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MEMORANDUM FOR: CHIEF EXECUTIVE OFFICERS

FROM:

Richard M. Riccobono

SUBJECT:

Certain Transfers of "Higher-Risk" Assets

Summary: Some savings associations may have transferred, or are contemplating a transfer of, "higher-risk" assets, including nonperforming loans, to entities or parties outside of the savings association, in a transaction where the transferor both 1.) retains significant credit risk in the transferred assets, and 2.) unlike typical securitization transactions, often provides substantial funding to the transferee. As such transfers may be motivated by favorable regulatory reporting treatment, but lack economic substance or a sound business purpose, they raise supervisory concerns. Accordingly, if such transfers have been made, or are being contemplated, please contact your regional office.

Background

In recent months, there have been stories in the news media about companies that transferred assets to an outside entity, and then aggressively accounted for such transfers as sales. For example, in at least one of these cases, it was a banking organization that transferred troubled loans to a special purpose entity (SPE). The organization retained significant credit risk in the transferred assets, and provided substantial funding to the SPE. The organization accounted for the transfer as a sale. As a result, the transferred assets were removed from its balance sheet. In addition, reported earnings were not reduced for subsequent declines in the fair value of the transferred assets that were held for sale, and those assets were not included in the organization's reported nonperforming assets. That accounting treatment was eventually reversed, as it was deemed inappropriate.

More specifically in this arrangement, the organization provided substantial financing to the SPE in the form of preferred stock; while a third party investor provided a significantly smaller portion of the financing. The organization's return on its investment in the SPE is dependent on the proceeds from the eventual sale of the transferred assets to unaffiliated third parties (other than the third party investor).

The removal of the transferred assets from the balance sheet was dependent on not consolidating the financial statements of the SPE with those of the organization. Conversely, if the SPE were consolidated, then after elimination entries, the transferred assets would remain on the organization's consolidated balance sheet.

The organization initially took the position that nonconsolidation of the SPE was consistent with generally accepted accounting principles (GAAP), as 1.) the organization did not have a controlling interest in the SPE, and 2.) the third party investor had a substantive equity investment. After this arrangement was brought to the attention of certain users of the financial statements, the organization reversed its accounting treatment. The organization ultimately concluded that the transfer did not meet the requirements for sale and nonconsolidation treatment under GAAP.

Guidance

Some savings associations may have transferred, or are contemplating a transfer of, higher-risk assets to outside parties, in a transaction where the transferor both 1.) retains significant credit risk in the transferred assets, and 2.) unlike typical securitization transactions, may provide substantial funding to the transferee. Examples of “higher-risk” assets include, but are not limited to, performing subprime loans, nonperforming or otherwise troubled loans, repossessed assets, and subordinate interests in securitized financial assets (including residual interests). Examples of transferees include, but are not limited to, holding companies, affiliates, or SPEs. As such transfers may be motivated by favorable regulatory reporting treatment, but lack a sound business purpose, these transactions raise supervisory concerns; that is, both safety and soundness concerns, and regulatory reporting concerns.

With respect to safety and soundness concerns, these transactions may be based on legal form, rather than economic substance. This is especially true where the transaction results in decreased earnings and liquidity, and an increase in operational risk, with no reduction in credit risk.

With respect to regulatory reporting concerns, we expect that the accounting and reporting treatment for such transfers 1.) will reflect the economic substance, and 2.) be consistent with GAAP and regulatory reporting instructions. If not appropriately accounted for, the transaction could result in 1.) an understatement of reported nonperforming assets, and 2.) an overstatement of reported earnings and capital.

Accordingly, if such transfers have been made, or are contemplated, please contact your regional office.