Litigation Related to Subprime Mortgages: A Review of Accounting Concepts

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Of the top 10 subprime originators in 2006, all are facing borrower class actions, four are facing securities lawsuits, five are facing contract claims, and seven are facing employee class actions, bankruptcy-related filings or other litigation. These include the biggest names in the business.

While many of the 278 subprime lawsuits filed in 2007 were brought on behalf of consumers, 44 percent are contract claims and securities cases. Mortgage lenders, national commercial banks, federally chartered savings institutions and securities brokers are the biggest targets. In the securities cases, directors and officers are named in 80 percent of the suits; in securities fraud class action cases, that number jumps to 97 percent.

In addition to the alleged civil wrongdoing, 14 companies allegedly connected to the subprime mortgage crisis are under investigation, among them those that bundled the loans and the banks that invested in the securities. The FBI is looking into allegations of fraud.

In some cases, accounting and financial officers will be involved in the defense of the decisions their institutions made leading up to these lawsuits. Most accountants would agree that the accounting for the origination of a prime, nonsecuritized mortgage loan is fairly straightforward. The same is not true for the securitization of mortgages after the origination of a mortgage loan. It is those subsequent transactions—and the attendant lending and underwriting decisions—that began the drama that is ending in litigation in courtrooms around the country.

Many of these lawsuits are directed at underwriting practices of mortgage lenders, as well as their accounting estimates in specific areas. Among other things, the lawsuits allege that the lenders failed to appropriately account for the assets and liabilities associated with the mortgage loans they underwrote and securitized or sold to third parties. Defending against these allegations depends in part on how lenders arrived at their accounting estimates and whether they can demonstrate good-faith efforts were made to determine those estimates based on information available at the time.

As defendants examine their roles, it may be helpful to look at the elements that go into determining certain of these estimates, including the following:

- Loan-loss reserves
- Valuations of mortgage-servicing rights (MSRs)
- Valuations of residual interests
- Repurchase obligations

Each will be examined both from the plaintiffs' and the defendants' points of view.

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Loan-Loss Reserves: When Should They Have Been Established and Increased?

One of the most contentious accounting areas is whether loan originators were sufficiently prudent—and prompt—in establishing loan-loss reserves for the loans they held for investment. Many of the subprime-related lawsuits contain allegations related to inadequate estimation, understatement and underreporting of loan-loss reserves. Such lawsuits charge that lenders failed to record impairment charges for mortgage portfolios in a timely fashion.

It can be difficult to determine the triggering or obligating event for the establishment of a loan-loss reserve. Generally accepted accounting principles (GAAP) specify only that the loss needs to be probable and estimable. While models can predict that a certain percentage of a certain kind of loan will go into delinquency over a certain period of time, no one can know the day upon which a specific loan will go into default or foreclosure—or if a specific kind of loan, even a subprime loan, will actually default—and what proceeds will be generated from the sale of the underlying collateral.

According to many plaintiffs, a loan-loss reserve should have been established on the day each loan was originated. After all, lenders knew that at some future date they would incur losses on certain loans, especially loans to nonprime borrowers. Add to the mix mortgage loans justified via allegedly poor underwriting procedures, and you have a volatile stew, plaintiffs claim.

But plaintiffs' claims may not reflect accounting reality. GAAP requires that a loan-loss reserve be set up when it becomes probable a loan will default and a reasonable estimate of the loss can be determined. In this regard, according to the Financial Accounting Standards Board (FASB) Staff Implementation Guidance, *Application of FASB Statements 5 and 114 to a Loan Portfolio*, "Losses should not be recognized before it is probable that they have been incurred, even though it may be probable based on past experience that losses will be incurred in the future. It is inappropriate to consider possible or expected future trends that may lead to additional losses."

The significant increase in the rate of loan delinquencies and defaults that occurred during 2007 combined with the dramatic decline in real estate prices prompted a number of lenders to sharply increase their loan-loss reserves in response to these events. Plaintiffs have raised questions about the propriety of the estimates and assumptions used by mortgage lenders to arrive at the loan-loss reserves reported in prior periods.

Under these circumstances, mortgage lenders should demonstrate that they had made good-faith efforts to arrive at their previously established loan-loss reserves based on information that was available at the time, employing reasonable estimates supported by appropriate evidence—preferably both internal and external sources that provide objective support for the assumptions used to arrive at the estimated loan-loss reserves. Also, they should establish that they had applied a systematic methodology to determine their loan-loss reserves that included a detailed analysis of their loan portfolio, taking into consideration, for example, known relevant internal and external factors and current collateral values.

MSRs: Were They Valued Properly?

Mortgage-servicing companies handle the operational aspects of mortgage lending, including collecting and processing mortgage loan payments and establishing escrow accounts for the payment of taxes. The servicing company is also responsible for managing loss mitigation when a loan goes into delinquency or default. For these services, the servicing companies are paid a fee typically based on the unpaid principal balance of the mortgage loans themselves. MSRs typically originate when servicing is retained by the transferor in a transfer of mortgage loans that meets the requirements for sale accounting. For example, the transfer of the servicer's mortgage loans to a qualifying special-purpose entity that would be accounted for as a sale.

MSRs ordinarily are valued using models that calculate the present value of the expected cash flows, taking into consideration both future inflows of servicing revenues the servicing company expects to receive and future outflows of servicing costs it expects to incur. This valuation process often results in the recognition of a servicing asset in the balance sheet upon a securitization transaction that qualifies for sale accounting treatment, although it is possible for a servicing company to recognize a servicing liability if the estimated future servicing revenues are insufficient to adequately compensate them for performing the servicing. Servicing companies can also acquire MSRs from other companies.

The amount and timing of cash flows that are used to value MSRs are projected based on a number of assumptions, including prepayment speeds, delinquency and default rates, cost of servicing and discount rates, among other assumptions. Based on this data, the fair value of MSRs is calculated. If more loans prepay than initially assumed (and thereby more revenue streams are adversely affected), these realities are reflected in the balance sheet and statement of operations by way of impairment charges or reductions in the value of the MSRs.

Mortgage lenders should demonstrate that they had made good-faith efforts to arrive at their previously established loan-loss reserve.

According to many plaintiffs, the assumptions in the cash flow models used to value the MSRs were flawed from the start. Plaintiffs claim the servicing companies should have used more aggressive assumptions regarding prepayment speeds and default rates from the outset. They believe corporate accountants overvalued the MSRs and could have made keener assumptions about prepayment speeds and default rates and done so sooner—say, at the time the loans were securitized. By using inappropriate assumptions, the initial gain on sale of the mortgage loans and earnings were overstated, they claim.

But each class of loan has certain prepayment speeds associated with it. The assumptions used in the cash flow models need to be reasonable and supportable and consistent with assumptions used by other market participants valuing similar MSRs. Because assumptions used by other market participants may not always be available, servicing companies often use their own historical experience as a basis for developing the assumptions used in the cash flow models. More (or less) aggressive model assumptions are appropriate when actual results prove to be inconsistent with modeled results. Therefore, it is reasonable and appropriate for servicing companies to update these assumptions periodically as actual experience and market conditions change.

Lenders who are the targets of litigation should ask themselves: Was the MSR valuation methodology appropriate? Were assumptions used in the cash flow models reasonable and fairly consistent with assumptions used by other market participants for similar MSRs—to the extent available? Were model assumptions reviewed and updated periodically to reflect the company's experience with its loan portfolio and current market conditions, particularly prepayment speeds and discount rates? Did the company document contemporaneously its periodic review of the model assumptions? Did the company use relevant information that was reasonably available at the time, for example, comparisons to recent trades of comparable MSRs and peer comparisons?

Residual Interests: Were They Valued Properly?

Residual interests are assets reported in the balance sheet of the lender-transferor that represent interests retained in transferred mortgage loans following a securitization qualifying for sale accounting treatment. These interests essentially represent the transferor's right to any cash remaining in the securitization trust after all other investors in the securitization have been paid their principal and interest and after all of the trust's expenses have been paid. They are the most subordinated claim (equity) in a pool of securitized assets.

For many residual interests, no active market exists from which a market value can be readily obtained. As a result, lenders typically estimate the fair value of retained interests based on the present value of the expected future cash flows, taking into consideration expected prepayment speeds, credit losses and discount rates, among other assumptions.

Many plaintiffs are asserting that the residual interests established on the day the loans were securitized were overstated and, therefore, the gain on sale of the mortgage loans and earnings were overstated as well. They further claim that the ongoing valuation of residual interests was also overstated and that the defendants failed to take impairment charges on a timely basis.

The valuation of residual interests takes into consideration various subjective assumptions regarding the cash flows that are expected to be generated by the mortgage loans in the trust, including, for example, expected loan prepayments, default rates and losses suffered from the defaults (or loss severity). Furthermore, market events can affect the discount rates that are used to arrive at the present value of future cash flows, as well as the performance of the loans supporting the residual interests. Due to the subjectivity associated with these assumptions, a number of plaintiffs have challenged the valuation of residual interests.

Consequently, lender-defendants should ask themselves: Was the valuation methodology appropriate in the circumstances? Were the assumptions reasonable and did they reflect (or were they consistent with) market information available at the time? Were assumptions reviewed and updated periodically to reflect current market conditions? Were periodic reviews of assumptions documented contemporaneously? Did the company use relevant information that was reasonably available at the time to arrive at the assumptions?

Repurchase Obligations: Were the Repurchase Liabilities Properly Set?

Loan sales can occur in two ways: whole loan sales and securitizations that qualify for sale accounting treatment. In a whole loan sale, the loans are sold to a third party and taken off the originator's books. In a securitization accounted for as a sale, the loans are also taken off the books, but the accounting for the transaction is more complex.

For both loan sales and securitizations, the transferor of the loans may retain liabilities in the transaction for representations and warranties made about the loans (for example, that the loans won't default within a certain period of a time, the loans comply with relevant loan criteria determined by the buyer or the loans comply with applicable laws). Should the loans not live up to those representations and warranties, the transferor may be required to repurchase them from the buyer at the original selling price. Because the market value of the loans on the date of repurchase may be less than the original selling price, the transferor will effectively record a loss on the date of repurchase.

The liability for representations and warranties established on the date of sale should be sufficient to absorb such future losses. In addition, the repurchase price may also include foregone interest for the period the buyer held the loan and any premium (or portion thereof) originally paid by the buyer. To calculate the potential future losses and expenses associated with such repurchases, transferors often consider their historical experience with repurchase claims, claims refutation rates and repurchase losses and expenses, among other things.

Plaintiffs have alleged that balance-sheet liabilities established on the day the loans were sold were insufficient to cover potential losses and expenses associated with the future repurchases of such loans. As a result, the gain on sale of the mortgage loans and earnings were overstated.

From the perspective of the preparer of the financial statements, the determination of liabilities for representations and warranties takes into consideration a number of subjective assumptions, including the expected number of loans that will actually be repurchased in the future and related losses and expenses to be incurred upon repurchase.

Defendants should ask themselves: Did assumptions used to estimate the liability reflect the company's current experience in repurchase claims and refutation rates? Did the assumptions take into consideration current market conditions known at the time? Were expected loss and expense assumptions reasonable and appropriate based on the information that was available at the time the assumptions were made?

Contemporaneous Documentation: The Best Defense

With bank failures tied to subprime mortgages, anyone even remotely involved with subprime mortgages should be looking at what role they played—especially financial statement preparers.

As the number of lawsuits increases, defendants should conduct investigations to determine if the events that dramatically altered the carrying value of these assets and liabilities were out of their control. Many of the accounting issues being challenged in these lawsuits involve accounting estimates. Because they are estimates, they almost always differ from actual results. Sometimes these differences can be dramatic if future events differ materially from the assumptions used to arrive at these estimates.

Subsequent events do not necessarily provide evidence regarding fair-value measurements and assumptions as of the balance-sheet date. Some subsequent events reflect changes in circumstances or market conditions that occur after the balance-sheet date and, therefore, do not constitute evidence available at the balance-sheet date.

Some write-downs and changes in estimates resulted from events that couldn't have been predicted by defendants. Valuations change as a result of market conditions all the time. Courts will rule against plaintiffs who cannot show evidence that defendants ignored market information when these assets and liabilities were valued. The best defense against subprime lawsuits is internal and external contemporaneous documentation supporting critical accounting estimates and assumptions.