

How the Mortgage Bailout Strains Accounting

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CFO.com –US - Efforts to contain damage from the subprime mortgage meltdown are stretching accounting safeguards put in place after Enron.

Unveiling a industry-developed plan late last week to freeze the interest rates on thousands of mortgages, President Bush and Treasury Secretary Paulson emphasized the shared interest among homeowners, banks, and investors in avoiding mass foreclosures. "Lenders and investors would face enormous losses," the president said.

But while a rash of foreclosures would cost investors dearly, the plan allows the financial institutions that wrote it to declare large swaths of mortgages in danger of default, and to rewrite those loans without sign-off from homeowners or the investors who own the loans. That may help investors "in the aggregate," as the plan says, but it also may limit the ability of individual investors to sue, and represents a further blow to investor confidence in the practice of securitization.

Written by the American Securitization Forum, the plan represents a dramatic increase in leeway for banks since June, when ASF issued an earlier plan that also gave banks wider license to act. With tens of thousands of subprime mortgages at risk this past spring, policymakers agreed with industry groups such as the ASF and the Mortgage Bankers Association that banks could step in to rework loans if their default was "reasonably foreseeable." That in itself was a big change. A securitized mortgage is technically owned by investors, with the banks that originally wrote the loan typically acting only as bill collectors. Historically – and under accounting rules – banks stepped in to rework loans only if they were actually in default, when it became the bill collector's responsibility to minimize investor loss.

Of course, few homeowners are likely to object to the friendlier terms unveiled Thursday, and banks are still theoretically acting to minimize investor losses. But individual investors who own asset-backed securities have no say in how they are altered, or how much of their money banks can spend to protect them. At the same time, banks continue to keep those loans off their own balance sheets via an increasingly flexible interpretation of existing accounting rules, a move which may have the added benefit of helping protect the banks themselves from investor lawsuits.

Accounting and Liability

In a securitization, a bank or other mortgage lender sells the future proceeds of a mortgage loan to a trust, or special purpose entity (SPE). The trust then pools them with other loans and issues bonds backed by the loan payments. Under accounting rule FAS 140, lenders must make a "true sale" to the trust, so that it, and not the lender, is the actual owner of the loan proceeds. That allows the lender that originally made the loan to remove it from its balance sheet.

After Enron, which frequently set up SPEs that it secretly controlled, FASB issued stricter guidelines for such trusts. To keep an SPE off of a bank's books, and ensure that it isn't used for nefarious purposes, accounting rules require that its activities be

strictly limited to passively receiving and disbursing securitized funds. Such trusts are known as "qualifying SPE" or QSPEs.

But that passive role – QSPEs are variously described as "brain-dead" or "on autopilot" – came under fire as the subprime crisis grew. Because banks merely acted as servicers of the loans, they resisted calls to work with borrowers or restructure loans for fear that doing so would violate the QSPE structure.

For the most part, that reluctance has been chalked up to banks' fears that they would have to consolidate the QSPE's assets and liabilities on their own balance sheets. That happened in November, when HSBC was forced to put \$45 billion back on its balance sheet. On Thursday, Amsterdam-based Rabobank did the same, taking \$7.6 billion onto its balance sheet. Although investors still eat most of the losses, such moves make banks' balance sheets look worse, and wreak havoc with the amounts of regulatory capital they are deemed to have on hand.

But critics say another important reason banks and policy makers are straining accounting rules to preserve the QSPE structure is that the legal and accounting structure of the "true sale" is designed to shield banks from investor lawsuits. Rating agencies require an attorney's letter stating that a securitization trust is "non-recourse" to the bank that sold the loans. If forced to consolidate the trusts back on their own balance sheets, banks would have a harder time denying liability for the QSPE and shielding their own assets from investors seeking to recover their losses.

"The primary reason that a Q is set up in the first place is protection against legal liability and it would seem to me to be the preeminent reason for trying to keep it intact," says attorney Mark Maddox.

With Federal Reserve president Ben Bernanke saying mortgage defaults could reach \$300 billion, and some critics saying the amount could be three times that, the potential liability for banks that set up these securitization structures could vastly outnumber the tens of billions banks paid out after Enron. "That sort of liability exceeds anything I've seen Wall Street involved in in the last 20 years," says Maddox. Indeed, Treasury Secretary Paulson attempted to assuage the banks' litigation fears in his Thursday remarks unveiling the plan, noting that "with the investor community on board and as a clear beneficiary of this approach, the risk of litigation should be manageable."

Maddox's firm, Indiana-based Maddox Hargett & Caruso, is currently representing about a dozen investors who have lost more than \$10 million in subprime mortgage investments in cases against Credit Suisse First Boston (CSFB), Bear Stearns, Bank of New York and others. "This is the very tip-top of the iceberg of investors rising up and trying to do something about their surprising losses," says Maddox, who added that the QSPE structure forms a significant barrier in several of his cases. "In order to get around it, you have to show a pretty close relationship between the trust and the bank. It is something we have to overcome."

George Miller, executive director of the ASF, disagrees. "I don't see why [preserving QSPE treatment] would affect the investors' legal or contractual rights," he says. He maintains that the primary concern over loss of QPSE treatment is the balance-sheet impact for banks, which is "potentially quite significant."

Principled Accounting?

Regardless of why banks fear compromising the QSPE treatment, their resulting reluctance to help struggling homeowners this spring caused Congress, regulators, policy-makers, and the ASF to create increasingly elastic interpretations of the accounting rule. The effort started in June, when House Financial Services chairman Barney Frank (D-Mass.) asked Securities and Exchange Commission chairman Christopher Cox if FAS 140 could "be clarified in a way that will benefit both borrowers and investors?"

That prompted Cox, along with SEC chief accountant Conrad Hewitt, to sign off in July on the idea that a "reasonably foreseeable" default gave banks the same authority as an actual default. Both Cox and Hewitt cited a June 22 roundtable hosted by FASB – at their request – as justification for that ruling. In a detailed memo, Hewitt noted that there was "general agreement among the participants at the FASB educational forum" that this new interpretation of FAS 140 "is not inconsistent with the notion of continued off-balance sheet accounting treatment."

The SEC, of course, is the ultimate arbiter of U.S. generally accepted accounting principles. But it's far from clear that Cox and Hewitt's frequent references to the "FASB educational forum" actually mean the accounting board agrees with the new interpretation.

"The board's never formally endorsed it," says FASB Chairman Bob Herz, who told CFO.com that only two or three of the seven FASB board members were at the roundtable. "It wasn't a formal board vote or anything like that."

Herz says that "in the context of what was going on at the time," there seemed to be "general agreement" that acting in the face of a reasonably foreseeable default "seemed to be something that would not taint the Q[SPE]."

Contacted late Thursday by CFO.com, Herz said he had not studied the details of the broader plan announced by the President, adding "It's up at first blush for the audit firms and the SEC to look at. I'm not looking to make a ruling. Everyone wants principles-based standards. That means letting the system operate."

ASF's Miller agrees that there is no guarantee the ASF's latest guidance conforms to FAS 140. "There's nothing we can do that can override applicable accounting standards. We certainly hope and would believe that there's enough in [ASF's guidance] that would still satisfy 140 criteria," he says. "At the end of the day, individual servicers and their auditors will have to come to that conclusion." Miller says the ASF relied heavily on the July memo from the SEC's chief accountant. He adds that ASF is currently "seeking an additional level of comfort and clarification from the SEC and FASB."

Herz says FASB will "look at [the plan] if someone asks us." But with the subprime crisis so serious, and with people's homes at risk, it's unlikely that any policymaker will begin to fret about the purity of accounting rules. Still, it's clear that as the crisis has grown, so has the flexibility of the financial community's interpretation of QSPE accounting rules. In June, the ASF said banks could modify loans when default was reasonably foreseeable, but only on a "loan-by-loan" basis. Likewise, it said, that determination required "direct contact between the servicer and the borrower," and that it "opposed to any across-the-board approach."

Under the plan announced yesterday, however, loan modifications can be applied to large groups of borrowers without even speaking to them. Banks should "endeavor to discuss the modification with the borrower in a live call," the new ASF guidelines explain, but it is sufficient for banks to simply send a letter outlining the new terms of the mortgage. Moreover, there's no requirement that borrowers respond or sign any documents agreeing to change the terms of their mortgages. According to the ASF, a bank can simply declare that the borrower has agreed to the modification once the borrower has made two payments under the new terms. That's a far cry from the situation just a few months ago, when banks were afraid that merely responding to borrower requests for aid could compromise the QSPE.

Miller acknowledges that the new plan goes much farther than the "overarching guidance" in its June document. "This latest guidance is borne out of recognition in the industry — and certainly enabled and encouraged by the federal government — that there is a fairly formidable loss mitigation challenge that servicers are facing." As Treasury Secretary Paulson explained in his speech Thursday, "The standard loan-by-loan evaluation process that is current industry practice would not be able to handle the volume of work that will be required."

In October, the ASF also issued a paper saying banks that provide credit counseling to borrowers should reimburse themselves out of the securitization trust cash flows — in other words, at the investors' expense. "That is just bizarre," says Maddox. "The Q[SPE] has turned into a very different animal than these investors thought they were investing in."

ASF's Miller disputes that characterization, and argues that the new guidelines simply streamline a loss mitigation process that investors had already signed on for. "It's true investors aren't asked to consent to individual loan modifications because they don't have that right and the servicer doesn't have that obligation," he says. But whether servicers reimburse themselves for credit counseling or modify loans, he says, "The whole purpose is to forestall a greater loss. As long as that basic principle is being served by the servicer, I think you can view all this guidance as very consistent with the existing contractual overlay."

Still, that comes as small comfort to investors who have already suffered losses, or who must stand idly by while the banks that sold them securities decide how best to salvage them. In his speech announcing the plan to freeze interest rates for five years, Treasury Secretary Paulson noted that the new standards "are the product of discussions among investors and servicers." **Maddox scoffs at that idea, theorizing that the investors who are said to have signed off on the new plan are likely the same Wall Street banks that set up these structures. "They sampled their own product pretty heavily," he says, pointing to recent CEO exits at Merrill Lynch and Citigroup that resulted from subprime losses. "I've never been asked to sit down with those guys, nor do I expect an invitation."**