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Scandal: Subprime Meltdown, Securitization Accounting

Since January 2006, scores of subprime mortgage lenders have failed. As major lenders like New Century Financial file for bankruptcy, banking regulators and lawmakers alike have questioned the wisdom of those companies' lending practices. While the outcome of this crisis could have important practical consequences for credit-impaired borrowers, the recent subprime "meltdown" could also generate the next big round of corporate accounting scandals.

On March 27, Securities and Exchange Commission Chairman Christopher Cox informed Congress that the commission's division of enforcement has assembled a 25-person "working group" to examine the subprime industry. New Century also has reported that federal authorities are investigating its accounting practices.[1] These are unsettling developments given the way in which many lenders report the paper gains they receive from securitizing their loans and selling mortgage-backed securities—a required practice criticized by some as "Enron accounting."[2] The value of those gains is determined by estimating future loan performance. As borrowers default in record numbers, investors and regulators are likely to ask whether the critical accounting estimates used by lenders to calculate their gains were reasonable in the first instance.[3]

Whatever may follow, this is not the first crisis of its kind. In 1998 and 1999, the subprime industry experienced similar problems in the wake of the Russian and Asian debt crises. Then, as now, changes in loan performance had a dramatic impact on the value of assets retained by lenders following securitization. And then, as now, lenders unable to function in the absence of a ready market for their loans were forced to close their doors.

The Securitization Cycle

Widespread securitization of subprime mortgages began in earnest in the early 1990s and accelerated rapidly throughout the mid-1990s. While every lender is different, most subprime lenders confront similar challenges with respect to securitization accounting.

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Historically, subprime lenders have not held most of their loans for long-term investment. Instead, to grow and secure the funds necessary to their operations, lenders have depended on their ability to securitize and sell their loans in the form of mortgage-backed securities. Cash received from securitization is in turn used to pay down revolving lines of credit and underwrite new loans. The up-front proceeds from securitization are considerable, but many lenders also recognize a sizable "residual" interest reflecting the difference between the interest collected from borrowers over the life of their loans and the rates paid to investors in mortgage-backed securities. It is this basic practice that has caused so much difficulty over the past decade.

For many lenders, these residual assets represent substantial value. New Century's 10-Q for the third quarter of 2006 reported residual assets valued at $224 million.[4] Because reporting such assets up-front rather than when interest payments are actually received from borrowers necessarily accelerates revenue recognition, so-called "gain-on-sale" accounting has been much criticized. Some lenders have attempted to avoid that criticism by adjusting their accounting assumptions to negate gain and track actual cash flows. Nonetheless, FASB 140 and other accounting rules require that lenders report the "fair value" of residual interests at the time of sale. Indeed, the SEC cautioned lenders in the late 1990s that gain-on-sale accounting is mandatory, and that negating such gain is improper.[5]

Perils of Prognostication

In order to carry their residual assets at "fair value," lenders typically make a series of critical assumptions about the future performance of their loans. Interest rate movements, shifts in the housing market, and changes in loan collections (also called "servicing") can all impact those assumptions. Though evaluating their appropriateness is a task best left to accounting experts, the following is an overview of some of the basic assumptions that many lenders make when valuing residual assets.

First, lenders typically estimate the rates at which their loans will "prepay." Prepayments may occur voluntarily, such as through refinancing, or involuntarily through foreclosure. Either way, prepayment cuts short the interest paid to the lender—and with it, a portion of the lender's retained interest. Prepayment rates do not remain constant over time and are directly affected by interest rates. For example, declining interest rates may increase the likelihood of voluntary prepayments, especially where housing values are increasing and competing lenders are facilitating refinancing.

Second, subprime lenders typically assess the losses to be experienced over the lifetime of their loans. Loan losses are a function of both loss frequency and loss severity. Losses can be affected by overall market conditions, the quality of collateral, the effectiveness of lenders' servicing operations, and other variables. Where defaults are rapidly increasing alongside a decline in housing values, losses can increase dramatically. Similarly, disruptions in lenders' servicing efforts or their disposal of foreclosed property can have a dramatic impact on losses.

Third, many subprime lenders discount the value of their retained assets to present value in order to reflect the timing of future cash flows and the fact that their retained interests are subject to a certain amount of risk. Lenders have used various discount rates

over time, and the particular risks anticipated by their discounting vary. There is no liquid market for the residual assets themselves, making the question of discounting ripe for disagreement.

Lenders like New Century describe the risks associated with these assumptions at great length in their public filings, and for good reason. Predicting future loan performance necessarily involves estimation, and a significant spike in prepayments or loan losses can cause tens or even hundreds of millions of dollars in paper assets to vanish. For example, lender Countrywide Financial recently announced $155 million of impairment charges against its subprime residual interests.

Lessons of the 1990s

Disclosures and cautionary language aside, the worry for lenders, their executives, accountants, underwriters, and anyone else involved with the securitization process is that lenders' financial problems could also trigger rampant second-guessing of their original estimates. As time passes, the recent surge in defaults that caught the entire industry flat-footed may come to be seen as a foregone conclusion that should have been anticipated.

The events of the late 1990s are instructive. Like the current crisis, the run-up to the crisis of the late 1990s was marked by exuberance and expansion. In 1998 and 1999, however, the market for subprime lenders' securities collapsed as investors made skittish by the Asian and Russian debt crises sought comfort in higher quality investments. Lenders simultaneously experienced an unanticipated spike in prepayments. As prepayments surged and lenders found themselves unable to issue mortgage-backed securities at favorable rates, companies like Citiscape Financial, Southern Pacific Funding, ContiFinancial, and United Companies Financial Corporation reported dramatic writedowns in their retained assets or were forced to shut down.

Analysts attributed these events to a financial crisis of overseas origins—one that also claimed hedge fund giant Long-Term Capital Management. Nonetheless, many blamed the companies and their professionals for this collapse. Shareholders sued companies like Southern Pacific Funding, ContiFinancial, and their executives for securities fraud, while litigating trustees for both of those companies sued auditing firms for allowing the reporting of inflated residuals.[6]

United Companies' bankruptcy trustee sued the company's outside auditors following a $605 million write-down of the company's residual assets, alleging that the auditors were to blame.[7]

These cases were eventually resolved, but similar recriminations appear to be in the offing. In addition to disclosing pending federal investigations, New Century has reported that independent counsel is reviewing that company's valuation of residual assets.[8] Shareholders have already filed multiple lawsuits, accusing New Century and its executives of securities fraud.[9]

Similar lawsuits have been filed against lenders NovaStar and Accredited Home Lenders, and the 2005 collapse of American Business Financial Services has spawned litigation against multiple financial institutions and former executives for purportedly facilitating that company's booking of more than $500 million in illusory gains.[10]

As borrowers default in record numbers, investors and regulators are likely to ask whether the critical accounting estimates used by lenders to calculate their gains were reasonable in the first instance.

Massachusetts securities regulators recently issued subpoenas to Bear Stearns & Co. and UBS Securities in connection with their analysts' coverage of subprime lenders. In late March, accounting firm Grant Thornton resigned as outside auditor to Accredited Home Lenders Holding and Fremont General after advising those companies of the need to expand the scope of its audits.[11]

And multiple lawsuits have been filed by financial institutions arising out of lenders' obligations to repurchase underperforming loans.[12] While the issues presented by those repurchase cases are distinct, they may well implicate many of the very same questions of loan performance relevant to securitization accounting.

In litigating such claims, lenders' business practices and the parallel efforts undertaken by independent third parties to predict the performance of loans—analysts, monoline insurers, and ratings agencies among them—will necessarily be relevant. For example, analysts periodically perform quantitative analyses regarding many of the same variables considered by lenders when making their gain-on-sale estimates. Their work product may be of some assistance when addressing criticism regarding the reasonableness of lenders' assumptions.

Likewise, counsel should be sensitive to the potentially significant impact that changes in lenders' underwriting standards, loan-to-value ratios, or loan servicing and "loss mitigation" practices can have on the value of retained assets. Lesser quality loans are typically more likely to default, and lenders' failure to react to defaults in a timely manner can have a dramatic impact on loan-related losses.

Ironically, subprime lenders now face a liquidity crisis similar to that confronting many borrowers. On paper, these lenders may have substantial assets. However, by relying upon their ability to securitize their loans to generate the funds necessary to pay down revolving lines of credit and continue underwriting new loans, many lenders are extremely vulnerable to short-term disruptions in their ability to sell their loans on favorable terms. Cash-poor and confronted by demands for higher interest rates by purchasers of mortgage-backed securities, these companies face serious difficulties when the market for those securities dries up.

It remains unclear who will bear the blame for today's subprime crisis. Lenders and their executives may seek to blame accountants and outside professionals. Accounting firms and underwriters might blame management. Shareholders and their counsel could blame all of the above. The only certain outcome here is that there will be plenty of finger-pointing to go around.

1. See New Century Financial Corp., Notification of Late Filing (Form 12b-25) (March 2, 2007).

2. See Whispers, Asset Securitization Rep., April 9, 2007.

3. Subprime defaults spiked to 13.3 percent in the fourth quarter of 2006, a four-year high. See Shannon D. Harrington, Investors Absorb Worst of Subprime Rout, Markets Show (March 23, 2007), available at http://www.bloomberg.com/apps/news?pid=20601170&sid=atuMCA1ImLrI&refer=home.

4. See New Century Financial Corp., Quarterly Report (10-Q), at 1, 14 (Nov. 9, 2006).

5. Jane Adams, deputy chief accountant, SEC Office of the Chief Accountant, remarks at 17th Annual SEC and Financial Reporting Institute Conference (May 14, 1998), available at sec.gov//news/speech/speecharchive/1998/spch215.htm.

6. See *In re ContiFinancial Corp. Sec. Litig.*, No. 99-cv-10941-LAP (S.D.N.Y.); *In re Southern Pacific Funding Corp. Sec. Litig.*, No. CV98-1239-MA (D. Or.); *Beck v. Arthur Andersen*, No. 00 B 12184 (AJG) (Bankr. S.D.N.Y.); *Beck v. KPMG*, No. 01-03253-elp (Bankr. D. Or.).

7. See *Hays v. Deloitte & Touche* (19th Judicial District Court, La.). The author represented the defendant in that case while at a previous firm.

8. See New Century Financial Corp., Notification of Late Filing (Form 12b-25) (March 2, 2007).

9. Id.

10. See *Miller v. Santilli*, No. 06-3587 (E.D. Pa.).

11. See Floyd Norris, Grant Thornton Resigns as Fremont's Auditor, N.Y. Times, April 3, 2007, at C9.

12. See, e.g., *DLJ Mortgage Capital v. Right-Away Mortgage*, No. 07-cv-2781 (S.D.N.Y.); *DLJ Mortgage Capital Inc. v. Sunset Direct Lending*, No. 07-cv-1418 (S.D.N.Y.); *UBS Real Estate Sec., Inc. v. New Century Mortgage Corp.*, No. 07-50875 (Bankr. D. Del.); see also Beth Bar, Litigation Just Starting in Subprime Meltdown, NYLJ, April 12, 2007, at 5 (collecting other cases).

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