

# SQUAR MILNER

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## COMMUNITY BANK NEWS

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Fall 2008

Issue 2

### Squar Milner's Financial Services

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- Revising capital in a turbulent time
- FIN 48 for private banks

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## On-Balance Sheet Mortgage Securitization

Securitization accounting is broken. More specifically, "on-balance sheet" securitization accounting is posing problems beyond those ever imagined.

For those banks and finance companies who sponsored securitizations of mortgage loans in the past, these companies economically retain the unrated residual interest, which is the "first-loss" component and serves to partially protect the bond holders from principal loss in the event of default of the underlying mortgages. GAAP currently allows for one of

two methods to account for such transactions depending on the structure of the specific transaction - referred to as "on-balance sheet" or "off-balance sheet". There is a third approach currently being discussed by the FASB as they contemplate the QSPE (qualifying special purpose entity) rules. This third approach is currently referred to as the "linked-presentation" approach, which may end up being a hybrid approach, encompassing elements of both "on" and "off" balance sheet accounting, slated for adoption in 2010.

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## Construction Loans and Interest Reserves

### INTEREST RESERVE ACCOUNTING

Proper accounting for interest income on development and construction loans is different. The great majority of banks in the western U.S. include a so called "Interest Reserve" in the total amount of such loans. This sort of financing mechanism allows borrowers to effectively pay monthly interest due on construction advances out of additional funds drawn from the same loan. Sometimes referred to as "Bootstrapped Interest," it is a method of keeping the loan current during the development and construction process until the project reaches a point that it can be either sold, or refinanced with a longer term permanent mortgage.

Properly underwritten, such loans contemplate a prudent loan to value relationship, a reasonable estimated time period for project

completion, sale or rental of the property, and an ultimate due date for borrower repayment. Just to be cautious some lenders build in an extension provision to enable a borrower to pay an added fee for some short deferral of the due date just in case it takes a bit longer.

In a normal real estate market, the estimation of the start to finish time of construction is dependent upon such factors as availability of building materials, labor forces, permits, and developer stability. Furthermore, it is also dependent upon an underlying assumption that the completed project will in fact either sell or rent within a reasonable time period. It also relies on the fact that permanent financing is available at a reasonable rate for buyers or investors to pay off the construction loan.

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## Construction Loans and Interest Reserves

(continued)

### CURRENT REAL ESTATE CONDITIONS

It is apparent that we are not in a normal real estate market. At the present time, although the construction development cycle remains reasonably estimable, the ultimate completed project disposition period does not.

Moreover, because of nationwide economic slowdown and instability, investors that typically purchase rental projects, especial-

**“What does a lender do if they have a potentially troubled development and construction loan that is still generating interest income from an interest reserve?”**

ly commercial and industrial developments, may not be able to find permanent financing, because tenants are unavailable.

These factors have an adverse impact on the ability to continue to reasonably estimate the ultimate due date of the construction and development loan. It is quite likely that even if the project is in fact completed when originally estimated, it may not be sold or refinanced when originally thought.

### So Now WHAT HAPPENS?

Of course everyone has perfect hindsight. But no one has perfect future sight. What does a lender do if they have an in-process development and construction loan that is still generating interest income from an interest reserve?

Although generally accepted accounting principles (GAAP) has not specifically addressed recognizing interest income funded from interest reserves, it has lots to say about the collectibility of income.

GAAP states that if there is some level of doubt that the collectibility of interest added to a loan exists, then it should not be included in interest income.

(For more details see Accounting Research Bulletin No. 43, Chapter 1A, paragraph 1; Accounting Principles Board Opinion No. 10, paragraph 12; and Statement of Financial Accounting Concepts No. 5, paragraph 84(g))

In addition, the Call Report instructions indicate that banks should not accrue interest on any asset for which payment in full of principal or interest is not expected.



### ACTION STEPS TO TAKE

Because of current conditions, it is wise to carefully analyze all development and construction loans looking for the following matters that might be indicative of a potentially troubled loan:

- Renewed, extended, or refinanced loans
- Compliance with all loan covenants such as starts, and pre-sales
- Re-Evaluating the "current" loan to project value ratios
- Assessing the ongoing stability of the borrower

In the event that there is likelihood that a particular development and construction loan may indeed become troubled, it might be prudent to discontinue the recognition of reserve funded interest income.

The volatility of current real estate market conditions makes it prudent for the allowance for loan losses (ALLL) to be recalculated more frequently, and that it is properly integrated with the analysis and propriety of continuing to accrue interest on potentially troubled development and construction loans.

# On-Balance Sheet Mortgage Securitization *(continued)*

## OPTIONS FOR SECURITIZATION ACCOUNTING

For now, the difference in GAAP accounting for an on-balance sheet securitization versus an off-balance sheet securitization is significant. With on-balance sheet accounting, the securitized loans remain on the books, and the original funding source for those loans (such as deposits, FHLB advances or warehouse lines of credit) are converted into securitization bonds. With off-balance sheet accounting, the securitized loans and related funding obligations are removed from the balance sheet, and interests retained, such as residual interests or servicing rights, are recorded at their fair value. Despite the significant accounting differences, the economic differences are often considered negligible.

**“...On-balance sheet securitization accounting can require companies to record GAAP losses by adding to their allowance for loan losses beyond what they will ever suffer...”**

For those securitized loans that are on the balance sheet, they are subject to the GAAP loan accounting rules, which require an allowance for loan losses on probable losses inherent within those loans, even if losses on the loans will not be suffered or funded by the sponsor (beyond the residual interest retained, and subject to any legal claims). In today's world, projected losses on the loans are eroding the value of not only the residual, but the B-tranche and A-tranche rated bonds as well. This is requiring companies to record GAAP losses by recording additions to their allowance for loan losses beyond what they will ever suffer or have to fund...and in essence creating a "deferred gain" in their balance sheet that will not manifest itself until years later when the securitization is collapsed.

## BUT WHY IS THIS THE CASE?

How is it possible that a company structuring an on-balance sheet securitization would be required to record charges beyond what the company would have to fund, where in nearly the same scenario but if using an off-balance sheet structure, the maximum accounting exposure to the company is the amount of the residual interest?

**Answer:** there is precedent in GAAP for recording losses in situations with similar fact patterns.

As the mortgage industry's use of securitization proliferated over the last few years, especially with Alt-A or subprime product, there have been a number of securitization transactions experiencing higher than predicted losses. These losses have completely eroded the value of the residual interests and are eroding into the value of the bonds as discussed above. Company sponsors in the Alt-A or subprime space (who still exist), who effectuated securitizations accounted for as on-balance sheet, are reporting GAAP losses beyond amounts they will suffer as described above. But is this accounting properly reflective of the underlying economics and consistent with precedent?

Over the past few months I have held conversations with some of the top "securitization minds", and their positions on the subject differ. A notion that was suggested to me, which I believe has significant merit, is a stop-loss concept. The theory is that the securitization process (by the sponsor who

holds the residual interests) changed the legal characterization of what is owned, and therefore the bonds sold to third parties represent a stop loss measure for the sponsor who accounts for the loans and bonds in an on-balance sheet securitization. This stop loss measure is accounted for akin to a guarantee or loan specific credit protection when determining the allowance for loan losses. This stop loss would limit the amount of the allowance for loan losses to the amount that the sponsor would ultimately be responsible to fund, such as the residual interest retained.

Another method that has been achieved by one registrant (yes, only one without the sale of the residual interest - others have done it by selling their residuals) is the subsequent revision of certain legal provisions in the securitization agreements to remove the discretion provisions and convert the special purpose entity into a QSPE. This is known as securitization recharacterization. This is a complex process (both from a legal and accounting standpoint), and we have an audit client attempting to achieve this recharacterization and modified accounting. If successful, our client will unwind the loans and bonds from their balance sheet and record the fair value of beneficial interests on the effective date and not have to record losses beyond their residual interest and actual funding obligations.

*If you have any questions about the above or would like more information, please feel free to contact us at your convenience.*

# SQUAR MILNER

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## **ABOUT SQUAR MILNER**

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Squar Milner is one of the nation's 100 largest accounting firms as well as one of the largest independent accounting and advisory firms in California. Squar Milner has offices in Los Angeles, Newport Beach, San Diego and Cayman Islands, and a combined operating experience exceeding 75 years.

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