Consider the impact of the following transactions on financial statements:

1. A large portion of commercial banks’ lending activities involves making loans against property (your basic home mortgage is just one instance of such loans). Banks often “securitize” their mortgage loans by collecting a large group of loans into a portfolio and selling off the rights to the cash-flows from the portfolio via a type of security called a CMO (Collateralized Mortgage Obligation). Issuing CMOs is profitable because the aggregate risk of a CMO is lower than that of an individual mortgage and thus can be sold to investors at attractive prices. The bank makes a nice profit simply by “bundling” risks into nice, easily-tradable packets of relatively liquid risks. Consequently by artful repackaging, CMOS can improve risk-sharing in the economy as a whole.

The accounting for CMOs and asset securitizations is complex (cf. SFAS #140). What follows is a highly stylized summary that highlights certain strategic issues that come into play in structuring CMOs. Note that this is by no means a satisfactory treatment of the many complex issues that arise in properly accounting for CMOs.

The key determining factor in the accounting treatment of CMOs is the terms of the sale. If the loans are sold with recourse, i.e. if the seller (the bank) remains liable to the buyers of the securities in the event of defaults or early redemption by the borrowers, the transaction must be treated as a borrowing against receivables. This has two important consequences: First, the seller cannot recognize any gain on the sale of the obligation. Second, the loans remain on the seller’s financial statements. (The cash received from the “sale” is offset by the creation of a corresponding liability.) If the loans are sold without recourse, the accounting treatment changes somewhat. Now gains on sale of the CMOS may be recognized. The loans are however, still reported as receivables of the seller’s financial statements.

Tasks:

1. How does the accounting for the two types of sales (with and without recourse) affect the seller’s financial statements?
2. Identify key financial performance indicators that would be affected by the type of sale.
3. As a manager which type of transaction would you prefer? Under what circumstances? Why?

2. Suppose the seller of the CMOs transfers the mortgages underlying the CMO to a third party in exchange for cash. The third party then turns around and sells the underlying cash flows to private investors.

Task:

1. How does involving a third party affect financial statements and financial performance indicators?
2. Name a class of third parties that has been widely discussed in the news media recently.