortgage Bankers Association and distributed at the FASB's educational forum. Preparers and auditors must carefully consider the complex provisions of Statement 140 and its QSPE requirements to ensure proper application.

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