June 2009

Speaking of Securitization

Accounting, tax, regulatory, and other developments affecting transfers and servicing of financial assets

The RE-REMIC phenomenon:

- Is it a regulatory capital play?
- Is it a defensive play against further ratings downgrades?
- Is it a tax-advantaged transaction?
- Is it a cost-efficient funding strategy for the new AAA securities?
- Is there an economic trading arbitrage?
- Does it make AAA bonds more saleable?

Sometimes the impetus for a RE-REMIC[1] is one or more of the factors listed above, and in rare circumstances, all of the above. Given the paucity of any new primary issuances in the mortgage securitization market and the yet-to-develop traction in government strategies to revive mortgage securitization, just about the only non-agency game in town are RE-REMIC transactions, and there is no shortage of supply.

This paper will summarize technical accounting, regulatory, and tax issues that apply to these transactions. The paper does not address the credit re-rating analysis or any economic valuation of the sum of the parts in relation to the whole. Because the technical accounting and regulatory developments outlined herein are very fast-moving, readers should be aware that this paper might not represent the up-to-date status of these matters as of the date of their reading.

The mechanics of the RE-REMIC process

In its simplest form, an investor transfers ownership of one or more RMBS bonds[2] to a special-purpose entity (the "depositor") (often wholly owned by a dealer) which in turn transfers the bonds to a newly formed trust created specifically to issue the top-deal RE-REMIC securities. Typically, to achieve economies of scale, multiple RMBS bonds are put into the trust that issues the RE-REMIC securities. A trustee is appointed and receives the cash distributions on the underlying securities and makes the cash distributions to the holders of the RE-REMIC securities (typically with a one-day delay, but might vary between zero and three days, depending on arrangements with trustee). The RE-REMIC securities can be as simple as two pro rata pay classes[3] with realized losses allocated first to the subordinated class and then to the senior class, or the RE-REMIC structure could have multiple sequential pay classes and more complex interest and principal waterfalls and exchangeable features to capitalize on future upgrades or downgrades. When there are multiple RMBS bonds placed in the REMIC, most often a separate bond "group" is created for each of the underlying RMBS bonds (for example, 40 underlying RMBS supporting 80 senior/support classes) and a separate REMIC election is made for each group. There is typically no cross-collateralization across the RE-REMIC groups; however, super-senior classes can be

1 RE-REMIC stands for resecuritization of real estate mortgage investment conduit securities. Since REMIC is only a tax construct, not all resecuritizations of RMBS are RE-REMICs (some are grantor trusts; some are owner trusts issuing debt for tax).
2 RMBS: residential mortgage-backed securities. We often refer to the underlying REMIC securities (RMBS) as "bonds" in this paper, although technically, they are more likely to be one or more classes of multiclass pass-through certificates.
3 Virtually none of the RE-REMICs of recent vintage use a pro rata pay structure. Locking out the support class from principal payments provides greater credit enhancement to the senior class and more efficient ratings.

structured with a shared senior support class. The RE-REMIC classes are rated by one or more rating agencies based upon their current assessment of the expected performance of the loans underlying the REMIC bonds, as well as the payment priorities of the underlying REMIC structure, and lastly the RE-REMIC structure.[4] Some, none, or all of the RE-REMIC securities may be sold to other investors with some, none, or all of the RE-REMIC securities taken back by the original investor. (See further discussion that follows.)

Why private placements?

Traditional league tables are not disseminated for the overall RE-REMIC issuance levels. Because of securities law concerns and SEC registration fees, the vast majority of RE-REMICs are done as 144A private placements. The public deals would most likely be deals from dealer inventory with the underlying REMIC bonds coming from prior deals of that same dealer. If a sponsor were to do a RE-REMIC as a public offering, the offering and the applicable disclosures would be subject to the rules applicable to public offerings generally (including those pertaining to liability) for all of the disclosures required in the prospectus by Regulation AB concerning the underlying REMIC securities, including static pool information.

When the underlying bonds are from deals that were brought to market by unaffiliated issuers, the sponsor of the RE-REMIC would likely not want to be subject to the additional rules and regulations applicable to public offerings covering data for which they have no control over its preparation and for which, as a practical matter, they may be unable to obtain. Additionally, for a public offering, the sponsor would have responsibility for periodic reporting including signing a Sarbanes-Oxley certification. Although 144A bonds generally have less liquidity than SEC-registered bonds, that is not a primary concern in RE-REMICs if all or most of the newly created RE-REMIC bonds are taken back by the sponsor and not marketed. Market transparency is accomplished by way of the placement agent posting the new CUSIPs[5] on Bloomberg and Intex. Additionally, transparency is enhanced by the availability of monthly certificate-holder remittance distribution reports so that subsequent investors can perform an analysis on the RE-REMIC bonds as well as the traditional analysis of the underlying RMBS bonds and trustees have deal information on their websites that are password protected for investors in private placements.

Another source of timely information about new issuance is DBRS, Inc. (www.dbrs.com) since they issue a press release on the closing date announcing each new RE-REMIC issue they rate.

Rating	Risk Weight	Capital Required for Each $1 of Investment*
AA or AAA	20%	1.6 cents
A	50%	4.0 cents
BBB	100%	8.0 cents
BB	200%	16.0 cents
B and below and unrated	Up to dollar for dollar maximum**	100 cents

* The risk weighting is applied against the book value of the investment (typically amortized cost) and not the face amount. The amounts shown as capital required assume an 8% required capital level. For example, $1 x 20% x 8% = $.016.

** These securities are not eligible for the risk-weighting approach. The capital requirement would be equal to the face amount of the security plus the pro rata portion of all the more-senior positions it supports (that is, the institution's proportional ownership of the subordinated security multiplied by all of the more-senior securities in the securitization) times 8%, but not greater than the amortized cost. Dollar-for-dollar treatment means, effectively, that one dollar in total risk-based capital must be held against every dollar of a security rated B and below, or unrated.

Bank regulatory capital risk weightings

U.S. banks and thrifts apply the following risk weightings to their RMBS, CMBS and ABS investments.[6]

For this ratings-based approach, only one rating is required if there is a reasonable expectation that, in the near future, either the security may be traded or the security may be used in a secured loan or repo. Otherwise, to qualify for the ratings-based approach, the security must be rated by more than one rating agency, the security must be the equivalent of BB or better by all rating agencies providing a rating, and the ratings must be publicly available. If there is a split rating, the lowest rating will determine the risk weight. When assessing the adequacy of capital at an institution with significant holdings of MBS, particularly those that have been or are likely to be downgraded, bank examiners are instructed to include in their assessment a comprehensive evaluation of the risks inherent in these securities. Even when an institution's capital

4 *Emergent Trend in Re-REMICs for Capital Preservation.* DBRS-December 8, 2008.
A Closer Look at Rating Triple-A Re-REMICs. DBRS-July 28, 2008.
Super-Senior Resecuritizations-A Way to Enhance AAA RMBS. DBRS-June 16, 2008.
Re-REMICs, Why Underlying Bond Structure Matters. Fitch Ratings-November 18, 2008.
Re-REMICs, Why Structure Matters. Fitch Ratings-August 20, 2008.
Methodology and Assumptions for Resecuritizations of U.S. RMBS. Standard & Poors-March 17, 2009.
Methodology for the Surveillance of US RMBS Re-REMIC Transactions. Standard & Poors—December 23, 2008.
5 CUSIP refers to both the "Committee on Uniform Security Identification Procedures" and the 9-character alphanumeric security identifiers that they distribute for all North American securities for the purposes of facilitating clearing and settling of trades.
6 *Risk Management of Investments in Structured Credit Products.* FDIC Financial Institution Letter FIL-20-2009—April 30, 2009. http://www.fdic.gov/news/news/financial/2009/fil09020.html. Credit unions also have risk-based capital requirements and risk weightings for investments.

exceeds the minimum ratios, examiners are to determine whether the bank is holding capital commensurate with the level and nature of the risks to which it is exposed.

Bank and thrift regulatory financial reports (quarterly "call reports") are based on the institution's U.S. GAAP financial statements. Let's say a bank does a RE-REMIC and converts its ownership of a recently downgraded or soon-to-be-downgraded bond into a new AAA-rated senior bond for 70% of the face amount and a new BBB-rated bond for the remaining 30% of the face amount. To be able to apply the new and improved risk weightings to its new positions, such holdings would have to be recognized as being different for regulatory purposes than their original position, since the aggregate cash flows and their timing have not really changed. Under U.S. GAAP, if an entity transfers financial assets to a trust and takes back 100% of the beneficial interests issued by that trust, the transferor has to consolidate the trust in its financial statements. In other words, if no RE-REMIC securities are sold to third parties, then the investor would continue to show on its U.S. GAAP balance sheet the original underlying securities -- not the new RE-REMIC classes. (See section on U.S. GAAP accounting later in this paper for information on the minimum amount of securities to be sold to third parties to achieve a U.S. GAAP sale and non-consolidation of the RE-REMIC trust.)

To illustrate the point just made, the following is an excerpt from the third quarter 10-Q of a bank that had sponsored a resecuritization but did not sell any of the new securities:

"During 2008, the bank formed a wholly-owned subsidiary, [ABC Bank] Resecuritization Trust 2008-1 (the "Trust"), for the purpose of resecuritizing its portfolio of corporate sponsored CMOs. The bank transferred all of its right, title, and other ownership interests in the CMOs to the Trust in exchange for notes issued by the Trust (the "Notes"). These resecuritized bonds were rated by independent rating agencies giving consideration to the purchase discounts and credit enhancements associated with each specific bond. The Notes were then rated. As of March 31, 2009, 25.1% of the Notes were rated below investment grade by the investment rating agencies. These Note ratings were risk weighted in accordance with the bank's reading of applicable regulatory capital guidance. This guidance, however, does not contemplate the specific type of resecuritization transaction undertaken by the bank. After discussions with the FDIC, the bank was told to file its December 31, 2008 call report based on the bank's understanding of the risk-based capital treatment of the resecuritized portfolio of CMOs. In April 2009, the FDIC informed the bank that because it had not sold any of the Notes, it could not rely on its interpretation of the applicable regulatory guidance."

In contrast, the following is an excerpt from the third quarter 10-Q of a bank who had sponsored a resecuritization and sold two of 14 tranches:

"During the first quarter of 2009, [XYZ Bank] (the "Company") resecuritized certain existing non-agency mortgage-backed securities and U.S. Treasury securities using a qualifying special-purpose entity (QSPE). The resecuritization was made in exchange for all of the beneficial interests in the QSPE. XYZ received the beneficial interests in the form of 14 tranches and during March subsequently sold two tranches issued by the QSPE to third parties for cash proceeds. Upon the completion of the resecuritization, the previous carrying amount of the securities was allocated between the interests sold and the interests retained based on their relative fair values. The Company recorded a loss of $40.6 million at the time of sale. The Company retained the remaining 12 tranches totaling $1.2 billion in par value. Subsequent to the transaction, the beneficial interests (i.e., debt securities) retained by the Company are accounted for as available-for-sale securities carried at fair value. At March 31, 2009, the fair value of the retained securities, which was determined using a discounted cash flow approach, was approximately $1 billion. The Company does not have any continuing involvement (such as servicing responsibilities or recourse) with the two tranches that were sold to third parties. Additionally, there are no material restrictions on the interests that the Company continues to retain. The resecuritization reduced the risk in the securities portfolio as all retained securities are investment grade which has the impact of significantly reducing the risk-weighted assets and the regulatory capital held on the retained securities versus the capital held on the bonds before the resecuritization."

Risk-based capital requirements — Reserve percentage factors

Rating	Designation	Life	P&C
A and above	NAIC 1	0.4%	0.3%
BBB	NAIC 2	1.3%	1.0%
BB	NAIC 3	4.6%	2.0%
B	NAIC 4	10.0%	4.5%
CCC	NAIC 5	23.0%	10.0%
CC and below	NAIC 6	30.0%	30.0%

Insurance company risk-based capital factors and statutory accounting

Insurance companies had been very active investors in RMBS and are particularly attracted to the wave of RE-REMICs, especially if they can get clarity surrounding the statutory accounting and risk-based capital treatment. Statutory accounting practices applicable to insurance companies differ from U.S. GAAP in a number of areas. Most noteworthy in the context of RE-REMICs is that subsidiaries and special-purpose entities are not consolidated for statutory purposes.[7] There are also differences in the accounting for investments. Property and casualty ("P&C") insurance companies are required to record securities at the lower of cost or fair value when the NAIC[8] designation falls to a level 3 or below (generally equivalent to a BB rating). Life insurance companies are required to do the same at NAIC level 6 (generally equivalent to a CC rating[9]). NAIC designations are used to set the reserve factor that the insurer will use to calculate the risk-based capital (RBC) charge applicable to the security in the insurer's total RBC calculation.[10]

The factors are applied against the Book/Adjusted Carrying Value of the securities under each NAIC designation. In evaluating a RE-REMIC transaction, it is important to consider which securities, both before and after the RE-REMIC, would be required to be carried at the lower of cost or market based on NAIC designation, and the resulting effect on surplus. Carrying securities at the lower of cost or fair value does not represent a permanent write-down; that is, the carrying value can be increased if the fair value increases.

Note that although the official risk-based capital calculations are only required at year-end, insurers monitor their risk-based capital throughout the year as rating agencies and others typically ask for the data.

As previously indicated, insurance companies do not consolidate subsidiaries (including securitization vehicles) for statutory accounting purposes. Statement on Statutory Accounting Practices No. 25, *Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties* (SSAP No. 25), paragraph 14, introduces the concept of "non-economic transactions" and states that "transfers of assets from a parent reporting entity to a subsidiary, controlled, or affiliated entity shall be treated as non-economic transactions at the parent reporting level because the parent has continuing indirect involvement in the assets."

The significance of that conclusion can be found in paragraph 15c, which states: "Non-economic transactions between a reporting entity and an entity that has no significant ongoing operations other than to hold assets that are primarily for the direct or indirect benefit or use of the reporting entity or its affiliates, shall be recorded at the fair value at the date of the transaction; however, to the extent that the transaction results in a gain, that gain shall be deferred until such time as permanence can be verified."

Questions have arisen as to whether this SSAP No. 25 guidance is required to be applied to transfers that do not meet the sale accounting criteria of SSAP No. 91 (R), *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. An example of a transfer that does not meet the sale accounting criteria would be a RE-REMIC transaction in which the insurance company takes back all of the RE-REMIC securities. Paragraph 5 of SSAP No. 91 (R), mirroring its parallel in FAS 140[11], provides that a **transfer** of a group of financial assets in which the transferor surrenders control over those financial assets shall be accounted for as a sale **to the extent that consideration other than beneficial interests in the transferred assets is received in exchange**. The glossary entry for "transfer" in SSAP No. 91 (R) includes conveying financial assets into a securitization trust.

With respect to measurement, paragraph 6 of SSAP No. 91 (R) provides that upon completion of any transfer of financial assets, the transferor shall allocate the previous carrying amount between (1) the assets sold, **if any**, and (2) the interests that continue to be held by a transferor, if any, based on their relative fair values at the date of transfer and continue to carry in its balance sheet any interest it continues to hold in the transferred assets, including, if applicable, beneficial interests in assets transferred to a QSPE in a securitization. This paragraph is subsequently expanded by paragraph 48 which provides: "Other interests in transferred assets, those that are not part of the proceeds of the transfer, are interests that continue to be held by a transferor over which the transferor has not relinquished control. They shall be measured at the date of the transfer by allocating the previous carrying amount between the assets sold, if any, and the interests that continue to be held by a transferor, based on their relative fair values. That procedure shall be applied to all transfers in which interests continue to be held by the transferor, even those that do not qualify as sales."

7 SSAP No. 97—Investments in SCA Entities. SCA = Subsidiary, Controlled and Affiliated Entities.
8 NAIC: National Association of Insurance Commissioners.
9 NAIC Staff Report: Use of NRSRO Ratings in Regulation, March 10, 2009. www.naic.org/documents/committees_e_rating_agency_comdoc_naic_staff_report_use_of_ratings.doc. Securities rated by one NRSRO (Nationally Recognized Statistical Ratings Organization) are assigned the equivalent NAIC Designation. A security rated and monitored by two NRSROs is assigned the lowest of the two ratings. A security rated by three or more NRSROs is ordered according to their NAIC equivalents and the rating falling second lowest is selected, even if that rating is equal to that of the first lowest.
10 NAIC Securities Valuation Office Special Report *Quantification Of Investment Security Risk*, September 18, 2008. www.naic.org/documents/committees_e_vos_prop_app_quant_sec_risk.pdf.
11 FAS 140: Financial Accounting Standards Board (FASB) Statement No. 140: "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities-a replacement of FASB Statement No. 125."

Lastly, paragraph 37 of SSAP No. 91 (R) reads: "Reporting entities that have qualifying special-purpose entities as affiliates shall carry their investment in such entity at its underlying statutory book value in accordance with SSAP No. 46.[12] Additionally, transactions entered into involving affiliated qualifying special-purpose entities are subject to the provisions of SSAP No. 25."[13]

In summary, it appears that SSAP No. 91 (R) can be the foundation for recognizing the multiple CUSIPS of a RE-REMIC instead of the one underlying CUSIP (without selling 10% and creating a QSPE) for purposes of listing the securities in the detailed investment analysis (Schedule D and Schedule BA) in the annual statement blank. However, SSAP No. 91 (R) does not answer the question of fair value vs. carrying amount for purposes of applying SSAP No. 25.

As of the date of this writing, we have not seen anything from the insurance regulators that addresses whether SSAP No. 25, paragraph 15 would apply in the circumstances in which the only consideration received in exchange for the transferred assets is beneficial interests in those assets. The NAIC Valuation of Securities Task Force is considering this question but, at this date, there has been no public response. Also, we understand that insurance company sponsors of RE-REMIC transactions have discussed their transactions in advance with their applicable state insurance regulator, and have agreed on the statutory and risk-based capital reporting to be afforded the transaction, including in situations where all of the RE-REMIC securities are retained.

What are the federal income tax consequences of sponsoring a RE-REMIC?

Any REMIC regular interest (but not a REMIC residual interest) can be an eligible asset for a RE-REMIC. Certain RMBS (frequently ones issued by some mortgage REITs) that did not elect REMIC status, but rather, were structured as debt-for-tax transactions are not eligible for a RE-REMIC, but can be resecuritized using other tax vehicles.

No tax gain or loss is recognized upon the transfer of the REMIC securities to the RE-REMIC in exchange for RE-REMIC regular or residual interests.[14] Gain or loss is immediately recognized, however, with respect to any of the RE-REMIC securities sold to third parties. The gain or loss is measured by the difference between the net sale proceeds and the allocated tax basis of that sold RE-REMIC class. The allocated tax basis for each class sold is determined by dividing the fair market value of the sold class by the sum of the fair market values of all of the RE-REMIC classes and then multiplying that result by the then-current tax basis of the underlying REMIC securities transferred to the RE-REMIC as increased by organizational costs of the RE-REMIC (e.g., rating agency, trustee, legal, and accounting). This allocation of basis approach is substantially the same as the FAS 140 methodology for recording partial sales as discussed in the U.S. GAAP section that follows. Placement fees are treated as a reduction of the sale proceeds.

Given the current environment, it is common for a loss to be sustained upon the sale or disposition of a RE-REMIC class. For banks, dealers in securities, and certain traders in securities, such as hedge funds electing mark-to-market, a loss on the sale of a RE-REMIC class is as an ordinary loss.[15] For insurance companies and other taxable entities, the loss is treated as a capital loss. A benefit of a REMIC election is that the excess of the adjusted tax basis of each **retained** RE-REMIC regular interest class over the fair value for that class (namely, the unrecognized loss) is allowed as an amortizable, ordinary deduction recognized similarly to the amortization of bond premium under Code Section 171.[16] In the case of a retained RE-REMIC residual interest, such excess is amortized as an ordinary deduction over the anticipated weighted-average life of the RE-REMIC. The two ordinary deductions just discussed are applicable without regard to whether the sponsor is a bank, insurance company, or other taxable entity.[17]

There have been a few resecuritizations done without electing REMIC status for the resecuritization even though the underlying assets were REMIC eligible securities. This debt-for-tax structure avoids the creation of a non-economic REMIC residual interest (NERD), since NERDs often involve the payment of consideration to a third party willing to take on the adverse tax consequences associated with potential phantom income in the RE-REMIC. In a debt-for-tax resecuritization for an onshore entity, maturity or time tranching (e.g., sequential pay) of the debt classes is not permitted; rather, either: (i) a single class of debt is issued and is supported by retained equity or (ii) multiple tranches of debt are issued that pay principal pro rata but absorb realized losses in a non-pro rata prescribed manner.

12 SSAP No. 46, Investments in Subsidiary, Controlled, and Affiliated Entities Sliding Scale Discounting of SCA entities using the Market Valuation approach.
13 SSAP No. 46 was replaced by SSAP No. 88 which in turn was replaced by SSAP No. 97, "Investments in SCA Entities." SCA = Subsidiary, Controlled and Affiliated Entities.
14 Internal Revenue Code §860F(b)(1)(A).
15 Internal Revenue Code §582(c) and Section 475.
16 Internal Revenue Code §860F(b)(1)(D)(i).
17 This analysis does not take into account whether the mark-to-market rules of Section 475 are applicable to the taxpayer.

For tax preparation and other tax services relating to RE-REMIC and other forms of resecuritization transactions, please contact Terry Meyers, Director, Deloitte Tax LLP, +1 410 576 7360; tmeyers@deloitte.com.

How is a RE-REMIC accounted for under U.S. GAAP?

The answer is based on the facts and circumstances of the specific transaction, including structuring considerations for the RE-REMIC and historical accounting for the underlying REMIC investments. To start the analysis, you need to gather the following facts:

- Are the underlying REMIC investments classified as held-to-maturity[18], available-for-sale, or trading?
- What is the amortized cost, fair value, and tax basis of each underlying security, and what is the amount of unrealized loss (gain) for that security included in other comprehensive income in the equity section and its related tax effects?
- If the fair value of an available-for-sale or held-to-maturity security is less than amortized cost, do you have intent to sell the security, or is it more likely than not that you will be required to sell the security before recovery?
- Will the securities be transferred to the RE-REMIC in a manner that will achieve an accounting sale?
- What percentage of the value of the overall securities in the RE-REMIC trust, if any, will be sold to unaffiliated third parties?

QSPE considerations

The applicable accounting pronouncements are FAS 140 dealing with accounting for transfers of financial assets and FIN No. 46R[19] on consolidation of variable -interest entities.[20]

In a typical two-step transfer, a trust is created to hold the underlying securities and, consequently, the transferor has to determine if it has to consolidate the trust for financial reporting purposes. If the trust qualifies as a QSPE pursuant to FAS 140, however, it is not required to be consolidated by the transferor; in fact, it is not permitted to be consolidated even if the transferor wanted to.[21] If the trust does not qualify as a QSPE and the transferor has to consolidate the assets and beneficial interests of the trust, the underlying REMIC assets stay on the transferor's balance sheet and the RE-REMIC securities retained by the transferor are not reflected on its balance sheet since they are eliminated in consolidation.

In situations in which the current holder of the underlying REMIC securities first transfers ownership to a depositor SPE owned by a dealer who in turn transfers the assets to a trust that issues the RE-REMIC securities, it is our view that the original holder of the assets would be considered to be the FAS 140 transferor, not the dealer. We consider it akin to a rent-a-shelf transaction since the dealer is not acting as a principal but merely as an agent to facilitate the transfer.

With one notable possible exception, most RE-REMIC trusts are the classic example of an SPE on "auto-pilot" that would generally meet the conditions to qualify as a QSPE. The assets it holds are passive financial assets, it cannot sell or otherwise dispose of those assets; its beneficial interests are issued at inception and cannot be changed; and its permitted activities are significantly limited and entirely specified in the trust agreement. The possible exception is that at least 10% of the fair value of a QSPE's beneficial interests have to be held by parties other than any transferor, its affiliates, or its agents at all times subsequent to the initial qualification of the QSPE and sale of beneficial interests.[22] If and when the required minimum level of outside beneficial interests is no longer maintained, the transferor is considered to have regained control of the transferred financial assets (provided the conditions for the surrender of control and derecognition, discussed below, were met initially) and, thus, should account for this as a repurchase of such assets.[23] So if the transferor takes back all of the RE-REMIC certificates, the trust is consolidated and the original assets stay on the U.S. GAAP balance sheet.

Note that the 10% threshold is based on fair value, not face (principal) amount. Further note that the 10% has to be sold to **unaffiliated** third parties; so, for example, beneficial interests transferred from a transferor bank to its parent bank holding company would not meet the test. Lastly, if there are multiple groups in the RE-REMIC that are not cross-collateralized in

18 An investment classified as "held-to-maturity" cannot be sold or otherwise disposed of (including in securitizations accounted for as sales, or partial sales, but not including securitizations accounted for as financings) except under certain limited circumstances without risking tainting the rest of the held-to-maturity portfolio, which may have serious consequences. An actual significant downgrade of an HTM security is sufficient cause to be able to sell the security without tainting the rest of the portfolio (but a security placed on watch for possible downgrade is probably not). See Question 23 of FASB Guide to Implementation of Statement 115.
19 "FASB Interpretation No. 46(R), Consolidation of Variable Interest Entities (revised December 2003) - an interpretation of ARB No. 51."
20 See Deloitte publication, Securitization Accounting-The Ins and Outs (And Some Do's and Don'ts) of FASB 140, FIN No. 46R, IAS 39 and More, Seventh Edition. http://www.securitization.net/pdf/Publications/SECAccounting_Jul05.pdf.
21 See later section, "How will the proposed changes to FAS 140 and FIN No. 46R affect the U.S. GAAP treatment?"
22 The 10% at all times requirement is not explicit in FAS 140 but it is explicit in Remarks by David A. Kane, Professional Accounting Fellow at the 2000 National Conference on Current SEC Developments, December 4, 2000. Also, paragraph 36 of FAS 140 provides that the transferor, its affiliates, and agents cannot have the power to unilaterally dissolve a qualifying SPE.
23 Paragraph 55 of FAS 140.

any manner, the 10% threshold would be applied for each group because each group would have to qualify on its own as a QSPE in order not to be consolidated. FIN No. 46R, paragraph 15 describes these discrete portions of entities as *silos*.

There are no requirements as to the mix of beneficial interests that have to be held by third parties. For example, selling a 10% pro rata vertical slice of all classes would suffice and would not fall below 10% on later dates. While selling 10% of the overall value in the form of a first pay sequential tranche could work initially, it would not work much beyond the first distribution date when it is likely that the remaining amount held by third parties would fall below 10%. At that point, however, the transferor could sell some additional holdings of the front pay sequential bonds to meet the 10% threshold. If the transferor sold 10% in the form of a last pay support tranche, the third-party ownership would stay above 10% unless and until there were losses that diminished the value of that tranche.

If greater than zero but less than 10% of the beneficial interests are sold to third parties, the proceeds received are recorded as a collateralized borrowing on the balance sheet.

FAS 140 considerations

To continue with the theme of using a QSPE and selling some and retaining the remainder of the RE-REMIC securities, in FAS 140 parlance the sponsor is seeking a *partial sale*.[24] To achieve that:

a. You need to address the requirements of the rating agencies and the accountants for a legal true sale opinion, or its equivalent and, if the transfer is to an affiliate, a non-substantive consolidation opinion;

b. Each holder of the QSPE's securities should have the unconstrained right to pledge or exchange the securities (subject to normal 144A restrictions); and

c. The transferor and its affiliates can not have the unilateral ability to cause the QSPE to return specific transferred assets, and can not have a call option on the RE-REMIC bonds sold to third parties.

Legal true sale

For entities subject to the U.S. bankruptcy code, a "would level" legal true sale opinion is sought and if the transfer of the underlying assets is to an affiliate, a non-substantive consolidation opinion (i.e., an opinion that the separateness of the entities would be respected by a bankruptcy court) is also sought.[25] Banks and insurance companies, however, are not subject to the bankruptcy code and consequently have different opinion requirements. For banks, an opinion in accordance with the FDIC Securitization Regulation[26] suffices. For insurance companies, the opinion should address the powers that the applicable state insurance department would apply in the event of a conservatorship or liquidation of the insurance company.

A key aspect of the legal true sale analysis in resecuritizations involves what percentage of the resecuritized securities must be sold to third parties. Different law firms have different views, depending on the deal structure. One objective is ensuring that there is economic substance (similar to the 10% held by third parties for a QSPE) and the other is recourse. For the recourse considerations, the concern would be if the transferor retained excessive risk to the assets, including ownership of beneficial interests in the transferee. The other consideration relates to a sole beneficiary of a self-settled trust where no third party holds more than a *de minimis* interest in the trust. The general view appears to be that a seller is required to sell to a third party a minimum of 10% to 15% of the issued securities. In a resecuritization involving multiple senior and subordinate classes where the subordinate securities can be viewed as true equity in the trust (e.g., non-investment grade), the legal opinions typically permit the seller to retain all the investment grade seniors if it sells all the below investment grade and unrated classes.

Some law firms fine tune the analysis if the resecuritization involves "fast pay/slow pay" structures (deals where principal is allocated entirely [or disproportionately] to one class before another). In these arrangements, law firms often insist that a greater percentage (often 15%) of the "fast pay" bonds be sold to third parties, presumably because of their shorter duration. The analysis is often waived if the seller is also a broker dealer (under the theory that the entity is in the business of selling securities of the same kind).

Sometimes, the seller is inclined to retain all of the resecuritized securities, at least initially. In these cases, rating agencies still require a legal opinion. Here, a "springing true sale opinion" is often issued. Such an opinion concludes that in the

24 See Deloitte publication, Securitization Accounting-The Ins and Outs (And Some Do's and Don'ts) of FASB 140, FIN No. 46R, IAS 39 and More, Seventh Edition. http://www.securitization.net/pdf/Publications/SECAccounting_Jul05.pdf.

25 AICPA Auditing Interpretation, The Use of Legal Interpretations as Evidential Matter to Support Management's Assertion That a Transfer of Financial Assets Has Met the Isolation Criteria in Paragraph 9 (a) of Statement of Financial Accounting Standards No.140. [AICPA § AU9336.01-.21].

26 "Treatment by the Federal Deposit Insurance Corporation as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection with a Securitization or Participation" (12 CFR §360.6).

event of a bankruptcy of the Seller, upon a "qualifying sale" (i.e., either the 10% or 15% sale thresholds referred to above), the transfer would be treated as a legal true sale. The rating letter typically references the "springing" arrangement and limits the opinion to the extent (a) the seller retains ownership of all the above-referenced obligations; or (b) the seller sells the threshold percentage of the series to a third party. Importantly, if a sponsor finances a retained security through a repo transaction, law firms usually take the position that so long as the certificate is subject to the repo, it would not be subject to the debtor's bankruptcy estate.

How do you determine gain or loss on sale?

FAS 140 provides that in a partial sale, gain or loss is determined by first allocating the cost basis of the transferred assets between the portions sold and the portions retained based on their relative fair values. The amount of the pre-tax gain or loss is then determined by comparing the net proceeds received on the sold portions to their allocated cost basis determined in the first step.

The effect of this allocation of basis approach is that if there is an existing unrealized loss (excess of carrying cost over fair value) on the underlying REMIC investments prior to the transfer, then the amount of pre-tax loss to be recognized when a portion of the RE-REMIC securities is sold to third parties will approximate the same proportion of the overall value represented by the sold securities. In other words, if 10% of the overall value (not face amount) of the RE-REMIC securities were sold to third parties, a pre-tax loss equal to approximately 10% of the unrealized loss on the underlying REMIC investments would be recognized (but see below for discussion of differing views on recognition of impairments). It is important to know the tax basis of the security as well in order to determine the FAS 109[27] tax effects associated with the loss.

The other consequence of this allocation of basis approach, based on relative fair value, is that the allocated carrying amount of the retained securities as a percentage of their face amount will likely result in premiums on the higher rated securities[28] and discounts on the lower rated securities. Consider this example: An Underlying REMIC has a face amount of $100 and a cost basis of $100. The senior RE-REMIC bond has a face amount of $80 but represents 90% of the overall value of the RE-REMIC. The support RE-REMIC bond has a face amount of $20 but only represents 10% of the overall value of the RE-REMIC. The portion of the asset represented by the senior RE-REMIC bond will be allocated $90 as its cost basis (a dollar price of 112.5% of face) and the portion of the asset represented by the support bond will be allocated $10 as its cost basis (a dollar price of 50% of face). If the RE-REMIC bonds are classified as available-for-sale[29] and there is no intent to sell (and it is not more likely than not that you will be required to sell[30]), the adjustment for the difference between fair value and allocated cost immediately after the transfer is charged to other comprehensive income in the equity section.

The recent FASB Staff Position, FSP FAS No. 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*, says that "if an entity has decided to sell (or it is more likely than not an entity will be required to sell before recovery) a debt security whose fair value is less than its amortized cost[31] at the balance sheet date, it shall recognize in earnings the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date."

If an entity does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security, but the entity does not expect to recover the entire amortized cost basis of the security, the other-than-temporary impairment shall be separated into (a) the amount representing the credit loss and (b) the amount related to all other factors.

It is clear that if there is any **credit** loss anticipated on the underlying REMIC investment, that amount shall be recognized in earnings before any RE-REMIC accounting is done.[32] But what about unrealized losses beyond the anticipated credit losses, if any? Meaning, does the decision to do a RE-REMIC constitute a decision to sell the security, or does it constitute a decision to sell only a portion (or portions) of the security and to retain the other portion(s)?

27 "FASB Statement No. 109, Accounting for Income Taxes."
28 An investment carried at a significant premium will likely be subject to EITF 99-20, as amended by FSP EITF 99-20-1 and applied in accordance with the recent OTTI FSP 115-2 and FAS 124-2.
29 The retained RE-REMIC bonds might instead be classified as held-to-maturity or trading, depending on intent. Also, the investor should consider whether a security includes an embedded derivative instrument pursuant to FAS 133.
30 For example, cash or working capital requirements or contractual or regulatory obligations indicate that the security will be required to be sold before a forecasted recovery occurs.
31 Amortized cost basis includes adjustments made to the cost of an investment for accretion, amortization, collection of cash, previous other-than-temporary impairments recognized in earnings and fair value hedge accounting adjustments.
32 It would be incongruous to conclude that the underlying REMIC security is "money-good" yet create a RE-REMIC support class and in estimating its fair value to conclude that it is probable that there will be a loss of principal or interest with respect to that class. FSP FAS No. 157-4 should also be looked to for guidance on establishing fair values of the RE-REMIC classes retained. An arms-length sale price on classes that are sold will be a useful data point for estimating fair value of classes retained. The sum total of the fair values of the RE-REMIC classes should also be compared to the total fair value of the underlying REMIC securities for overall reasonableness, taking into account transaction costs.

The entity clearly has the intent to sell at least a portion of the underlying security. However, does deciding to execute the RE-REMIC transaction contradict its assertion that it does not intend to sell (has not decided to sell) the portion of the original REMIC that does not get sale accounting and thus receives carryover basis? In other words, what is the unit of account for the "does not intend to sell" assertion—the entire REMIC or a portion of the REMIC? There are two views on this issue, both of which appear to be reasonable interpretations.

View A — Holders of View A believe that the unit of account for purposes of making the intent assertion is the entire original REMIC security. Proponents argue that entities should not be able to make a piecemeal (cash flow-by-cash flow) assertion about a single unit of account. They point to FSP FAS115-1 and FAS124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments* (paragraph 7), which indicates that "impairment shall be assessed at the individual security level; that is, the level and method of aggregation used by the reporting entity to measure realized and unrealized gains and losses on its debt and equity securities."

View B — View B proponents believe that the unit of account for purposes of the intent assertion is complicated by the fact that securities can be securitized under FAS 140 and receive partial sale accounting with carryover basis for the retained interests. Q&A 62 of FAS 140 supports this view, and it applies to securities in both gain and loss positions. They also believe that paragraph 273 of FAS 140 is supportive of this view. Paragraph 273 provides that "retained interests in the transferred assets continue to be assets of the transferor, albeit assets of a different kind, because they never left the possession of the transferor and, thus, a surrender of control cannot have occurred. Therefore, the retained interests should continue to be carried at their allocated previous carrying amount, with no gain or loss recognized." Further, FSP EITF Issue No. 99-20-1, paragraph 8, states that "the objective of an OTTI[33] assessment is to determine whether a **portion** of the unrealized loss will ultimately be realized."

The FASB staff and the SEC staff have been asked to look at this issue but it is unlikely they will provide any formal guidance on the subject since the alternatives will no longer be relevant after the proposed amendments to FAS 140 go into effect, scheduled in 2010. (See next section, "How will the proposed changes to FAS 140 and FIN No. 46R affect the U.S. GAAP treatment?") In the meantime, it is our view that application of either View A or View B is reasonable provided it is consistently applied and disclosed and that if there is any unrecognized impairment of the underlying security relating to credit losses, that impairment must be recognized before doing any accounting for the resecuritization. See the next section, "How will the proposed changes to FAS 140 and FIN No. 46R affect the U.S. GAAP treatment?" for a discussion of the likely resolution of this matter when the amendments to FAS 140 become effective.

Some banks and insurance companies have asked whether a RE-REMIC makes sense in light of the new FSP on OTTI referred to above which can limit the recognized loss and the hit to capital to the amount representing credit losses. Although the hit to regulatory capital can be less than it would have been without the accounting rule change (provided that you do not intend to sell and it is not more likely than not you will be required to sell), if the ratings on the security have been or will likely be downgraded, the risk weighting associated with the underlying investment could move to 200% or even dollar for dollar of its cost basis vs. the risk weightings on retained RE-REMIC securities. But you also have to consider the gain or loss on sale and the effect on capital from doing a RE-REMIC transaction in which some of the securities are sold.

How will the proposed changes to FAS 140 and FIN No. 46R affect the U.S. GAAP treatment?

The proposed amendments to FAS 140 that are expected to be issued in June 2009 could dramatically change the calculation of gain or loss on a RE-REMIC for transactions done after the effective date of the proposed standard. The proposed amendments are scheduled to go into effect on January 1, 2010 for calendar year-end companies. The allocation of basis based on relative fair value approach is being abandoned. Rather, the revised FAS 140 will consider all "retained interests" as if they were newly acquired interests (i.e., proceeds), and accordingly measured at fair value. Consequently, under the proposed amendment, gain or loss on transactions that are afforded sale accounting will be measured by the difference between the net cash proceeds received plus the fair value of any interests obtained compared with the amortized cost basis of the underlying securities making the View A vs. View B debate (described earlier) moot. Accordingly, this accounting change might cause RE-REMIC transactions to be viewed as more appealing in 2009 than in 2010.

The proposed amendments to FIN No. 46R, expected to be issued in June 2009, are scheduled to go into effect on January 1, 2010 for calendar year companies. All existing QSPEs will lose their QSPE status and lose their automatic exemption from consolidation by the transferor and by third-party investors. However, that does not necessarily mean that the entity holding the support class of a RE-REMIC will have to consolidate as the primary beneficiary. The basis for the determination of who is the primary beneficiary (the enterprise that consolidates a variable interest entity) will also undergo dramatic changes. The

33 OTTI: Other-Than-Temporary Impairment.

quantitative test to identify who has the majority of the expected losses or expected residual returns will be abandoned. According to the latest FASB deliberations, in making the determination, you are to consider the entity's purpose and design, including the risks that the entity was designed to create and pass through to its variable interest holders. A variable interest holder will be deemed to have a controlling financial interest if it has **both** *the power* to direct the activities of the variable interest entity that most significantly impacts the entity's economic performance **and** *the right* to receive benefits from the variable interest entity that could potentially be significant to the variable interest entity or the obligation to absorb losses of the entity that could potentially be significant to the variable interest entity.

In a RE-REMIC, the risks that the entity was designed to redistribute and pass through to its variable interest holders are credit risks and to a lesser extent, prepayment or extension risk. Typically, given the nature of the RE-REMIC's assets (passive RMBS), generally none of the holders of the certificates (variable interests) have the power to direct the activities of the RE-REMIC trust in a manner affecting either the credit performance or the prepayment performance. There is no servicer appointed and the trustee has only limited functions to perform. Since no variable interest holder has the power to direct activities that significantly impact the success of the entity (i.e., credit risk and prepayment risk), it is possible that no party will be required to consolidate a RE-REMIC trust.

However, if the final amendments to FIN No. 46R are interpreted to force you to always identify some activity that is being performed (within the confines of the variable interest entity) which **most** significantly impacts the entity's economic performance and determine whether anyone has the sole power to direct that activity, some might suggest that the trustee has the relevant power.[34]

The trustees' duties generally include (i) maintaining a certificate register; (ii) calculating and making the required distributions to certificate holders on each distribution date; (iii) preparing and making available to certificate holders the monthly distribution reports and any other reports required to be delivered by the trustee; (iv) sending a notice to holders of a class of offered certificates when the remaining certificate principal balance of such class of certificates is to be paid on a specified distribution date; (v) performing certain tax administration services for the Trust and (vi) communicating with investors and rating agencies with respect to the offered certificates. Also, the trustee is to use all commercially reasonable efforts to collect all payments due with respect to the underlying certificates and is to follow such normal and customary collection procedures as it deems necessary or desirable.

However, the trustee fees are generally paid up-front (or as part of float) and are for services provided and are subject to cancellation provisions that are customary for such contracts. Additionally, the activities of the trustee may be considered purely ministerial in nature (i.e., they do not have any real impact on credit risk or prepayment risk and therefore should not be considered to represent power to direct activities in the consolidation analysis). Even if one believed the trustee was the party that had the power to significantly impact the performance of the trust, unless the trustee and its related parties also owned certificates that would absorb more than a trivial amount of the entity's losses or receive more than a trivial amount of the entity's returns, the trustee would not be the primary beneficiary.

For those that believe FIN No. 46R requires one to determine some activity being performed that most significantly impacts the performance of an entity, the consolidation challenge might shift to the sponsor or other investors in the trust. That is, the consolidation analysis might turn to the identification of the parties involved in the design of the trust (i.e., on the basis that a party that had an opportunity to establish the contractual arrangements must be the variable interest holder that most significantly impacts the performance of the trust). However, the fact that a party was significantly involved with the design of an entity does not, in isolation, establish that party as the party with the power to direct the activities that most significantly impact the future economic performance of the entity.

Maintaining a significant amount of unaffiliated third-party ownership may still be needed in order to address the question of whether the trust is sufficiently distinct from a holder of substantially all of the beneficial interests. A holder of substantially all of the beneficial interests might be considered to be in a position to control the trust by buying out the small minority interest and then being able to liquidate the entity.

34 The draft FIN No. 46R amendment provides that if a single enterprise has the unilateral ability to exercise kick-out rights to replace the party that otherwise has the power, that enterprise may be considered to be the one with the power. Some securitization agreements include a provision that the holders of certificates evidencing, for example, at least 66 2/3% of the voting rights may, at any time, remove the trustee and appoint a successor trustee without cause.

In summary, it is quite possible that no one will be deemed to have a controlling financial interest and no one would consolidate, but we wait to see the final amendments before it is possible to evaluate the facts and circumstances surrounding any individual transaction.

Accountants' agreed-upon procedures reports

The procedures that we are typically asked to perform with respect to the information included in a RE-REMIC private-placement offering include:

- **Underlying securities and underlying mortgage loans disclosure**
  - We compare data disclosed in the offering document regarding the terms of the underlying securities to source documents, such as print screen images from The Bloomberg Professional service, underlying monthly distribution/remittance reports and underlying prospectus supplements.
  - We compare data on the underlying mortgage loans to either computer readable data files containing the characteristics of the underlying mortgage loans or other source documents. We recompute the related weighted averages, percentages, and ranges.
- **Cash flow modeling procedures**
  - We recompute the percentages in the declining balance ("dec") tables and weighted-average lives of the offered securities based on (i) assumptions, methodologies, and information provided which we do not independently assess; (ii) projections of monthly cash flows of principal and interest reflecting different prepayment scenarios with respect to each underlying security that are provided to us by the placement agent; or (iii) independently recompute such cash flows reflecting different prepayment scenarios by modeling each individual underlying security.

We, of course, can expand or contract the scope of agreed-upon procedures to meet our clients' needs. For agreed-upon procedures transactions support, please contact Jim Jones, Director, Deloitte & Touche LLP, +1 703 251 1330; jimjones@deloitte.com, or Ellen Koo, Senior Manager, Deloitte & Touche LLP, +1 212 436 5359; ekoo@deloitte.com.

Concluding remarks

This article addressed many of the technical accounting, tax, and regulatory aspects of otherwise fairly straightforward RE-REMIC transactions. We tried to draft the article without getting too tangled in the mosaic of differing accounting, tax, and regulatory rules and interpretations, but an understanding of these areas is critical to a successful transaction and we are convinced that the subject matter is not conducive to simple, straightforward commentary. As the industry looks forward to the day when primary issuance of new issue whole loan securitizations overtakes the pace of RE-REMIC activity, we stand ready to help our clients navigate this complex terrain.

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