Common Security Types

U.S. Treasury Security

- A U.S. treasury security is a bill, note, or bond (collectively known as “Treasuries”) that is issued by the U.S. Department of the Treasury and represents direct obligations of the U.S. government. Treasuries are backed by the full faith and credit of the U.S. government.

- Treasury bills (T-bills) mature in one year or less, do not pay interest before maturity, and are sold at a discount. Many regard T-bills as the least risky investments available to investors.

- Treasury notes mature in 2 to 10 years and pay interest semiannually. The 10-year Treasury note has become the security most frequently quoted in discussions of the performance of the U.S. government bond market.

- Treasury bonds cover terms of more than 10 years and are currently issued only in maturities of 30 years. Interest is paid semiannually.

- Treasury inflation-protected securities (TIPSs) are inflation-indexed bonds whose principal is adjusted to the consumer price index (CPI) and multiplied by the constant coupon rate protecting the holder against inflation.

Agency Security

- The term “Agency” describes debt obligations issued by either government agencies or government-sponsored entities (GSEs). The U.S. Congress created GSEs to foster a public purpose (e.g., affordable housing).

- An example of a government agency is the Government National Mortgage Association (also known as Ginnie Mae). Securities issued by government agencies are backed by the full faith and credit of the U.S. government (i.e., an explicit guarantee).

- Examples of GSEs include the Federal National Mortgage Association (FNMA or Fannie Mae) and the Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac).
Asset-Backed Security

- An asset-backed security (ABS) is a type of bond or note collateralized by the cash flows from a specified pool of underlying assets that otherwise could not easily be traded. Securitization makes these assets available for investment to a broader set of investors. These asset pools can consist of any type of asset with a revenue stream (e.g., credit card receivables, auto loans, or student loans).

- Most ABS trading is conducted in over-the-counter markets. Compared to treasuries and mortgage-backed securities (MBSs) (see below), many ABSs are not liquid and their prices are not transparent, partly because ABSs are not as standardized as treasuries or even MBSs.

- An ABS differs from most other kinds of bonds since it assumes the credit risk of the underlying assets without taking on specific corporate credit risk of the originator.

Mortgage-Backed Security

- An MBS is an asset-backed security whose cash flows are backed by the principal and interest payments of a set of mortgage loans. As the underlying mortgage loans are paid off by homeowners, the investors receive interest and principal payments.

- Investors in mortgage securities earn a coupon rate of interest, similar to other fixed-income securities, but also receive repayments of their principal in increments over the life of the security, as the underlying mortgage loans are paid off, rather than in a single lump sum at maturity. Because the timing and speed of principal repayments may vary, the cash flow on mortgage securities is irregular.

- Mortgage securities play a crucial role in the availability and cost of housing in the United States. The ability to securitize mortgage loans enables mortgage lenders and mortgage bankers to (1) access a larger reservoir of capital, (2) make financing available to home buyers at lower costs, and (3) spread the flow of funds to areas of the country where capital may be scarce.

- The majority of mortgage securities are issued or guaranteed by an agency of the U.S. government (e.g., Ginnie Mae), or by government-sponsored enterprises (e.g., Fannie Mae and Freddie Mac). These agencies (1) buy qualified mortgage loans or guarantee pools of such loans originated by financial institutions, (2) securitize the loans, and (3) distribute the securities throughout the dealer community.

- Some private institutions (e.g., subsidiaries of investment banks, financial institutions, and home builders), also package various types of mortgage loans and mortgage pools. The securities they issue are known as “private-label” mortgage securities, in contrast to “agency” mortgage securities issued by Ginnie Mae, Fannie Mae, or Freddie Mac.
Corporate Debt (Bond)

- Corporate bonds may be either secured or unsecured. If a bond is secured, the issuer has pledged specific assets (known as collateral) that can be sold, if necessary, to pay the bondholders. If the debt is unsecured, the bonds are considered debentures (backed by the issuer’s general credit).

- Corporate bonds tend to be categorized as either investment grade or noninvestment grade. Investment-grade bonds are rated BBB or higher by S&P, and they are rated Baa or higher by Moody’s. Noninvestment-grade bonds, also referred to as “high-yield” or “junk” bonds, tend to pay higher yields than investment-grade corporate bonds. This higher yield reflects the higher level of credit risk.

- Interest may be fixed or floating, or the bonds may be zero-coupon bonds. Interest on corporate bonds is typically paid semiannually and is fully taxable to the bondholder. Most corporate bonds are issued with maturities ranging from one to 30 years.

Other Definitions

Entities may use broker quotes or pricing service quotes (see below) to determine the fair value of certain assets, liabilities, or instruments classified in a reporting entity’s shareholders’ equity. For example, mutual funds that carry large portfolios of investments at fair value and produce a daily net asset value often obtain fair value information from third-party pricing service firms, brokers, or both.

Broker Quote

A broker quote is the last price at which a security or commodity traded (i.e., the most recent price on which a buyer and seller agreed and at which some amount of the asset was transacted). A broker is an individual or firm that charges a fee or commission for executing buy and sell orders submitted by an investor.

Vendor Pricing

Third-party pricing service vendors provide security pricing to financial firms, traders, and investors. The data distributed are collected from sources (e.g., stock exchange feeds or broker and dealer desks). Examples of vendors include Bloomberg, IDC, PricingDirect, Reuters, and S&P.

Fair Value

- Fair value is “[t]he price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date” (ASC 820-10-20).

- Fair value represents an exit price, which is the amount a company would pay or receive in a transaction to exit from an asset or liability position. This may differ from the transaction (or entry) price.
Selection of the Appropriate Valuation Technique

While ASC 820 does not prescribe the use of a specific technique, it notes three possible approaches that may encompass multiple techniques:

- **Cost approach** — Reflects the amount that would currently be required to replace the service capacity of an asset (i.e., replacement cost).

- **Income approach** — Converts future amounts (e.g., cash flows) to a single current (i.e., discounted) amount. Discount rate and estimated cash flows should reflect current market expectations about those future amounts.

- **Market approach** — Uses prices and other relevant information generated by market transactions involving an identical or comparable (i.e., similar) item. This approach includes the use of quoted prices for the identical item in an active market that the company can access (i.e., Level 1 inputs).

Entities should select a technique or techniques that maximize the use of observable inputs and minimize the use of unobservable inputs.

Inputs and the Fair Value Hierarchy

The fair value hierarchy classifies inputs into three distinct categories (Levels 1, 2, and 3) on the basis of whether the input is observable. Because a fair value measurement should maximize the use of observable inputs and minimize the use of unobservable inputs, entities use the fair value hierarchy to determine which inputs should be used in a fair value measurement.

A fair value measurement will fall into a given level in the fair value hierarchy in its entirety based on the lowest level input that is significant to the fair value measurement in its entirety. Entities are required to disclose the level within the fair value hierarchy at which a fair value measurement is categorized and make other disclosures related to the hierarchy classification.

**Level 1 Inputs**

- Level 1 inputs are unadjusted quoted prices in active markets for identical assets, liabilities, or own equity that the reporting company is able to access at the measurement date.

- Level 1 inputs are the most reliable type and should be used when available.

**Level 2 Inputs**

Level 2 inputs, other than quoted prices included within Level 1, are either directly observable or indirectly observable (market-corroborated) in the market for the item including:

- Quoted prices for similar items in active markets.

- Quoted prices for identical or similar items in inactive markets.
• Other market inputs that are observable for the asset or liability (e.g., yield curves at commonly quoted intervals).

• Inputs that are derived principally from or corroborated by observable market data, correlation, or other means.

**Level 3 Inputs**

Level 3 inputs are not observable and should be used only to the extent that observable inputs are unavailable.

• They should reflect a company’s assumptions about market participants’ assumptions in pricing the item, including their assumptions about risk.

  o For example, estimated cash flows in an income-approach valuation of a reporting unit in a goodwill impairment test.