



Accounting for Loans Held- For-Investment (HFI)

September 15, 2008

Purpose and Content

- **Purpose**
 - **To provide an overview of the accounting pronouncements related to loans Held-for-Investment with an emphasis on the operational examples.**
- **Content**
 - **Overview of HFI Loan Accounting**
 - Key Definitions
 - Key Business and Accounting Transactions
 - **Historical Cost Accounting Model**
 - SFAS 91 – Deferral and Amortization
 - SOP 03-3 – Accounting for Certain Loans Acquired in a Transfer
 - SFAS 114/5 – Specific Reserve for Impaired Loans
 - Accounting for Loan Modifications / Impairments (SFAS 15 and SFAS 91)
 - **Fair Value Accounting Model**
 - Accounting for a Loan under SFAS 159, Fair Value Option

Overview of HFI Loan Accounting

Overview of HFI Loan Accounting

Key Definitions

Held-for-Investment – “a mortgage or non-mortgage loan shall not be classified as a long-term investment unless the entity has both the ability and the intent to hold the loan for the foreseeable future or until maturity.” – SFAS 65 and SOP 01-6

Performing Loan – generally, a loan for which payments of principal and interest are less than 90 days past due

Non-Performing Loan – a loan for which payments of interest and principal are past due by 90 days or more, or at least 90 days of interest payments have been capitalized, refinanced, or delayed by agreement, or payments are less than 90 days overdue, but there are other good reasons to doubt that payments will be made in full

Overview of HFI Loan Accounting

Key Business and Accounting Transactions

Initial Business Event

Origination

3rd Party Purchase

Business Acquisition

Intent Redesignation
HFS to HFI

Investor Repurchases

Consolidation Event – FIN46R

On-Going GAAP Accounting (Excludes P&I Accrual and Cash)

Historical Cost Accounting

SFAS 91 Deferral and Amortization

SOP 03-3 Accounting for Certain Loans in a Transfer

SFAS 5 / 114
Allowance for Loan Losses and Leases

Loan Modifications
(SFAS 15 TDR or SFAS 91)

Fair Value Accounting

SFAS 159 Fair Value Option
(Requires SFAS 157 Adoption)

Reporting & Disclosures

General Ledger

Internal Reporting

External Reporting (10K)

Overview of HFI Loan Accounting

What Accounting Applies under which Circumstances?

Short Answer – It Depends.....

- **Is the loan originated or acquired?**
- **Is the loan performing or non-performing at acquisition or transfer?**
- **What type of loan product?**
 - Residential, Commercial, or Consumer?
 - Is it a Term Loan, Revolving, or Non-Revolving?
- **What are the loan terms?**
 - Fixed vs. Floating?
- **Is the loan impaired at the time of the loan modification?**

SFAS 91 Deferrals and Amortization

SFAS 91

Deferrals and Amortization

- **Deferrals**

- **Permits certain non-refundable fees and costs associated with the lending process to be deferred on the balance sheet as part of the loan balance (both HFI and HFS) – Examples:**
 - Origination Fees
 - Commitment Fees
 - Purchase Premium/Discounts with 3rd party purchases
 - Costs Associated with the Origination Process includes Salaries and Wages, Travel, Legal

- **Amortization**

- **Applies to HFI loans only**
- **Generally requires the deferred amounts to be amortized over the contractual terms of the loan at the loan level**
- **May elect to amortize over the expected life of a homogenous group of loans if an entity can estimate prepayments (usually only applicable to a residential portfolio)**
- **Cease amortization if loans becomes non-performing / non-accrual**

SFAS 91

Example of a Term Loan – Contractual Level Yield

- **Term Loan**
 - **Originates 6/13/2006**
 - **Loan Amount = \$25,800,000**
 - **Product Type – Permanent**
 - **Interest Type – Floating Rate, Interest Only**
 - **Interest Rate – 375 Basis Points over 1 Month LIBOR**
 - **Maturity Date – 6/30/2008**
 - **Amortization Term – 24 months**
 - **Net Fees - \$500,000**
- **Accounting Events**
 - **Loan Origination**
 - Calculate Original Contractual Level Yield Schedule
 - **SFAS 91 Deferral and Amortization**
 - Generate JE for Fee Deferral
 - Commence Monthly Amortization and Generate JE for Amortization

SFAS 91

Example of a Term Loan – Contractual Level Yield

Original Contractual Level Yield Schedule

	Interest Rate	8.9490%	A						
	Monthly IRR	0.835198%	B						
	Net Fees	(500,000.00)							
	Annualized IRR	10.0223780%							
		C	D	E = Prior D * A	F = Prior J * B	G	H	I = Prior I - G	J = D + I
Date	Period	Cash Flows	UPB	Stated Interest	Interest Income	Amortization	Fees	Unam Balance	Carrying Value
6/13/2006	0	(25,300,000.00)	25,800,000.00				(500,000.00)	(500,000.00)	25,300,000.00
7/13/2006	1	192,403.50	25,800,000.00	192,403.5000	211,305.14	18,901.64		(481,098.36)	25,318,901.64
8/13/2006	2	192,403.50	25,800,000.00	192,403.5000	211,463.00	19,059.50		(462,038.86)	25,337,961.14
9/13/2006	3	192,403.50	25,800,000.00	192,403.5000	211,622.19	19,218.69		(442,820.17)	25,357,179.83
10/13/2006	4	192,403.50	25,800,000.00	192,403.5000	211,782.70	19,379.20		(423,440.97)	25,376,559.03
11/13/2006	5	192,403.50	25,800,000.00	192,403.5000	211,944.56	19,541.06		(403,899.91)	25,396,100.09
12/13/2006	6	192,403.50	25,800,000.00	192,403.5000	212,107.76	19,704.26		(384,195.65)	25,415,804.35
1/13/2007	7	192,403.50	25,800,000.00	192,403.5000	212,272.33	19,868.83		(364,326.82)	25,435,673.18
2/13/2007	8	192,403.50	25,800,000.00	192,403.5000	212,438.28	20,034.78		(344,292.04)	25,455,707.96
3/13/2007	9	192,403.50	25,800,000.00	192,403.5000	212,605.61	20,202.11		(324,089.93)	25,475,910.07
4/13/2007	10	192,403.50	25,800,000.00	192,403.5000	212,774.33	20,370.83		(303,719.10)	25,496,280.90
5/13/2007	11	192,403.50	25,800,000.00	192,403.5000	212,944.47	20,540.97		(283,178.13)	25,516,821.87
6/13/2007	12	192,403.50	25,800,000.00	192,403.5000	213,116.03	20,712.53		(262,465.60)	25,537,534.40
7/13/2007	13	192,403.50	25,800,000.00	192,403.5000	213,289.02	20,885.52		(241,580.08)	25,558,419.92
8/13/2007	14	192,403.50	25,800,000.00	192,403.5000	213,463.46	21,059.96		(220,520.12)	25,579,479.88
9/13/2007	15	192,403.50	25,800,000.00	192,403.5000	213,639.35	21,235.85		(199,284.28)	25,600,715.72
10/13/2007	16	192,403.50	25,800,000.00	192,403.5000	213,816.71	21,413.21		(177,871.07)	25,622,128.93
11/13/2007	17	192,403.50	25,800,000.00	192,403.5000	213,995.55	21,592.05		(156,279.01)	25,643,720.99
12/13/2007	18	192,403.50	25,800,000.00	192,403.5000	214,175.89	21,772.39		(134,506.63)	25,665,493.37
1/13/2008	19	192,403.50	25,800,000.00	192,403.5000	214,357.73	21,954.23		(112,552.40)	25,687,447.60
2/13/2008	20	192,403.50	25,800,000.00	192,403.5000	214,541.09	22,137.59		(90,414.80)	25,709,585.20
3/13/2008	21	192,403.50	25,800,000.00	192,403.5000	214,725.99	22,322.49		(68,092.32)	25,731,907.68
4/13/2008	22	192,403.50	25,800,000.00	192,403.5000	214,912.42	22,508.92		(45,583.40)	25,754,416.60
5/13/2008	23	192,403.50	25,800,000.00	192,403.5000	215,100.42	22,696.92		(22,886.48)	25,777,113.52
6/13/2008	24	25,992,403.50	-	192,403.5000	215,289.98	22,886.48		(0.00)	(0.00)

SFAS 91

Example of a Term Loan – Contractual Level Yield

Journal Entries – June 2006

Account	Debit	Credits
UPB	\$25,800,000	
Fee Clearing		\$500,000
Cash		\$25,300,000

<To record origination of UPB, collection of an origination fee and disbursement of cash to fund the loan>

Account	Debit	Credits
Fee Clearing	\$500,000	
SFAS 91 Deferred Fees		\$500,000

<To record reclassification of fee collected to deferred fee account on balance sheet>

Account	Debit	Credits
SFAS 91 Deferred Fees	\$18,901.45	
Amortization/Accretion P&L		\$18,901.45

<To record 1st month of amortization / accretion>

SFAS 91

Example of a Term Loan – cont... with a Curtailment

- **Term Loan**
 - A curtailment payment is received in month 3 (September 2006) for \$250,000 versus the expected monthly payment of \$192,425
- **Accounting Events**
 - **Adjustment to Interest Income and Maintain Level Yield**
 - Two approaches acceptable under SFAS 91 – Q&A #54
 1. Adjust the remaining term (i.e. shorter due to the curtailment)
 2. Keep the term the same but change the remaining payments

Period	Cash Flows	UPB	Stated Interest	Principal Paydown	Interest Income	Amortization	Unam Balance	Carrying Value	Carrying Amount with Contractual Level Yield	Adjustment due to Curtailment
0	(25,300,000.00)	25,800,000.00					(500,000.00)	25,300,000.00		
1	192,425.00	25,800,000.00	192,425.0000	-	211,326.45	18,901.45	(481,098.55)	25,318,901.45		
2	192,425.00	25,800,000.00	192,425.0000	-	211,484.33	19,059.33	(462,039.22)	25,337,960.78		
3	250,000.00	25,742,425.00	192,425.0000	57,575.0000	211,643.53	19,218.53	(442,820.69)	25,299,604.31	\$25,300,592.50	\$988.19

NPV of Remaining Cash Flows discounted at the original contractual level yield

SFAS 91

Example of a Term Loan – cont... with a Curtailment

Period	Cash Flows	UPB	Stated Interest	Principal Paydown	Interest Income	Amortization	Unam Balance	Carrying Value	Contractual Level Yield
0	(25,300,000.00)	25,800,000.00					(500,000.00)	25,300,000.00	
1	192,425.00	25,800,000.00	192,425.0000	-	211,326.45	18,901.45	(481,098.55)	25,318,901.45	0.008352824
2	192,425.00	25,800,000.00	192,425.0000	-	211,484.33	19,059.33	(462,039.22)	25,337,960.78	0.008352824
3	250,000.00	25,742,425.00	192,425.0000	57,575.0000	212,631.72	20,206.72	(441,832.50)	25,300,592.50	0.008391824
4	191,995.59	25,742,425.00	191,995.5865	-	211,331.40	19,335.81	(422,496.69)	25,319,928.31	0.008352824
5	191,995.59	25,742,425.00	191,995.5865	-	211,492.91	19,497.32	(402,999.37)	25,339,425.63	0.008352824
6	191,995.59	25,742,425.00	191,995.5865	-	211,655.76	19,660.18	(383,339.19)	25,359,085.81	0.008352824
7	191,995.59	25,742,425.00	191,995.5865	-	211,819.98	19,824.40	(363,514.80)	25,378,910.20	0.008352824
8	191,995.59	25,742,425.00	191,995.5865	-	211,985.57	19,989.99	(343,524.81)	25,398,900.19	0.008352824
9	191,995.59	25,742,425.00	191,995.5865	-	212,152.54	20,156.96	(323,367.85)	25,419,057.15	0.008352824
10	191,995.59	25,742,425.00	191,995.5865	-	212,320.91	20,325.33	(303,042.53)	25,439,382.47	0.008352824
11	191,995.59	25,742,425.00	191,995.5865	-	212,490.69	20,495.10	(282,547.43)	25,459,877.57	0.008352824
12	191,995.59	25,742,425.00	191,995.5865	-	212,661.88	20,666.29	(261,881.13)	25,480,543.87	0.008352824
13	191,995.59	25,742,425.00	191,995.5865	-	212,834.50	20,838.91	(241,042.22)	25,501,382.78	0.008352824
14	191,995.59	25,742,425.00	191,995.5865	-	213,008.56	21,012.98	(220,029.24)	25,522,395.76	0.008352824
15	191,995.59	25,742,425.00	191,995.5865	-	213,184.08	21,188.50	(198,840.75)	25,543,584.25	0.008352824
16	191,995.59	25,742,425.00	191,995.5865	-	213,361.07	21,365.48	(177,475.27)	25,564,949.73	0.008352824
17	191,995.59	25,742,425.00	191,995.5865	-	213,539.53	21,543.94	(155,931.33)	25,586,493.67	0.008352824
18	191,995.59	25,742,425.00	191,995.5865	-	213,719.48	21,723.89	(134,207.43)	25,608,217.57	0.008352824
19	191,995.59	25,742,425.00	191,995.5865	-	213,900.94	21,905.35	(112,302.08)	25,630,122.92	0.008352824
20	191,995.59	25,742,425.00	191,995.5865	-	214,083.91	22,088.32	(90,213.76)	25,652,211.24	0.008352824
21	191,995.59	25,742,425.00	191,995.5865	-	214,268.41	22,272.82	(67,940.94)	25,674,484.06	0.008352824
22	191,995.59	25,742,425.00	191,995.5865	-	214,454.45	22,458.86	(45,482.08)	25,696,942.92	0.008352824
23	191,995.59	25,742,425.00	191,995.5865	-	214,642.04	22,646.46	(22,835.62)	25,719,589.38	0.008352824
24	25,934,420.59	-	191,995.5865	25,742,425.0000	214,831.21	22,835.62	(0.00)	(0.00)	0.008352824

Adjustment to Interest Income in the month of curtailment

Remaining Months maintain original contractual level yield

Account	Debit	Credits
SFAS 91 Deferred Fees	\$20,206.72	
Amortization/Accretion P&L		\$20,206.72

<To record September 2006 amortization / accretion>

SOP 03-3 Accounting for Certain Loans Acquired in a Transfer

SOP 03-3

Accounting for Certain Loans Acquired in a Transfer

- **Scope**

- **Out-of-Scope**

- Mortgage loans held-for-sale (HFS) ¹
 - Originated loans
 - Loans that are retained interests
 - Revolving lines of credit (so long as the revolving feature was in effect when the loan was originated)
 - ADC loans (acquisition, development, and construction arrangements)

- **In-Scope**

- HFI loans
 - HFS Non-Mortgage Loans
 - Loans accounted for as a sale by the seller under SFAS 140 with a deterioration of credit quality since their origination are subject to SOP 03-3 by the purchaser
 - Loans acquired in a business combination
 - Loans written down to fair value in anticipation of a spin-off

¹ Excludes HFS Mortgage Loans due to GAAP Hierarchy of SFAS 65 over SOP 03-3. SFAS 65 par. 5 states “purchase discounts on mortgage loans shall not be amortized as interest revenue during the period the loans are held-for-sale”

SOP 03-3

Accounting for Certain Loans Acquired in a Transfer

- **Measurement**

- Record loan at fair value on purchase date with no recognition of loan loss allowance
- Calculate initial effective yield based on the expected cash flows at purchase and the fair value at purchase
- Effective yield can be increased (never decrease) and applied prospectively if the NPV calculated based on the current expected cash flows discounted at the existing effective yield is higher than the current recorded investment
- Any difference between the expected cash flow of a loan and the purchase price is defined as the “Accretable Yield” (basically the estimated discount)
- “Non-Accretable Difference” is the amount not considered collectible and equals the undiscounted total contractual payments less both the purchase price and the accretable yield (or more simply, the contractual payments less the expected cash flows)
- Purchaser accretes the accretable yield by recognizing income using the interest method
- Recognize impairment losses or impairment loss reversals when expected cash flows in subsequent periods’ change as compared to the original expected cash flows at acquisition (i.e., expect cash flows could decrease or increase)
- Typically must book adjustments related to the cash and accruals recorded in general ledger which are generally posted from the servicing systems based on contractual cash flows.

SOP 03-3

Example of SOP 03-3 Accretion and Subsequent Impairment

- **Acquisition of an Impaired Loan**
 - **Purchase Date – 1/31/2007**
 - **Purchase Price – 88.235%**
 - **Loan Amount = \$5,100,000**
 - **Product Type – Commercial**
 - **Interest Type – Fixed**
 - **Interest Rate – 12%**
 - **Maturity Date – 6/30/2007**
 - **Remaining Terms – 5 months**
 - **Payment Term – P&I**
 - **Accrual – Non-Accrual (Credit Deteriorated at Purchase)**
- **Accounting Events**
 - **Purchase Date**
 - Record FV at purchase
 - Establish Day 1 Initial Yield, Non-Accrutable and Accrutable Difference
 - **On-Going**
 - February 2007 Monthly Accruals / Accretion
 - Revised Estimated Cash Flows on 2/28/2007 resulting in an Impairment

SOP 03-3

Example of a Purchased Loan with Credit Deterioration

Day 1 SOP 03-3 Accretion Yield, Accretable and Non-Accretable Difference

	A	B	C	D = A-B	E = B-C	F
Period	Contractual Payment (P&I)	Expected Cash Flow (P&I)	Carrying Value	Non Accretable Difference	Accretable Difference	Monthly Yield (Based on Expected Cash Flows)
Initial Outflow		(\$4,500,000)				
2/28/2007	\$1,050,803	\$920,000				
3/31/2007	\$1,050,803	\$920,000				
4/30/2007	\$1,050,803	\$920,000				
5/31/2007	\$1,050,803	\$920,000				
6/30/2007	\$1,050,803	\$920,000				
Total	\$5,254,015	\$4,600,000	\$4,500,000	\$654,015	\$100,000	0.74% (8.8% annual)

Day 1 Purchase at Fair Value

Account	Debit	Credits
UPB	\$5,100,000	
Fair Value Adjustment – SOP 03-3		\$600,000
Cash		\$4,500,000

<To record purchase of SOP 03-3 loan at fair value>

SOP 03-3

Example of a Purchased Loan with Credit Deterioration

Day 1 SOP 03-3 Accretion Schedule

Period	Expected Cash Flows	SOP 03-3 Accretion		
		Accretion	Loan Balance Reduction	Carrying Value
1/31/2007	(\$4,500,000)			\$4,500,000
2/28/2007	\$920,000	\$33,171	\$886,829	\$3,613,171
3/31/2007	\$920,000	\$26,634	\$893,366	\$2,719,805
4/30/2007	\$920,000	\$20,049	\$899,951	\$1,819,853
5/31/2007	\$920,000	\$13,415	\$906,585	\$913,268
6/30/2007	\$920,000	\$6,732	\$913,268	0
		\$100,000		

SOP 03-3

Example of a Purchased Loan with Credit Deterioration

2/28/2007 – Interest Accrual and Principal Paydown Adjustments

Servicing System Entries			SOP 03-3 Accretion Schedule			SOP 03-3 Adjusting Entries	
A	B	C	D	E= C-D	F= D+E	G= D-A	H= E-B
Interest	Principal	Total Payment	Interest	Principal	Total Payment	Interest Adjustment	Principal Adjustment
\$51,000	\$869,000	\$920,000	\$33,171	\$886,829	\$920,000	(\$17,829)	\$17,829

Account	Debit	Credits
Interest Receivable	\$51,000	
Interest Income		\$51,000
Cash	\$920,000	
Interest Receivable		\$51,000
Loan Receivable		\$869,000
Interest Income– SOP 03-3 Adjustment	\$17,829	
Interest Receivable		\$17,829
Interest Receivable	\$17,829	
Loan Receivable		\$17,829

<To record monthly accrual from servicing system and interest and loan receivable adjustments for SOP 03-3>

SOP 03-3

Example of a Purchased Loan with Credit Deterioration

2/28/2007 – Revised Month-End Estimated Cash Flows for Impairment Evaluation

Remaining Periods	Expected Cash Flows
Month 1	\$918,000
Month 2	\$918,000
Month 3	\$918,000
Month 4	\$918,000
Total	\$3,672,000
Discount Rate	0.74%
New NPV	\$3,605,316
Recorded Investment	\$3,613,171
SOP 03-3 Impairment	(\$7,855)

Account	Debit	Credits
Provision for Loan Losses	\$7,855	
SOP 03-3 Impairment		\$7,855

<To record monthly impairment for SOP 03-3 based on revised estimated cash flows>

SOP 03-3

Example of a Purchased Loan with Credit Deterioration

Revised SOP 03-3 Accretion Schedule

Period	Expected Cash Flows	SOP 03-3 Accretion		
		Accretion	Loan Balance Reduction	Carrying Value
2/28/2007				\$3,605,316
3/31/2007	\$918,000	\$26,576	\$891,424	\$2,713,892
4/30/2007	\$918,000	\$20,005	\$897,995	\$1,815,897
5/31/2007	\$918,000	\$13,386	\$904,614	\$911,283
6/30/2007	\$918,000	\$6,717	\$911,283	0
		\$66,684		

Accretable Difference Rollforward Schedule

Beginning Balance	Accretion	Reclassification	Expected Ending Balance	Ending Balance	Difference
\$100,000	(\$33,171)	(145) *	\$66,684	\$66,684	\$0

* *Reclassification of accretable to non-accretable due to a reduction in estimated cash flows*

SFAS 5 / 114 Allowance for Loan Losses and Leases

SFAS 5 / 114

Allowance for Loan Losses and Leases (ALLL)

- **Only for HFI Loans**
- **Loan is either reserved under SFAS 114 or SFAS 5 – mutually exclusive (EITF Topic D-80)**
- **Incurred Loss Model not an Expected Loss Model**
- **Charge off a Loan when deemed not collectible (SOP 01-6)**
- **Recoveries of a Loan only when cash is received (SOP 01-6)**

SFAS 5 / 114

Allowance for Loan Losses and Leases

- **SFAS 5 – General Reserve**
 - Loss is probable AND can be reasonably estimated
- **SFAS 5 – Reserve Analysis**
 - Based on Historical Loss Experience related to a similar group of loans
 - Use Risk Ratings (i.e., PD, LGD, and EAD)
 - Additional Qualitative Factors used to adjust reserves (Changes in Credit Concentrations, Lending Policies, Risk Selection)
- **SFAS 114 – Accounting for Impaired Loans (Specific Reserve)**
 - *“...probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement”*
 - Troubled Debt Restructuring is an impaired loan subject to SFAS 114
 - Loans with unique characteristics evaluated on a loan by loan basis
- **SFAS 114 – Measurement of Impairment**
 - Present value of expected cash flows discounted at the loan’s original effective interest rate
 - Observable market value of the loan
 - The fair value of the underlying collateral value if the loan is “collateral dependent”

Accounting for Loan Modifications – SFAS 15 or SFAS 91?

Loan Modifications

SFAS 15 TDR and SFAS 91 Major vs. Minor

- **SFAS 15 Troubled Debt Restructuring (TDR)**
 - **Creditor grants a concession AND the borrower is experiencing financial difficulties for either economic or legal reasons (EITF 02-4)**
 - **Three Types of TDRs**
 - Receipt of Assets in Full Satisfaction of the Loan (SFAS 15 par. 28-29)
 - *Recognize a gain or loss on TDR*
 - Receipt of Assets in Partial Satisfaction of the Loan (SFAS 15 par. 33)
 - *Reduce recorded investment by Fair Value less Cost to Sell Assets*
 - Loan Modification (Reduce Interest Rate, Extension of Maturity, Reduction in Accrued Interest)
 - *Measure Impairment under SFAS 114*
- **SFAS 91 Major vs. Minor**
 - **Must be a modification that is NOT part of the original loan agreement**
 - **Determine whether the modification is a “Major” or “Minor” modification (EITF 01-7)**
 - Substantial Test (NPV Test)
 - Average Yield Test
 - Both Tests must “pass” the criteria for a Major Modification
 - **Minor Modification = Carry over unamortized deferred balances – modified loan**
 - **Major Modification = Recognize unamortized balance in P&L – new loan**

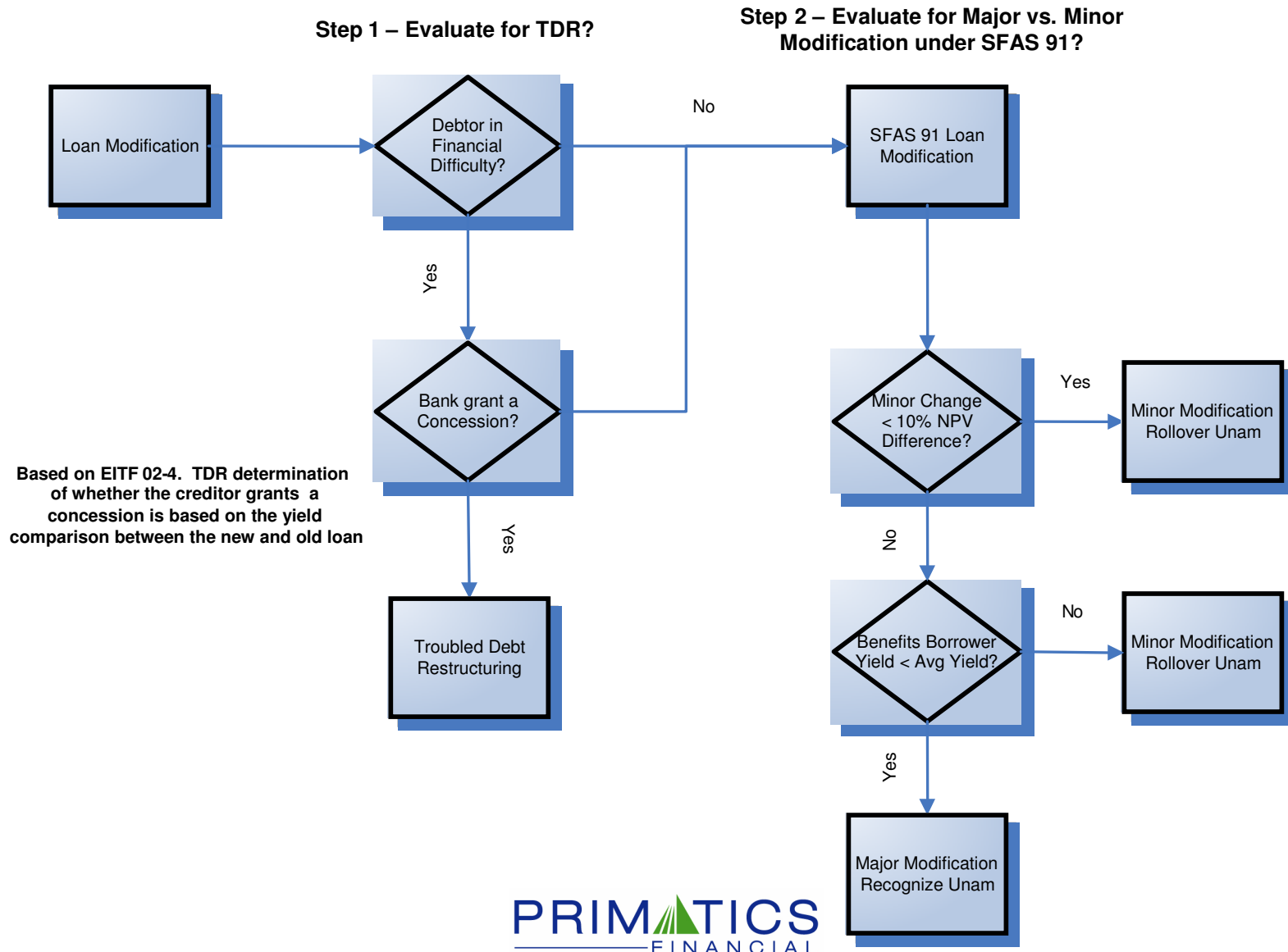
SFAS 91

SFAS 91 Major vs. Minor Modification

- **Substantial Test (NPV Test) – EITF 01-7 and EITF 96-19**
 - Compares the cash flows under the modified contract with the remaining cash flows of the original contract.
 - If the difference between the modified contract NPV and the original contract is less than 10%, the test “fails” for a substantial change
 - If the difference between the modified contract NPV and the original contract is greater than or equal to 10%, the test “passes” for a substantial change
- **Average Yield Test**
 - Compare the new loan yield to average yield with those of comparable new loan originations
 - Group loans by type and credit rating to ensure reasonable comparison of yields
 - Calculate a 3-month rolling average yield for newly originated loans
 - If the modified contract yield is less than the average yield, then the test “fails”
 - If the modified contract yield is greater than or equal than the average yield, then the test “passes”
- **Major Modification occurs when both the Substantial Test and Average Yield Test BOTH Pass otherwise the result is a Minor Modification**

Loan Modifications

Decision Overview – Is it a TDR or SFAS 91



SFAS 15 TDR

Example of TDR Assessment – continuation of SOP 03-3 example

- **3/1/2007 – Restructure Loan**
 - **Loan Amount = \$4,231,000**
 - **Payment Schedule – IO and Balloon at Maturity**
 - **Interest Rate – 7%**
 - **Maturity Date – 2/29/2008**
 - **New Modification Fee – \$2,000**
 - **Assume return to accrual after restructuring**
- **Accounting Events**
 - **Restructuring Date**
 - Determine if TDR applies
 - Measure TDR for impairment, if any

SFAS 15 TDR

Example of TDR Assessment – continuation of SOP 03-3 example

- **Is it TDR?**
 - Borrower in Financial Difficulty – Yes (Loan is Non-Accrual)
 - Is a Concession Granted? = Yes – see below

Pre Mod Recorded Investment \$3,613,171

Date	Contractual Interest	Contractual Principal	Cash Flows	UPB	Pre-Mod Contractual Yield
Initial Outflow			(\$3,613,171)	\$4,231,000	
3/31/2007	\$42,310	\$1,042,015	\$1,084,325	\$3,188,985	
4/30/2007	\$31,890	\$1,052,435	\$1,084,325	\$2,136,549	
5/31/2007	\$21,365	\$1,062,960	\$1,084,325	\$1,073,589	
6/30/2007	\$10,736	\$1,073,589	\$1,084,325	\$0	7.7%

SFAS 15 TDR

Example of TDR Assessment – continuation of SOP 03-3 example

Post Mod Recorded Investment \$3,611,171 (includes \$2,000 Modification Fee)

Period	Date	Contractual Interest	Contractual Principal	Total Payment	UPB	Modified Contractual Yield
0	Initial Outflow			(3,611,171)	4,231,000	
1	3/31/2007	24,681	0	24,681	4,231,000	
2	4/30/2007	24,681	-	24,681	4,231,000	
3	5/31/2007	24,681	-	24,681	4,231,000	
4	6/30/2007	24,681	-	24,681	4,231,000	
5	7/31/2007	24,681	-	24,681	4,231,000	
6	8/31/2007	24,681	-	24,681	4,231,000	
7	9/30/2007	24,681	-	24,681	4,231,000	
8	10/31/2007	24,681	-	24,681	4,231,000	
9	11/30/2007	24,681	-	24,681	4,231,000	
10	12/31/2007	24,681	-	24,681	4,231,000	
11	1/31/2008	24,681	-	24,681	4,231,000	
12	2/29/2008	24,681	4,231,000	4,255,681	-	1.97%

Modified Contractual Yield of 1.97% is less than the original contractual yield 7.7% resulting in a concession by the creditor

TDR = YES

SFAS 15 TDR

Example of TDR Assessment – continuation of SOP 03-3 example

- **Measurement of TDR Impairment**
 - Use NPV Test
 - Compare NPV against Recorded Investment
 - NPV is calculated using the effective yield carried at the SOP 03-3 loan before the TDR to discount the contractual cash flows of the new loan – (0.74%)

TDR Impairment Calculation

NPV	Recorded Investment	Impairment
\$4,162,488	\$3,611,171	\$0

Post TDR Carrying Value Calculation

UPB	FV Adj. Carry Over	SOP 03-3 Carry Over	TDR Deferred Fee	Ending Carrying Value
\$4,231,000	(\$600,000)	(\$17,829)	(\$2,000)	\$3,611,171

SFAS 91 Modification Analysis

Example of Mod Assessment – continuation of SFAS 91 example

- **12/31/2006 – Modify Loan**
 - **Decrease Interest Rate to 8.50%**
 - **New Modification Fee – \$200,000**
 - **Loan is on accrual and borrower is not in financial difficulty**
- **Accounting Events**
 - **Restructuring Date**
 - Determine if modification is minor or major based on NPV and Average Yield Tests

SFAS 91 Modification Analysis

Example of Mod Assessment – continuation of SFAS 91 example

- **NPV Test**

- Is NPV change at least 10%

Pre Mod NPV	\$25,415,803
Post Mod NPV	\$25,054,736
Change in NPV	(\$361,068)
Change % in NPV	(1.42%)
NPV Test Results	Failed

- **Average Yield Test**

- Is Modified Loan Yield at least equal to or higher than average yield

Modified Loan Yield	9.05%
Average Loan Yield	10.00%
Average Yield Test Results	Failed

- **SFAS 91 Mod = Minor**

- Carry over unam of (\$384,197) and additional mod fee (\$200,000)
- Calculate new effective yield prospectively = 10.1335%

Accounting for Loans under the Fair Value Option – SFAS 159

SFAS 159

Accounting for Loans under the Fair Value Option

- **Overview**

- Option to Elect Fair Value (Irrevocable) for certain assets and liabilities including whole loans– requires adoption of SFAS 157
- Reduces the need for complex hedge accounting
- Achieves greater convergence with International Accounting Standards

- **Disclosures (Balance Sheet)**

- Management's reasons for electing FV option for each item or group
- Aggregated differences between FV and unpaid principal balances relating to loans
- Aggregated FV and principal value of loans > 90 days past due

- **Disclosures (Income Statement)**

- Gains/Losses attributable to changes in FV including method and determination and changes in credit risk of loans
- Methodology of measurement of interest and dividends and where the amounts are recorded
- If interest income is recognized separately from other changes in FV, the aggregate fair value of loans on nonaccrual status

SFAS 159

Example of HFI Loan under Fair Value Option – use SFAS 91 example

- **Term Loan**
 - **Originates 6/13/2006**
 - **Loan Amount = \$25,800,000**
 - **Product Type – Permanent**
 - **Interest Type – Floating Rate, Interest Only**
 - **Interest Rate – 375 Basis Points over 1 Month LIBOR**
 - **Maturity Date – 6/30/2008**
 - **Amortization Term – 24 months**
 - **Net Fees - \$500,000 (\$1,500,000 Fees and \$1,000,000 Costs)**
 - **Assume Fair Value is \$25,000,000 at 6/30/2006**
 - **Assume Fair Value is \$25,300,000 at 7/31/2006 (no principal payments)**
- **Accounting Events**
 - **Loan Origination**
 - Record Loan at FV
 - **Subsequent Measurement**
 - Fair Value Mark-to-Market

SFAS 159

Example of HFI Loan under Fair Value Option – use SFAS 91 example

Journal Entries

Account	Debit	Credits
UPB	\$25,800,000	
Expenses	\$1,000,000	
Fee Income		\$1,500,000
Cash		\$25,300,000

<To record origination of UPB, collection of an origination fee and disbursement of cash to fund the loan>

Account	Debit	Credits
FV M-t-M Gain/Loss	\$800,000	
UPB Fair Value Adjustment		\$800,000

<To record fair value mark-to-market – self reversing – June 2006>

Account	Debit	Credits
FV M-t-M Gain/Loss	\$300,000	
UPB Fair Value Adjustment		\$300,000

<To record fair value mark-to-market – self reversing – July 2006>

SFAS 159

Example of HFI Loan under Fair Value Option – use SFAS 91 example

- **Impact of Fair Value Option**

- Increase in Expenses of \$1,000,000
- Increase in Fee Revenue of \$1,500,000
- Increase in gain/loss due to mark-to-market (\$300,000)
- Increased volatility for loans that elect FVO

Questions ?

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