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Goodbye and Good Riddance Arcane Accounting Rules Failed Us in Securitization Mess

Part 1 of 2

“All tragedies in life are preceded by warnings ”

Arthur Levitt, former chairman of the Securities and Exchange Commission

The accounting for the securitization of financial assets, particularly subprime home loans, has been defined by arcane accounting rules that helped many companies conceal mountains of debt and provided for the upfront recognition of massive and unearned future profits Here's part one of the sad story

In February 2003, Angelo R. Mozilo, an Italian butcher's son and the well-tanned and impeccably dressed manifestation of the American dream, stood before an audience of academics and mortgage professionals in Washington, D.C., to describe his vision.

“Expanding the American dream of homeownership must continue to be our mission,” he said, “not solely for the purpose of benefiting corporate America, but more importantly, to make our country a better place.” As the chairman, chief executive officer, and president of Countrywide Financial Corporation, the mortgage banking behemoth he co-founded nearly 35 years before, Mozilo possessed both the power and vast resources to transform his gauzy message into hard-boiled business policy.

Mozilo, something of an evangelical capitalist, talked that day of home ownership as the social glue that “increases personal wealth ... and increases social capital,” according to a Feb. 4, 2003 Countrywide news release. Home ownership, he said, “ties families, neighborhoods and communities together.” Children living in owned homes, he contended, have higher math and reading achievement levels and homeowners are more likely to join civic groups.

“Housing,” Mozilo concluded, “is critical to our nation's welfare and to our communities' well-being. Let's make sure that the American dream of home ownership is never a cliché, and always our cause, and always our steadfast mission.”

Between 2005 and 2007 Countrywide did its part by originating \$97.2 billion of subprime loans, more than any of its competitors. (See the May 6 article, “The Roots of the Financial Crisis: Who Is to Blame?” by John Dunbar and David Donald from The Center for Public Integrity's series, “Who's Behind the Financial Meltdown?”)

During the same period, Countrywide doubled the dollar value of its higher-risk nonprime and home equity loans to nearly 18 percent of the company's total loan production and recorded nearly \$11 billion of dubious profit, all of which would be reversed in 2008. In turn, Mozilo received compensation of nearly \$392 million from 2003 through 2007 (See the special report, “CEO Compensation,” edited by Scott DeCarlo in the April 30, 2008 issue of *Forbes* magazine.)

Countrywide wasn't the only lender that sold questionable loans with enormous fees that burdened hundreds of thousands of Americans with high-interest mortgages that many couldn't afford, but it was clearly the largest and most ubiquitous. Countrywide helped thousands realize their dreams of home ownership, but for many the experience was short-lived and ended in financial disaster. For Mozilo, who dumped more than \$400 million of his Countrywide shares, some at allegedly inflated values, this ill-fated experiment in home ownership removed the ambiguity of just whose mission he accomplished.

By Gordon Yale, CFE, CPA, CFF

The views expressed here aren't necessarily those of the ACFE its executives and employees – ed.

AFTERMATH OF SECURITIZATIONS

In 2005 Countrywide originated nearly \$500 billion in mortgage loans, and as in prior years, shoveled most of them off its balance sheet through securitizations—the bundling, sectioning, and remarketing of financial assets that have been central to the financial meltdown.

It's now common knowledge that the securitization of financial assets, particularly subprime and other nonprime home loans, was the highly combustible fuel that propelled the housing boom for much of the decade. But nearly lost in the relentless pageant of alarming economic news that has followed the collapse of home values is that arcane accounting rules have been an enabler for financial concerns like Countrywide. These rules have helped companies to conceal their ever-increasing mountains of debt and provided the cover for the upfront recognition of massive and unearned future profits that were too often the product of feckless guesswork.

For a generation, these flawed accounting rules have helped camouflage the risks of many highly leveraged companies and allowed them to overstate their financial condition. And though we should celebrate recent reforms that should prevent future abuse, there are also compelling reasons to ask what took the accounting standard setting bodies—the Financial Accounting Standards Board (FASB) and the Securities and Exchange Commission (SEC)—so long?

Auditors, regulators, investors, ratings agencies, and rule-making bodies have known for more than 20 years that accounting standards for securitizations reflected the legal form of these complex transactions rather than their economic substance. In some instances, regulators, analysts, and the ratings agencies have looked through the permissible accounting and made appropriate adjustments to balance sheets, income statements, and regulatory capital requirements that reflect the economic essence of securitizations. But in far too many cases these same analysts, as well as underwriters, lenders, and investors, have been naïve, cynical, or simply clueless to the distortions inherent in the financial reporting. The result has been a long series of abuses and scandals that have cost investors billions of dollars, and more recently, contributed to the near collapse of the U.S. financial system.

Securitizations can take many forms and employ a variety of structures. But the elements common to each are the aggregation of income-producing financial assets that, in turn, are transferred to a bankruptcy-remote entity, typically a trust, and then carved into pieces (or “tranches”) that have a structured hierarchy of rights to the anticipated cash that the assets are expected to generate. The financially engineered product is then remarketed much as a bond, secured by the financial assets, and separated into a series of tranches, each with different risks and returns.

In many securitizations, the assets are parsed so that the most senior tranche has the first right to virtually all the cash generated by the underlying assets that collateralize the security. When, and only when, the periodic interest and principal due the senior tranche are paid, the remaining cash flows to the next, most-senior tranche in the hierarchy and so on down to the

remaining subordinate tranches. One of the primary benefits of these securitization structures is that they facilitate what amounts to the mass syndication of participating interests in a pool of financial assets that might otherwise have been difficult to subdivide and sell. And because many structures provide for tranches of differing hazard, the tranching mechanism segments the instrument to meet the credit quality needs of purchasers with varying appetites for risk.

Unfortunately, the fragmentation of ownership interests in securitizations also fragmented the owners' interests. One of the more vexing problems with residential mortgage-backed securities (RMBS), for example, has been with the implementation of mortgage restructuring plans that compromise principal. While such write-downs might be in the interest of the owners of the senior tranche who are protected from loss, why would the subordinate tranche holders agree to a plan that inevitably destroys their value?

And though a servicing agent might have the legal authority to restructure the underlying loans, in many instances, the agent was owned by the firm that bundled the mortgages, initiated the securitization, reported a gain on its sale, and recognized mortgage servicing rights that would be, in whole or part, reversed if the underlying loans were worked out. Also, servicers have had to grapple with the specter of litigation by disgruntled, subordinated investors who are the likely, if not certain losers in this zero-sum game. (See the Oct. 29 2008 Center for American Progress Web article, “Next Steps to Resolve the Mortgage Crisis,” by Michael Barr.)

HIDE THE BALL

Some of the pernicious ramifications of securitizations were apparent long before the meltdown of the residential subprime mortgage market. The issues not only involve the inconvenient governance inherent in typical securitizations, but have far broader impact because of the permissive accounting principles that, more or less, have been the standard since 1984.

Deconstructed to their simplest terms, most securitization transactions are little more than a secured loan with recourse, often limited recourse, to the borrower. Suppose, for example, I want to borrow against my trade accounts receivable. Under normal circumstances, I will be advanced some fraction of the aggregate value of the receivables I pledge to protect the lender against loss. If the value of the receivables is significantly greater than the loan, then I'll likely borrow at a lower cost and upon more generous terms.

I enter into the transaction with the expectation that the collections from the receivables will be more than sufficient to pay interest and amortize the principal on my loan. If a portion of the receivables has been outstanding (or aged) beyond 90 days, an indication that the customer is less likely to pay, my lender will likely enforce a common loan provision (or covenant) that requires I substitute new receivables for the more dubious accounts.

The accounting for this transaction is straightforward. The receivables I pledge remain on my balance sheet as a pledged

asset and I must also record my borrowings as liabilities. In turn, the common metrics used to measure borrower risk—the debt-to-equity and debt service coverage ratios—erode my ability to obtain additional loans and might compel my lenders to raise the interest rates on my existing debt and harden the terms on which they lend to me. If my additional indebtedness is prohibited by agreements with my other lenders, the additional loan might trigger an event of default that might immediately compel me to repay their loans.

But what if I needed to borrow cash regardless of onerous loan covenants from other lenders? Under the current rules, the framers of generally accepted accounting principles (GAAP) provided a convenient and somewhat convoluted loophole. And therein lies the rub. What many analysts and investors, much less the public, continually fail to understand is that some accounting rules are the loophole-laden fine print to broader, seemingly high-minded financial reporting principles.

CARVED IN (SAND)STONE

In many instances, accounting is permissive, counterintuitive, and, at times, flatly abusive. For example, according to FASB Statement of Concepts No. 2, the broad principles of financial accounting recognize that the economic substance of a transaction should be reported, rather than its form. Further, according to FASB Statement of Concepts No. 5—a second fundamental tenet—is that income shall not be recognized until earned, or in other words, income shall not be recorded until the good or service has been delivered.

But the convolutions of modern financial transactions, coupled with the politics of standard setting that has, at times, favored industries over investors, have resulted in ambiguous, contradictory, or permissive promulgations that often encourage mischief. As widespread abuse becomes publicly apparent, rules are reformed or reversed so while the transactions might not change, the required accounting for them might be the professional gospel today and apostasy tomorrow.

Under FASB Statement No. 140, the primary professional authority on accounting for securitizations until November 2009 (thereafter,

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FASB Statements 166 and 167 will govern), I could borrow from a lender by securing the loan with my accounts receivable. But if I tweaked the structure of the transaction just so, I would be permitted not only to remove my receivables from my balance sheet, I could also escape recording the additional debt I incurred. And failing to recognize debt is, typically, a financial statement distortion quite favorable to me. Although the rules have changed several times, the essence of FASB Statement No. 140 has been practiced for nearly 25 years.

From approximately 1984 through 1996, the structuring was relatively simple. GAAP then outlined in FASB Statement No. 77 provided that my loan wasn't a loan, and the pledge of my accounts receivable wasn't a pledge, but the transaction was instead a sale of my accounts receivable to a third party as long as I could comply with three conditions.

According to the superseded FASB Statement No. 77 these conditions required that: 1) I give up the future economic benefits of the accounts receivable, (2) I am able to reasonably estimate the likely losses in the event some of my accounts receivable aren't collectible, and (3) that my lender (that is, purchaser) couldn't return the receivables to me except pursuant to the recourse provisions of our agreement.

GAAP has evolved since then, but a similar alchemy, a bit harder to engineer, remains. Under the provisions of the newly superseded FASB Statement No. 140, the operative accounting principles during the financial meltdown, I can "derecognize" my receivables and not record my secured loan, despite its recourse to me. Moreover, I can record the transaction as a sale of my assets, and I'm required to recognize a profit based upon the interests I retain even though I might not have collected the first dollar due to me.

To reap these considerable benefits, 1) the transaction must transfer my assets to a bankruptcy-remote special purpose entity (usually a trust) that is beyond my control, (2) the purchaser (my former lender) must have the right to pledge or exchange the receivables I transfer to him, and (3) I can't retain effective control over the receivables I transferred. Control, in this instance, means that there's no agreement that *both entitles and obligates* me to repurchase or redeem my accounts receivable before their maturity. (Emphasis added.)

In other words, I can account for my secured loan as if I sold my receivables rather than merely borrowed money against them even if I'm obligated (but not entitled) to take back these assets for any reason including their worthlessness, according to the old FASB Statement No. 140. The sad fact is while this accounting treatment sounds too good to be true, it hasn't been.

In fiscal 1999 for example, New Century Financial Corporation, one of the largest of the subprime mortgage bankers, securitized more than \$3 billion of mortgage-backed securities, but had only \$680 million of indebtedness, most of it financing mortgages that the company held for future securitizations that, in turn, would remove them from its balance sheet. Had the 1999 securitizations been accounted for as secured debt, the debt-to-

equity ratio of New Century would have been greater than 21-to-1, leaving little equity to cushion future loss in a high-risk business.

New Century's adjusted leverage was undoubtedly higher because it securitized nearly \$3.4 billion in 1997 and 1998, a large portion of which likely remained outstanding. At the same time, New Century held residual interests in its securitizations of approximately \$365 million, some 2.1 times stockholders equity. (See the New Century "Form 10-K" annual report for the year ended Dec. 31, 2005.) The interests retained by securitization sponsors like New Century, and accounted for as assets, were often the most risk-laden—that is—the most subordinate tranches.

In fiscal 2004 and 2005 Bear Stearns, the Wall Street investment bank whose failure compelled an arranged marriage with JP Morgan that was sweetened with a \$30 billion government dowry, securitized a massive \$221 billion of mortgage and asset-backed securities, and retained interests from those securitizations of \$5.5 billion and mortgage servicing rights of an additional \$468 million, an amount more than 55 percent of Bear's net worth. (See Bear Stearns Form 10-K for the year ended Nov. 30, 2005.) The interests retained by Bear Stearns, like New Century and others, were likely the riskiest tranches of the securitizations.

Merrill Lynch, the once venerable giant now merged into Bank of America, securitized more than \$100 billion in mortgages in 2007—a period clearly after home prices peaked in mid-2006 and some 72 percent more than its \$58 billion of securitizations in 2005. (See Standard & Poor/Case-Shiller Home Price Values, published March 31, 2009.)

In total, Merrill securitized approximately \$325 billion of assets in 2006 and 2007—including higher-risk collateralized debt obligations (CDOs). Merrill Lynch retained a residual interest in \$193 billion of these securitizations. Had Merrill increased its reported short- and long-term borrowings in 2007 by the \$193 billion of securitizations in which it retained a residual interest, its debt would have increased approximately 49 percent and its net-worth-to-asset ratio would have been approximately 38 to 1. (See Merrill Lynch Form 10-K for the years ended Dec. 29, 2006 and Dec. 28, 2007.)

Further, in 2007 Merrill wrote off \$1.1 billion of the residual interests it retained from its securitizations. After the write-down, Merrill reported remaining residuals of \$6.1 billion, an amount that represented approximately 19 percent of its remaining equity capital.

GHOST ASSETS AND PHANTOM PROFITS

The stealth debt permitted by accounting rules was only part of the permissive equation. Because GAAP treated securitization transactions not as loans, but as sales of financial assets, there was also a vast potential for the recognition of substantial, but unearned profits on these transactions. In many instances, the genius behind the financial engineering wasn't the advanced mathematics that endeavored to measure risk, but was more the simple salesmanship that persuaded all too many investors and ratings agencies that the value of a pool of mortgages was magi-

cally enhanced if one simply tinkered with investor rights to the pool's cash flows.

And to accept that securitization increased the value of a given pool of mortgages (and thus supported a lesser aggregate yield for the re-engineered product), investors first had to be convinced of the dubious proposition that the risks inherent in a mortgage pool as a whole was somehow reduced when the various ownership interests were fricasseed into tranches. The not-so-delicious irony of securitization is that it belies the efficient market theory that Wall Street has often embraced to support an anti-regulatory bias. Free and competitive markets, the theory holds, are self-correcting because large numbers of rational market participants receive and act on all the relevant information as it becomes available and that, in turn, drives security prices to their true fundamental values. And because the "market knows best," regulators ought to leave it alone.

But if that theory holds, then the initial pricing for risk on the mortgage pool in the aggregate shouldn't change no matter how the pool is parsed unless the risk was mispriced at origination. Charlie Munger, Warren Buffet's partner in Berkshire Hathaway, recently expressed it more directly: "They were going to take a lot of sewage and mix it up in a different way and say it's not sewage. The laws of nature are such that it keeps its sewage-like qualities." (See the article, "Buffett Lambastes Bankers, Insurers for 'Stupidity'" by Eric Holm and Andrew Frye,

on Bloomberg.com, May 4.)

The belief in the hocus pocus that securitizations somehow changed the aggregate risk and value of mortgage pools also gave rise to the equally harmful practice of immediately recognizing unearned profits as a result of the "gain" on sale that was permitted under GAAP. These gains—particularly with risky assets such as subprime mortgages and auto loans; defaulted credit card debt; and other higher-risk, higher-reward financial assets—were often quite substantial.

In typical securitization transactions, the seller of the financial assets retains an ownership interest in the pool that's securitized. The nature of the ownership interest can vary, but this residual is often the most subordinate portion of the securitization and is commonly known as the equity or first-loss tranche. The value inherent in the residual interest generally has two sources:

1) the difference, over time, between the earnings on underlying financial assets versus the interest payments due to the owners of the more senior tranches, and (2) the excess collateral, if any, that was provided to reduce the credit risk of the transaction.

Say, for example, that I securitize a pool of subprime mortgages that yield 12 percent per year. Because I can layer the risks of different tranches by varying the rights to the cash generated by these assets as well as over-collateralize the transaction, the interest payments I make to the more senior tranche owners average 7 percent. I pay less interest than I earn because I've convinced



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the more senior tranche owners that the expected losses will be absorbed by investors who are subordinate to them and because I over-collateralized the transaction. If I calibrate the tranches correctly, the risk of the most senior tranche is so contained, I argue, that the ratings agencies will crawl over one another to assign a AAA-rating – their highest credit ranking. And finally, if the mortgages I securitized remain outstanding as I forecasted and the default rates are as low as I estimated, then I get back both the interest spread and the excess mortgage collateral I provided to secure the lenders.

Because subprime mortgages typically had average lives of somewhere between two to five years, the value of my residual interest can't be precisely known until the mortgages pay off. The spread – the difference between what's paid and what's received – as well as how much of the excess collateral comes back depends on a number of future events about which I can make an educated guess but I can't know. If the financial assets that were securitized don't perform and the cash they generate isn't sufficient to pay interest and principal to the more senior tranches, then the value of my residual interest is reduced accordingly, if not eliminated.

The accounting for the senior tranches I sold is straightforward. The owners of the senior pieces of securitizations recognize their income as it is earned, typically in the form of interest income as it accrues or as it is paid out to them. Interest isn't earned and the income isn't recognized unless the debt upon which interest is paid remains outstanding over time, thus entitling the right to interest payments. Moreover, the debtor must have the ability to make payments because if the interest can't be paid, then the income I recognized must be offset by an allowance for loss.

The same dynamics are true for the rest of the tranches, but through the perverse magic of GAAP the seller of the pool of mortgages who retains a residual interest is permitted, even required, to recognize the present value of all its income upon the closing of the "sale" that typically occurs well in advance of the completion of the earnings process. The accounting creates a conundrum. Because the interest and repayment of principal on a residual is inherently more tenuous than the interest and principal paid to the senior tranches, it would follow that if any interest income was recognized before it was earned, it should be the income due the senior tranche because it's substantially more likely that its interest will, in fact, be paid.

To that extent as well, FASB Statement No. 140 is counter-intuitive. The standard is an outright rejection of two of the fundamental tenets of accounting that provide that income shall be recognized only when it's earned and that accounting shall reflect the economic substance of a transaction, not the form. Instead, FASB Statement No. 140 allows that gain on sale shall be recorded on what amounts to an estimate of the outcome of future events. And those estimates are dependent on the assumptions that the underlying pool of mortgages will remain outstanding as forecasted, that the borrowers will pay interest and repay principal

as anticipated, and that the cash assumed to trickle down to the residual tranche will be received as projected. Thus, the gain is measured, in large part, by an educated guess and sometimes, by a not-so-educated guess.

In accounting terms, the gain on sale is the difference between estimated fair value of the assets obtained less the liabilities incurred and the cost of the assets "sold." What's obtained includes the sales price received, the present value of the future spread between the interest earned and interest paid, and the even more perverse incentive of mortgage servicing rights (MSRs) that represent the present value of the future net revenue that the seller will receive for administering the mortgage loans it sold. The recognition of gain on MSRs is a GAAP concoction that permit the recognition of the present value of the future income streams expected from the retained servicing rights to the mortgages that were transferred in a securitization. (Servicing rights are the administrative functions of collecting, administering, and accounting for the underlying mortgages in a securitization pool.) And because no rational business typically enters into a transaction to generate a loss, the initial result of nearly all securitization transactions has been, not surprisingly, the recognition of a gain – often a very significant gain.

Estimates of future events are imbued in many financial statement accounts. Companies often estimate what portion of their receivables won't be collected, what future warranty costs will likely be, and what portion of goods sold will be ultimately be returned, to name a few. Audit literature requires independent Certified Public Accountants take special care in auditing estimates including fair-value measurements and investments in securities that aren't actively traded. In fact, Statement on Auditing Standards No. 99 (codified AU§316) Consideration of Fraud in a Financial Statement Audit specifically identifies "assets ... based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate" as risk factors that require additional scrutiny. (See Statements on Auditing Standards Nos. 57, 81, 101 and 99 or newly codified as AU§342, AU§326, AU§328, and AU§316, respectively.) 🔍

In part 2 Estimates of future accounting events can be the stuff of potential manipulations, and the Creditrust, Conseco, and New Century Financial failures were tangible warnings of worse abuses to come.

(Note: The opening quote, attributed to Arthur Levitt, is from "The Reeducation of Larry Summers," by Michael Hirsh and Evan Thomas in the March 2 issue of Newsweek.)

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