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Briggs & Veselka Co.
CPAs and Business Advisors

Loan Sales in the Secondary Market: Accounting Requirements and Implications

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The practice of selling government guaranteed loans in the secondary market has increased both in the volume of transactions and in the amount of premiums realized on sales over the past couple of years. This trend is the result of a combination of the low rates of return on investments of similar risk and the increase in volume of government guaranteed loans being originated by banks in response to several new government initiatives to stimulate the economy. Revenues that are being generated from the sales of government guaranteed loans in the secondary market have been increasing as a percentage of Bank revenues, and now more than ever, regulatory scrutiny has had an increased focus in this area.

The accounting requirements have not changed for the treatment of the premiums ("gains") on sales of loans, for recognition of servicing assets and liabilities, or for recognition of interest only strips and discounts on the retained portion of sold loans. What *has* changed are the levels of the premiums being generated and the volume of transactions, which have a direct impact on the materiality of the associated accounting considerations. In the past, as a function of the market and economy, these transactions were lower in volume and size and many community Banks and small regional Banks had not recorded servicing assets or liabilities, and had not allocated the premiums between the portion of the loans sold and portion of the loans retained, due to the cost-benefit of implementing the accounting guidance and the immateriality of the amounts.

It has been projected that the gains from sales of government guaranteed loans in the secondary market will increase as sources of revenues for banks. We have highlighted and summarized in this article the appropriate accounting treatment under accounting principles generally accepted in the United States of America ("GAAP").

The accounting and reporting standards under GAAP for transfers and servicing of financial assets are set forth in Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic No. 860, *Transfers and Servicing* (formerly FASB Statement No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities" as amended by FASB Statement No. 156, "Accounting for Servicing of Financial Assets").

ASC Topic No. 860, *Transfers and Servicing*, has modified the criteria that must be met in order for a transfer of a portion of a financial asset, such as loan participation, to qualify for sale accounting. Under ASC Topic No. 860, a transfer needs to meet the definition of "participating interest" (a newly created concept) in order to qualify for sale accounting. A participating interest must have all of the following characteristics:

a. It represents a proportionate (pro-rata) ownership interest in an entire individual financial asset.

b. All cash flows received from the financial asset are divided proportionately among the participating interest holders.

c. The rights of each participating interest holder must have the same priority, where participating interest holders have no recourse and no participating interest holder is subordinate to another.

d. No party has the right to pledge or exchange the entire financial asset.

If a transfer of a financial asset or a portion of a financial asset meets the definition of participating interest, it qualifies for sale accounting if all conditions of sale accounting have been satisfied. If the transfer of a portion of a financial asset does not meet the definition of a participating interest, both the lender transferring the participation and the party acquiring the participation must account for the transaction as a secured borrowing with a pledge of collateral.

A transfer of an entire financial asset, a group of entire financial assets, or a participating interest in an entire financial asset in which the transferor surrenders control over those financial assets shall be accounted for as a sale if and only if all of the following conditions are met:

1. Isolation of transferred financial assets.

2. Transferee's rights to pledge or exchange the assets or beneficial interests it receives.

3. The transferor, its consolidated affiliates, or its agents do not maintain effective control over the transferred financial assets or third party beneficial interests related to those transferred assets.

Upon the completion of a transfer of a participating interest that satisfies the above conditions to be accounted for as a sale, the transferor shall apply the derecognition guidance in ASC Topic No. 860-20-40, and shall also apply the recognition guidance in paragraph 860-20-25-1(b) related to assets obtained and liabilities incurred in consideration as proceeds of the sale. The following sections summarize the treatment of the premium on loan sales and the servicing assets and liabilities that may be created.

Treatment of the Premium on Sale:

1. Allocate the previous carrying amount of the entire financial asset between both of the following on the basis of their relative fair values at the date of the transfer:
   a. The participating interests sold;
   b. The participating interest that continues to be held by the transferor.
2. Derecognize the participating interests sold.
3. Recognize and initially measure at fair value servicing assets, servicing liabilites, and any other assets obtained and liabilities incurred in the sale (i.e. interest only strips).
4. Recognize in earnings any gain or loss on the sale.
5. Report any participating interests (portions of loans) that continue to be held as the difference between the previous carrying amount of the entire financial asset, and the amount derecognized (effectively recognizing a discount on retained portion).

"Allocate the previous carrying amount of the entire financial asset between the participating interests sold and the participating interest that continues to be held."

Servicing Assets and Liabilities:
A servicing asset is a contract to service financial assets under which the benefits of servicing are expected to more than adequately compensate the servicer for performing the servicing. A servicing contract is either undertaken in conjunction with selling or securitizing the financial assets being serviced, or purchased or assumed separately. A servicing liability is a contract to service financial assets under which the estimated future revenues from contractually specified servicing fees, late charges, and other ancillary revenues are not expected to adequately compensate the servicer for performing the service.

By definition, the amount of benefits of servicing that would fairly compensate a substitute servicer should one be required, includes the profit that would be demanded in the marketplace. It is the amount demanded by the marketplace to perform the specific type of servicing. Adequate compensation is determined by the marketplace; it does not vary according to the specific servicing costs of the servicer.

"Recognize and initially measure at fair value servicing assets, servicing liabilities, and any other assets obtained or liabilities incurred in the sale."

The Small Business Administration ("SBA") for instance, requires that a minimum of 1% of the interest payments on the guaranteed portion be retained by the lender. Banks follow this requirement by retaining at least 1% of the interest on SBA loans, which is allocated to them as servicing fees. In the industry, 40 basis points has generally been considered adequate servicing compensation based on studies performed by industry trade associations such as the National Association of Government Guaranteed Lenders ("NAGGL") and Colson. Discussions within the industry between banking regulators and other industry participants have determined 1% **not to be excessive compensation** and thus not require the recording of an interest only strip. Rather, the 1% is considered to be within an acceptable range for **adequate compensation**. In this example, the difference between the 1% servicing fee and the 40 basis points adequate compensation would be the servicing asset.

Typically, the benefits of servicing are expected to be more than adequate compensation to a servicer for performing the servicing, and the contract results in a servicing asset. However, the initial measure for servicing may be zero if the benefits of servicing are just adequate to compensate the servicer for its servicing responsibilities. A servicing contract that entitles the servicer to receive benefits of servicing **just equal** to adequate compensation, regardless of the servicer's own servicing costs does not result in recognizing a servicing asset or servicing liability. In these cases, management should document its considerations, the calculations and assumptions used to support the existence of a servicing asset or liability, or the absence of a servicing asset or liability.

The servicing asset and servicing liability is normally valued using a discounted cash flow model or multiple model. The guidance explains that whether a servicing asset or servicing liability is recorded is a function of the marketplace, not the individual servicer's costs of servicing. For example, a loss shall not be recognized if a servicing fee that is equal to or greater than adequate compensation is to be received but the servicer's anticipated cost of servicing would exceed the fee.

The policies and procedures for loan sales in the secondary market should be documented in detail and maintained on file. The assumptions and methodologies used in recognizing premiums on loan sales, establishing servicing assets, servicing liabilities and interest-only strips should be clearly documented and include supporting documentation for assumptions used. Lenders as well as accounting personnel and senior management should be familiar with the accounting requirements. As always, it is the responsibility of senior management and the Board of Directors to ensure that accounting records are maintained in accordance with GAAP, and that documentation is sufficient and comprehensive.

90-Day Guarantee Period for Small Business Administration ("SBA") Loans is No More

By: Rebecca O'Malley, CPA
Audit Supervisor

In June of 2009, the Financial Accounting Standards Board ("FASB") issued FASB Statement No. 166, *Accounting for Transfers of Financial Assets,* now included in the FASB Accounting Standards Codification ("ASC") as ASC Topic No. 860, *Transfers and Servicing*, which was effective for most entities beginning January 1, 2010. Among other changes, this standard restricted the situations when a transfer of the guaranteed portion of an SBA loan to a third party could qualify as a sale for accounting purposes.

Under the updated guidance, the rights of each participating interest holder must have the same priority where participating interest holders have no recourse and no participating interest holder is subordinate to another. Historically, SBA loan sales have been subject to a recourse provision where the buyer could require the seller to repurchase loans that defaulted within the first 90 days after the sale. For that 90 day period, the transfer did not qualify for sale accounting, and sellers were required to maintain the asset on their books while setting up a secured borrowing liability for the portion sold, and also recording the premium as a liability until the transaction was reevaluated after the 90 day recourse period. At that time, if the transaction qualified for sale accounting, the secured borrowing was removed, the asset was derecognized, and the portion of the premium which was allowed to be recognized in accordance with ASC Topic. No. 860 could be realized.

In January 2011, the SBA announced that it had updated SBA Form 1086 and, in doing so, removed the recourse provision from these loan sales. Accordingly, beginning with SBA loan sales on or after February 15, 2011, sellers are able to recognize the gain on sale immediately for accounting purposes, and apply the recognition guidance in ASC Topic No. 860-20-25-1(b) related to assets obtained and liabilities incurred in consideration as proceeds of the sale.

This change by the SBA does not have an impact on any other requirements of the accounting for loan sales. For instance, if an entity retains an **excessive** servicing fee or an interest only strip as a result of an SBA loan sale, the transfer cannot be treated as a sale for accounting purposes, and if the servicing fee received is greater than the costs to service, a servicing asset would be created.

The SBA made certain other changes to the form, including new lender certifications, and we encourage SBA lenders to ensure that the new SBA Form 1086 from the SBA's website (www.sba.gov) is in use. Lenders as well as accounting personnel should become familiar with the new requirements.

New Disclosure Requirements for Receivables and the Allowance for Credit Losses

By: Travis Williams, CPA
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The Financial Accounting Standards Board (FASB) has issued Accounting Standards Update (ASU) 2010-20 which requires significant additional financial statement disclosures relating to the credit quality of the financial receivable and the allowance for credit losses in response to the recent economic downturn. The intention is to provide financial statement users with additional information to assist in assessing the entity's credit risk exposure and in evaluating the adequacy of the related allowance for credit losses. The update is effective for nonpublic entities for periods ending on or after December 15, 2011; so while this information may be useful, it will come at additional efforts by the entity.

The disclosure requirements are applicable for "financing receivables" which the ASU defines as the contractual right to receive money on demand, or on fixed or determinable dates, and that is recognized as an asset by an entity. The significant change is the requirement for the disclosure to be made on a disaggregated basis which is comprised of two levels that the ASU terms as the "portfolio segment" and "class of financing receivable." A portfolio segment is defined as the level at which an entity develops and documents a systematic method for determining its allowance for credit losses. Classes of financing receivables generally are a disaggregation of portfolio segment. The new disclosures will require:

- A roll forward of the allowance for credit losses by portfolio segment, with the ending balance further disaggregated on the basis of the impairment method.
- The recorded investment in financing receivables for each portfolio segment disclosed in the allowance roll forward
- Nonaccrual status of receivables by class of financing receivable.
- Impaired receivable by class of financing receivable.
- Credit quality indicators of receivables by class of financing receivables.
- The aging of receivables by class of financing receivables.
- The nature and extent of troubled debt restructurings (TDR's) that occurred by class of financing receivable.
- The nature and extent of receivables modified as TDR's in the past 12 months that defaulted in the current year by class of financing receivables.
- Purchases and sales of receivables by portfolio segment.

In addition to the above quantitative disclosures, the ASU also requires an entity to disclose the following about their accounting policies and methodology used to estimate the allowance for credit losses by portfolio segment:

- A description of the factors that influenced management's judgment, including historical losses and existing economic conditions.
- A discussion of the risk characteristics relevant to the each portfolio segment.
- Any changes in policy or methodology from the prior period, the rationale for the change, and the effect of such change on the current year provision.
- Policy for charging off uncollectible financial receivables.

It will be important for entities to put processes in place well in advance of these effective dates in order to appropriately track the activity for disclosure. Again with effective date of 2011, we recommend you begin conversations with your auditors as the impact on the entity could be considerable.

Troubled Debt Restructuring (TDR)

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Given the recent economic downturn, the volume of debt restructured (modified) by creditors has increased which has raised concerns for additional guidance surrounding TDR's. The Financial Accounting Standards Board (FASB) issued Accounting Standards Update No. 2011-02 to improve financial reporting for TDR's. The update, which is not effective until annual periods ending after December 15, 2012, clarifies which loan modifications constitute a troubled debt restructuring. Look for additional updates in future newsletters as we near the effective date.

For more information on how Briggs & Veselka Co. can be of assistance, please contact us directly. For accounting assistance, contact **Dan St. Clair** at **713.353.1974** or **dstclair@bvccpa.com**. For internal controls, compliance and regulatory assistance, contact **David Phelps** at **713.353.1941** or **dphelps@bvccpa.com**.