



Loan Modifications

Current Programs and the Accounting Considerations

MBA's Accounting, Tax and Financial Analysis Conference
November 2009

Today's Presenters

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Agenda

- **Loan Modifications – Current Programs**
 - **Home Affordable Modification Plan (HAMP)**
- **Refresher on Accounting for Mortgage Loans**
- **On-Balance Sheet Loan Modification Accounting**
- **Off-Balance Sheet Loan Modification Impact**
- **Accounting Issues: HAMP**
- **Modifying SOP 03-3 Loans**

Unprecedented Environment

Japan's Economy, World's Second Largest. Is in Recession

Anatomy of the Morgan Stanley Panic

The Wall Street Journal – November 24, 2008

ie Suspend Foreclosures

Obama's Economic Stimulus May Top \$700 Billion as Paulson Maps New Program

Bloomberg, November 24

Go... Shares Tumble Below Their I.P.O. Price

The New York Times, November 20

Battered Wall Street Lost 16,000 Jobs in October

The New York Times, November 20

JPMorgan Set to Cut Investment Banking

market gets even weaker

CNN, November 24

Pledges Exceed \$7.4 Trillion to Rescue of Companies With Frozen Credit

Bloomberg, November 20

Goldman, Morgan Stanley Squeeze Exchanges With

November 20

Awaiting Reaction to 3rd Try at Bailout

The New York Times, November 24, 2008

Dow Jones industrials soar more than 500 points in late-day rally

Canadian Business - Nov 21

Dow Jones falls 400 points

BizJournals - Nov 20

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BANKS

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Mon Mar 17

First month recession, Q4 looks rough

Paulson Content to Let Bailout Play Out

American Banker - November 20

M&A Wave Seen Unlikely as Tarp Awards Multiply

Banker - November 20

Hartford to Get \$2.5 Billion from Allianz

The Wall Street Journal Online - Tue Oct 7

Madoff Investors Race to the Courthouse

Fortune - Thurs, December 18, 2008

Loan Modifications: Current Programs

Summary – Home Affordable Modification Program

Homeowner Affordability and Stability Plan (HASP)

Mortgage Refinancing:

- Targets borrowers with solid repayment history but decreasing home values
- Focused solely on a home's value, the program offers relief in the form of eligibility to refinance regardless of the LTV
- Only conforming loans owned or those guaranteed by Fannie Mae and Freddie Mac may be refinanced through those two institutions (other agencies plan to adopt similar plans).
- Establishes a \$10 million reserve to offset subsequent losses

Loan Modification:

- Targets borrowers near the brink of losing their home due to various financial constraints
- Centered on reducing a borrower's monthly payment to avoid foreclosure through interest rate reductions and other means to reduce DTI to 31 percent
- Borrowers not currently delinquent but at risk of imminent default (recent loss of job, anticipated payment increases, etc.) must be evaluated.
- Recipients of FSP assistance are required to participate; regulatory agencies encourage all lenders/servicers to participate.
- Compliance with program requirements will be independently reviewed by Freddie Mac

Incentives:

- Borrower
- Lender/Servicer
- Investor
- Reduction to 31 percent verified debt-to-income and reduction of principal for borrowers for remaining current (up to \$5,000) payment
- Lender/servicer incentives from \$500–\$1,500, annual pay for success incentives, and government cost sharing of reduced payments
- Investors can receive a \$1,500 one-time current borrower incentive for offering modification prior to delinquency.

Key Challenges

- Role of a Servicer
 - Loan population identification - in-depth integrated default management strategy
 - Training - one of the bigger issues are human error
- Program Complexity
 - National Standard for loan modifications?
 - Non GSE Investors
- Program Effectiveness
 - Post modification monitoring, testing and reporting - denied modifications
- Risk to Servicers
 - Fraud – future litigation
 - Quality Control and like control functions
 - Accounting and tax ramifications of the loan modifications
- Systems / Business Analysis
- Underwriting Culture
 - New guidelines require more of an "originations / underwriting" approach
 - Documentation standards - Freddie Mac audits of loan modifications

Making Home Affordable Program

Making Home Affordable Program

Servicer Performance Report Through September 2009

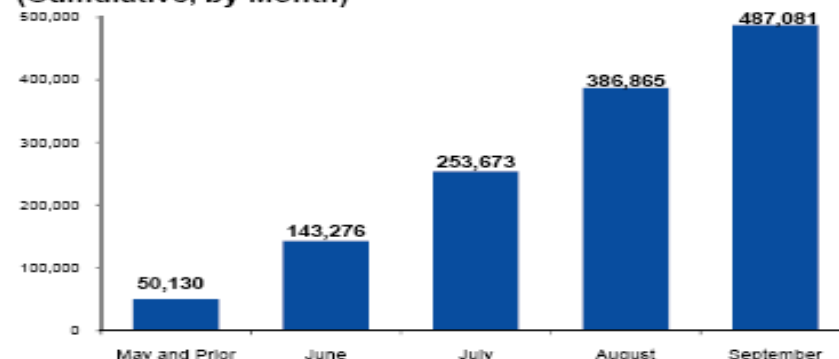
Home Affordable Modification Program (HAMP) Snapshot through September 2009

Number of Trial Modifications ¹	487,081
Number of Trial Period Plan Offers Extended to Borrowers (Cumulative) ²	757,955
Number of Requests for Financial Information Sent to Borrowers (Cumulative) ²	2,484,783

¹ Trial and permanent modifications as of September 30; based on numbers reported by servicers to the HAMP system of record.

² Source: Survey data provided by servicers, through October 1.

HAMP Trial Modifications (Cumulative, by Month)



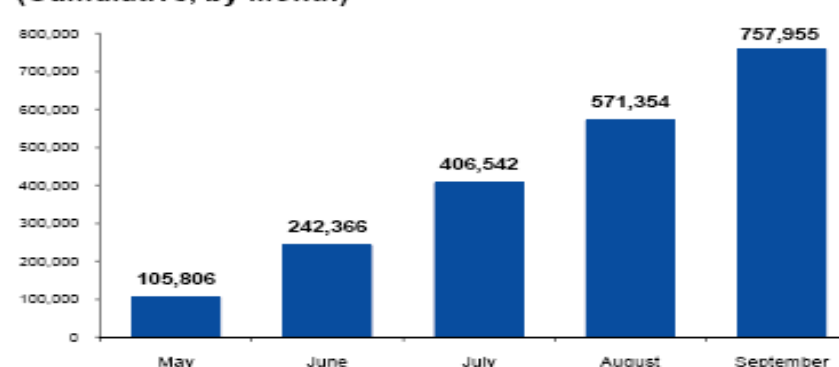
Source: Trial and permanent modifications as of September 30; based on numbers reported by servicers to the HAMP system of record.

HAMP Participating Servicers

- Approximately 85% of eligible 60-plus day delinquent mortgage debt outstanding is covered by HAMP participating servicers.
- 63 servicers have signed servicer participation agreements to modify loans under HAMP. These participants service loans owned or guaranteed by Fannie Mae or Freddie Mac, loans held in portfolio, or loans serviced on behalf of other investors.
- Approximately 2,300 participants service loans owned or guaranteed by Fannie Mae or Freddie Mac. These servicers automatically participate in HAMP.

Additional information on HAMP can be found on MakingHomeAffordable.gov or by calling the Homeowner's HOPE Hotline at 1-888-995-HOPE (4673).

HAMP Trial Plans Extended to Borrowers (Cumulative, by Month)



Source: Survey data provided by servicers. September data includes October 1.

Making Home Affordable Program

Making Home Affordable Program

Servicer Performance Report Through September 2009

HAMP Modification Activity by Servicer

Servicer	Participation Date	Estimated Eligible 90+ Day Delinquency ¹	Trial Plan Offers Extended	Trial Plan Offers as Share of Estimated Eligible 90+ Day Delinquencies	Trial Modifications Started ²	Trial Modifications as Share of Estimated Eligible 90+ Day Delinquencies
American Home Mortgage Servicing Inc	7/22/09	114,272	6,817	6%	440	0%
Aurora Loan Services, LLC	5/1/09	72,912	37,831	52%	23,869	33%
Bank of America, NA ³	4/17/09	875,917	156,120	18%	94,918	11%
Bayview Loan Servicing, LLC	7/1/09	8,987	2,158	24%	196	2%
Carrington Mortgage Services LLC	4/27/09	17,149	1,584	9%	584	3%
CCO Mortgage	6/17/09	4,648	879	19%	158	3%
CitiMortgage, Inc.	4/13/09	208,427	88,472	42%	68,248	33%
Franklin Credit Management Corporation	9/11/09	2,635	0	0%	NA ⁴	NA
GMAC Mortgage, Inc.	4/13/09	73,498	31,720	43%	19,331	26%
Green Tree Servicing LLC	4/24/09	4,114	810	20%	474	12%
HomeEq Servicing	8/5/09	39,934	444	1%	0	0%
Home Loan Services, Inc.	4/20/09	45,822	279	1%	26	0%
J.P. Morgan Chase Bank, NA ⁴	4/13/09	437,652	163,617	37%	117,196	27%
Litton Loan Servicing LP	8/12/09	107,341	13,567	13%	2,229	2%
MorEquity, Inc.	7/17/09	2,244	11	0%	0	0%
National City Bank	6/26/09	40,582	9,267	23%	3,845	9%
Nationstar Mortgage LLC	5/28/09	29,846	16,974	57%	8,413	28%
Ocwen Financial Corporation, Inc.	4/16/09	68,088	10,650	16%	5,193	8%
OneWest Bank	8/28/09	109,222	23,017	21%	5,217	5%
Residential Credit Solutions	6/12/09	1,831	364	20%	313	17%
RG Mortgage Corporation	6/17/09	3,473	173	5%	64	2%
Saxon Mortgage Services, Inc.	4/13/09	79,921	38,332	48%	32,931	41%
Select Portfolio Servicing	4/13/09	60,848	32,024	53%	15,706	26%
US Bank NA	9/9/09	28,356	6,925	24%	863	3%
Wachovia Mortgage, FSB ⁵	7/1/09	75,074	2,896	4%	2,019	3%
Wells Fargo Bank, NA	4/13/09	310,716	106,427	34%	62,989	20%
Wilshire Credit Corporation	4/20/09	29,153	6,412	22%	2,929	10%
Other SPA servicers ⁶	--	4,684	185	4%	102	2%
Other GSE Servicers ⁷	--	242,959	NA	NA	18,808	8%
Total		3,100,305	757,955	24%	487,081	16%

¹ Estimated eligible 60+ day delinquent mortgages as of August 31, 2009 include loans:

- in foreclosure and bankruptcy;
- with a current unpaid principal balance less than \$729,750 on a one-unit property, \$934,200 on a two-unit property, \$1,129,250 on a three-unit property and \$1,403,400 on a four-unit property;
- on a property that was owner-occupied at origination;
- originated prior to January 1, 2009.

Estimated eligible 60+ day delinquent loans excludes:

- FHA and VA loans;
- loans that are current or less than 90 days delinquent, which may be eligible for HAMP if a borrower is in imminent default.

² Trial and permanent modifications as reported into the HAMP system of record.

³ Bank of America, NA includes Countrywide Home Loans Servicing LP.

⁴ J.P. Morgan Chase Bank, NA includes EMC Mortgage Corporation.

⁵ Wachovia Mortgage FSB includes Wachovia Bank NA.

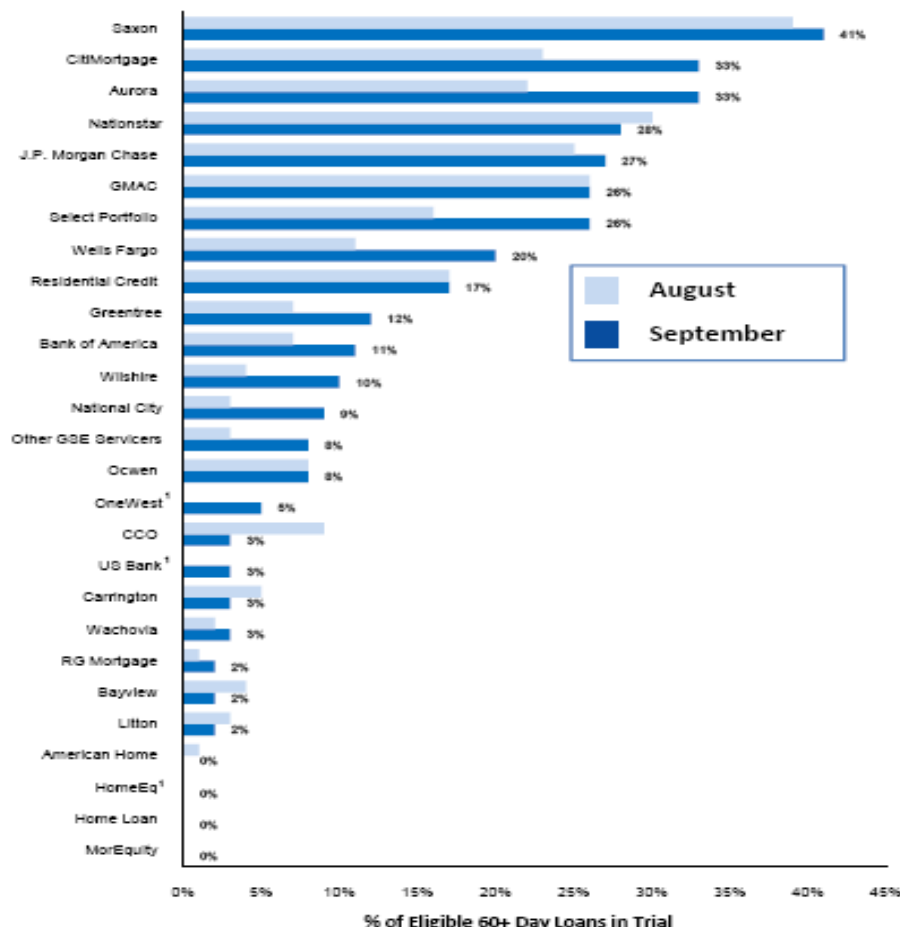
⁶ Other SPA servicers are entities with less than 1,000 estimated eligible 60+ day

delinquencies that have signed participation agreements with Treasury and Fannie Mae. Those servicers are: Altabe Mortgage Loans and Investments; AHS Servicing, LLC; Bay Federal Credit Union; Central Florida Education Federal Credit Union; Central Jersey Federal Credit Union; Citizens First Wholesale Mortgage Company; CUC Mortgage Corp.; Farmers State Bank; First Bank; First Federal Savings and Loan; Glass City Federal Credit Union; Horizon Bank; IBM Southeast Employees' Federal Credit Union; Lake City Bank; Lake National Bank; Metropolitan National Bank; Mission Federal Credit Union; Mortgage Center LLC; Oakland Municipal Credit Union; ORNL Federal Credit Union; PennyMac Loan Services LLC; PNC Bank, NA; Purdie Employees Federal Credit Union; Roundtop Mortgage Servicing Corp.; School Financial Credit Union; SFPDCU; Servis One, Inc.; Shore Bank; Stanford Federal Credit Union; Technology Credit Union; Ventum Capital, Inc.; Wescon Central Credit Union; and Yavapai Valley Bank.

⁷ Includes approximately 2,300 participants that service loans owned or guaranteed by Fannie Mae and Freddie Mac.

⁸ NA denotes a newly signed servicer not yet fully reporting into the program.

Trial Modification Tracker: Trial Modifications as a Share of Estimated Eligible 60+ Day Delinquencies

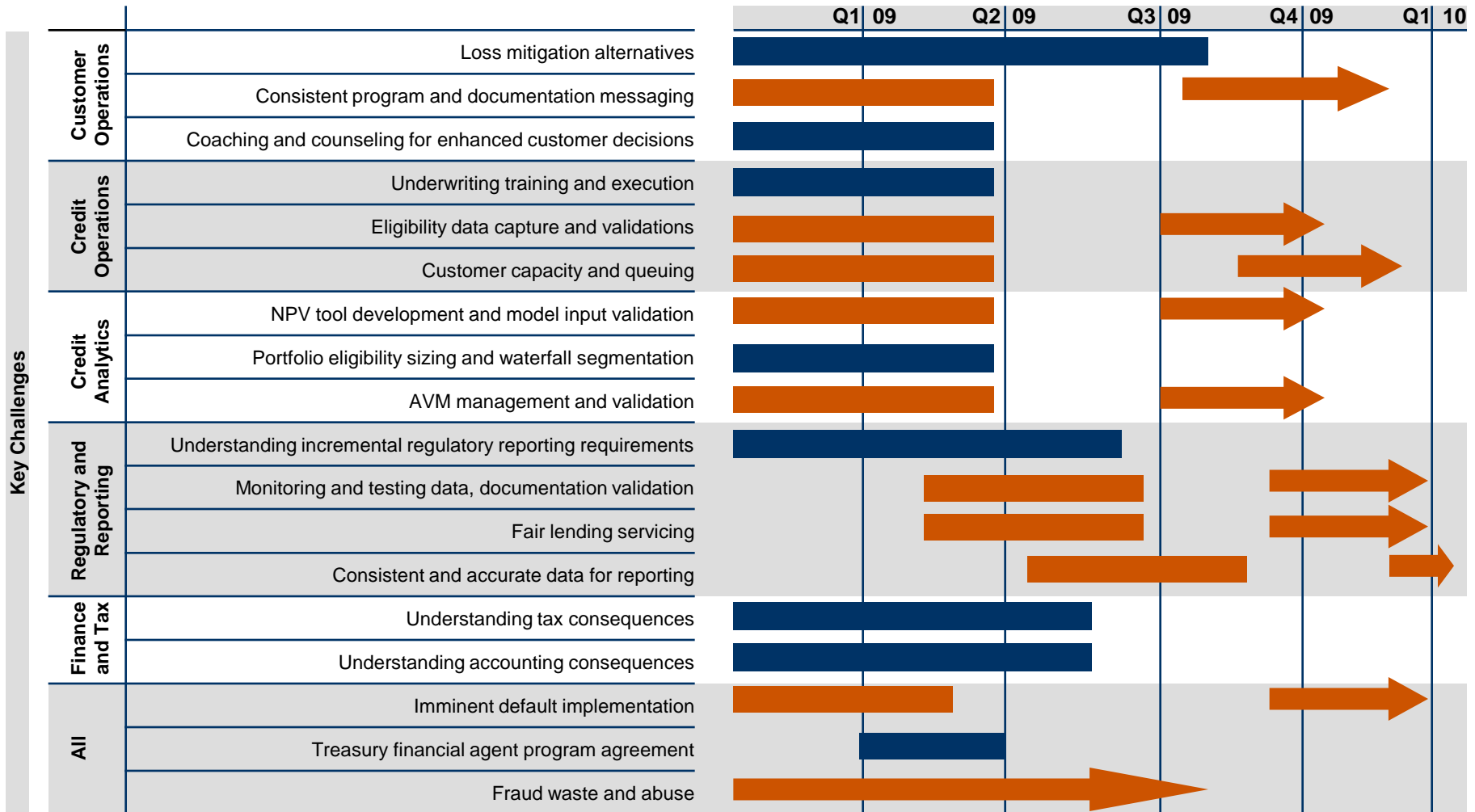


¹ HomeEq, OneWest and USBank began participation after July 31, 2009.

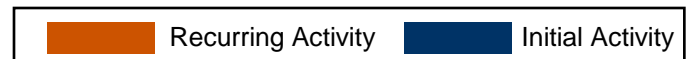
Note: August trials as a share of 60+ day delinquencies on July 31, 2009.

September trials as a share of 60+ day delinquencies on August 31, 2009.

Key Challenges and Timing *



* This timeline is meant as a guideline for implementation of the loan modification aspect of the HASP. It is divided into initial activity upon implementation of the program and ongoing activity thereafter. Actual timings may differ based on a specific company's operations and needs.



Accounting For Mortgage Loans

General Principles

On Balance Sheet Loans

- **Loans classified as held for investment are recorded at amortized cost**
- **Loans are included in the entity's SFAS 5 valuation allowance methodology**
 - **As the loan seasons, its default probability increases which is applied to the loan's unpaid principal balance by origination vintage**
 - **Severity rate is applied to the defaulted principal balance**
 - **An increase in the collective loan loss allowance is made with a charge to bad debt expense**
- **Loans acquired with credit impairment [see SOP 03-3 section, below]**

Off Balance Sheet Loans

- **At transfer, full-recourse and standard representations & warranty provisions require the transferor to record a non-contingent, stand ready obligation at fair value as a reduction of the gain on sale**
- **If a mortgage loan is reacquired at par plus accrued interest and fair value is a discount, then the loss is charged off against the off balance sheet liability**
- **Reacquired loans with credit deterioration between origination and acquisition may be subject to SOP 03-3**

Loan Modification Accounting On-Balance Sheet

Loan Modifications – Which Guidance?

Troubled Debt Restructurings (TDR) / FAS 114 Interaction:

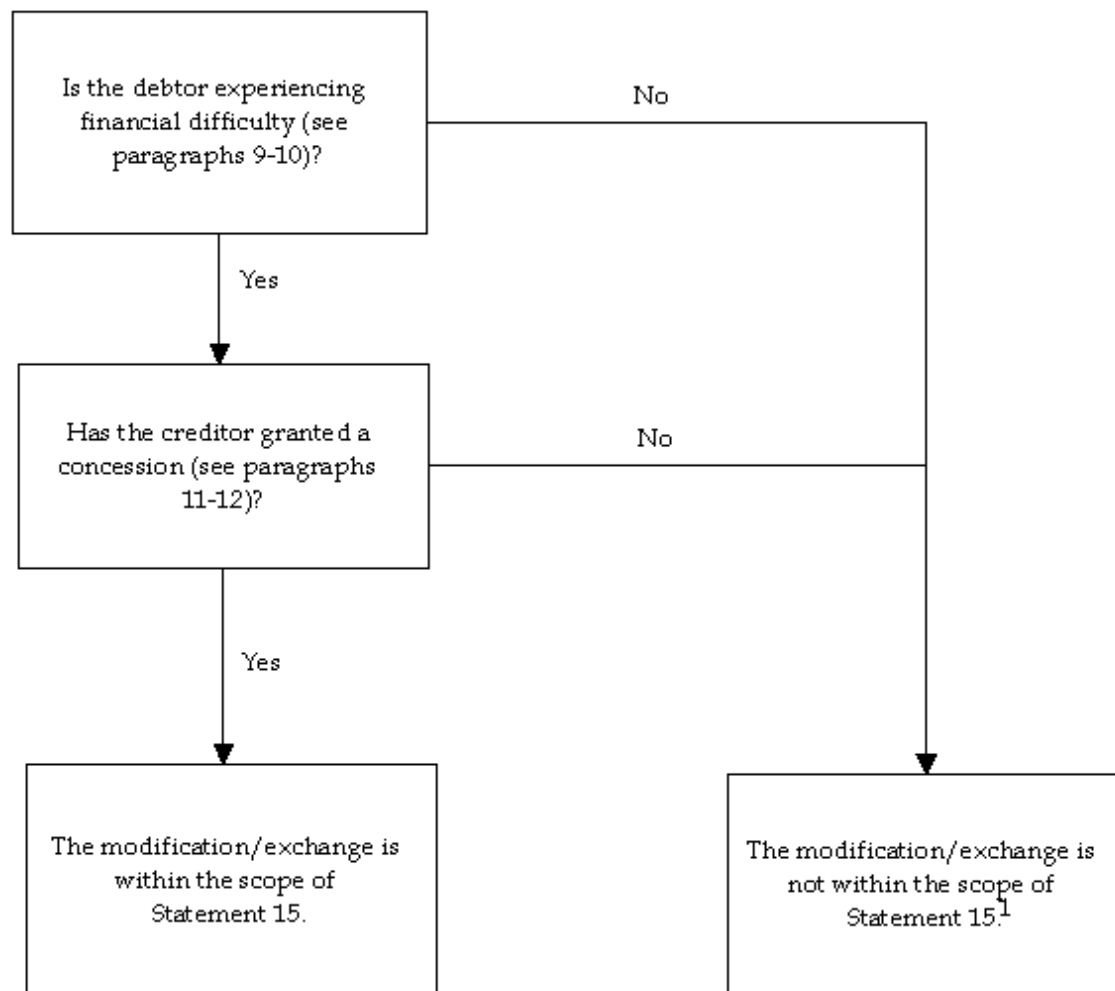
- **Scope of FAS 114:**
 - Paragraph 6 – All loans that are identified for evaluation, except:
 - a) Large groups of smaller-balance homogenous loans that are collectively evaluated
 - b) Loans measured at fair value or LOCOM
 - c) Leases as defined in FAS 13
 - d) Debt securities as defined in FAS 115
 - Paragraph 9 – Loans modified in TDRs, including those that were otherwise excluded from scope of FAS 114 under paragraph 6(a)
 - For example, certain residential mortgage loans modified in TDR
- **TDR—Defined in FAS 15:**

“the creditor for economic or legal reasons related to the debtor’s financial difficulties grants a concession to the debtor that it would not otherwise consider”

What is a TDR?

EITF 02-4:

Gateway to TDR determination!



Debtor Experiencing Financial Difficulty?

EITF 02-4 provides accounting guidance as to whether a debtor is experiencing “financial difficulty”

Indications of YES:

- The debtor is currently in default on any of its debt.
- The debtor has declared or is in the process of declaring bankruptcy.
- Absent the current modification, the debtor cannot obtain funds from sources other than the existing creditors at an effective interest rate equal to the current market interest rate for similar debt for a nontroubled debtor.

Indications of NO:

- The debtor is currently servicing the old debt and can obtain funds to repay the old prepayable debt from sources other than the existing creditors (without regard to the current modification) at an effective interest rate equal to the current market interest rate for a nontroubled debtor, and
- The creditors agree to restructure the old debt solely to reflect a decrease in current market interest rates for the debtor or positive changes in the creditworthiness of the debtor since the debt was originally issued.

Granted a Concession?

EITF 02-4 provides accounting guidance as to whether a modified loan is a troubled debt restructuring

- **If the post modification effective borrowing rate has declined below the original effective borrowing rate, then a concession is considered to have been made**
 - **Effective borrowing rate is calculated as projecting the newly modified cash flows and solving for the discount rate that equates the present value of the cash flows to the current carrying amount (i.e., an IRR)**
- **For multiple recent modifications, the new effective borrowing rate comparison should be made to the original debt's effective borrowing rate**

Impairment Calculation

Impairment measured as:

- Present value of expected future cash flows
- Discounted at the loan's original effective interest rate.

Other measurement options (practical expedients):

- Observable market price of the loan
- Collateral value (if the loan is collateral dependent)

Impairment Calculation (continued)

Practical Considerations

- **Determining “expected future cash flows”**
 - Include default and recovery assumptions?
 - Include prepayment assumptions?
- **Determining the “effective interest rate”**

Loan Modifications – TDR Example

- A defaulted 30 yr FRM mortgage loan was modified in the 3rd year after origination. 10 months of past due interest was capitalized, the loan term was extended for an additional 34 months and the interest rate was permanently reduced by 300 bps. According to the lender's non-accrual policy, 4 months of interest was recognized and all remaining contractual interest was suspended from income recognition.
- The impaired loan's valuation allowance resulted in an impairment charge of \$76,000.

	Orig_Loan	Mod_Loan
Orig Pribal	\$250,000.00	
Int Rate	7.00%	4.00%
Term	360	360
Price	102.00%	101.82%
Pmt	\$1,663.26	\$1,168.41
Eff Yld	6.80%	3.85%
Mod Period		34
Balance at Mod Date		\$244,737.37
Unamortized Premium		\$4,446.63
Interest Capitalized		\$14,213.52
Deferred Income		<u>(\$8,511.26)</u>
Carry Amt		<u><u>\$254,886.26</u></u>
DCF @ 6.80%		<u><u>\$179,133.84</u></u>
Val Allowance		<u><u>(\$75,752.42)*</u></u>

* Note that the example assumes no default assumptions for illustrative purposes. In practice, default would need to be considered.

Difficulty in Applying FAS 114

- **System Requirements and Process Challenges**
 - **Identifying TDRs in Loss Mitigation for proper flagging**
 - **System functionality to capture the terms before and after modification**
 - **Capturing/calculating the proper effective yield for discounting**
 - **System feeds for future contractual cash flows**
 - **Incorporating estimated default and prepayment assumptions**
 - **System capability of accreting any NPV impact of impairment**
 - **Ensuring the TDR reserve isn't double counting FAS 5 or other reserves (e.g., FFIEC)**

Accounting for FAS 91 Deferred Amounts

A TDR is a continuation of collection on the original loan

- **Therefore, FAS 91 deferred fees and costs continue as part of the carrying amount of the loan**
- **“New” fees received related to TDR is a reduction of the recorded investment**
- **Additional costs should be expensed as incurred**

NON-TDR – Major Mod Accounting

- **Loan modifications that do not result in a TDR and are not within the scope of SOP 03-3 are subject to the more than minor loan modification evaluation**
- **SOP 03-3 loan modifications – remain within the scope of SOP 03-3**
- **For loans within the scope of EITF 01-7, if the loan's modified cash flows discounted at the original effective yield is changed by 10% or more from its previous carrying amount, then the loan is considered to be a more than minor (i.e., a “major” modification)**
 - **Lender should perform the EITF 96-19 cash flow analysis**
 - **The old loan's unamortized fees and costs are recognized in full in current period earnings**
 - **New fees and costs are deferred and amortized according to the lender's income recognition policy**

Loan Modification Accounting Off-Balance Sheet

The Issue - QSPEs

A Qualifying Special Purpose Entity (QSPE) is a trust or other legal vehicle that meets **ALL** of the following criteria:

- Demonstrably distinct from the transferor
- *Permitted activities are significantly limited and entirely specified*
- May hold only certain passive assets, and
- May only sell or dispose of noncash assets in certain circumstances

Accounting Guidance for Loan Modification

- **QSPE's activities must be "significantly limited and entirely specified"**
- **'Work outs' allowed for loans that are delinquent or in default (140 Q&A #28B)**
- **SEC interpretation expands this to 'reasonably foreseeable' default**

Accounting Issues: Home Affordable Modification Program

On-Balance Sheet Loans

- Are modifications under this program TDR's?
- What is the accounting for the US Treasury Payments under the program?
 - Payment reduction cost share
 - One-time incentive
 - Pay-for-performance success
- Considerations for “expected cash flows”
- Servicing incentive fees – recognition model

Accounting Issues – HAMP

Off-Balance Sheet Loans

- Implications for QSPE's?
- Do servicers need to obtain “pre-approval” from investors?
- Who receives the US Treasury payments – investors or servicers?
- Servicing incentive fees – recognition model

Other Considerations

- Investor Considerations
- Derivatives (embedded)?
- Disclosures

Modifying SOP 03-3 Loans

Modifying SOP 03-3 Loans

Individual Loans

- What triggers impairment?
- How do you measure the impairment?
- Implications of loan modifications – do you continue to apply 03-3?

Pooled Loans

- Any differences to the considerations for an individual loan?
- Implications of loan modifications

Questions



Applicable Accounting Literature

- **FASB Statement No. 5, *Accounting for Contingent Losses***
- **FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings***
- **FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs with Originating and Acquiring Loans and Initial Direct Costs of Leases***
- **FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan***
- **FASB Statement No. 118, *Accounting by Creditors for Impairment of a Loan – Income Recognition and Disclosures***
- **FASB Interpretation No. 45, *Guarantor’s Accounting and Disclosure for Guarantees, Including Indirect Guarantees of Indebtedness of Others***

Applicable Accounting Literature (continued)

- **AICPA Statement of Position 03-3, *Accounting for Certain Loans Or Debt Securities Acquired in a Transfer***
- **Emerging Issues Task Force No. 92-2, *Measuring Loss Accruals by Transferors for Transfers of Receivables with Recourse***
- **Emerging Issues Task Force No. 96-19, *Debtor's Accounting for a Modification or Exchange of Debt Instruments***
- **Emerging Issues Task Force No. 01-7, *Creditor's Accounting for a Modification or Exchange of Debt Instruments***
- **Emerging Issues Task Force No. 02-4, *Determining Whether a Debtor's Modification or Exchange of Debt Instruments Is Within the Scope of FASB Statement No. 15***
- **Emerging Issues Task Force No. 02-9, *Accounting for Changes That Result in a Transferor Regaining Control of Financial Assets Sold***

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