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Securitization Accounting

Tenth edition—January 2017

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What's new since the last edition?



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Chapter 1: What's new since the last edition?

Clarity continues to forge ahead in the securitization market and a “new” landscape is beginning to take shape. Although the industry continues to face unique challenges while navigating through the new terrain, the importance and benefits of the overall securitization process is beyond question.

We continue to live in an exciting time for the securitization industry.

As before, we remain strong in our belief that accounting will play a significant role in securitization and remain embedded in its evolving foundation. Therefore, it is our pleasure to share with you this tenth edition of our Securitization Accounting book. Our mission was always to provide a roadmap that covers accounting, tax, and various regulatory changes impacting securitization and the overall markets. We feel that we met this goal once again with this new publication and, hopefully, you agree.

Some more expansive updates in this edition includes a detailed discussion related to:

- The latest changes to consolidation guidance and some unique complexities in consolidation analysis and determination
- Fair value guidance of assets and liabilities, and some structure around market questions related to inconsistencies with typical fair value techniques
- Regulatory changes and the interplay of such rules to accounting principles

While we continue to cover up-to-date issues, the Financial Accounting Standards Board and International Accounting Standard Board are hard at work with projects that may have a future impact on securitization. To that, we address some projects that may result in market participants facing challenges for the classification and measurements of financial instruments and impairment of financial assets.

Securitization accounting will continue to evolve and we will continue to provide a point a view about these changes and participate in valued dialogue with all market constituents.

We hope you find this edition enjoyable and useful (and easy to navigate).

All the best.



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Who has to consolidate the special purpose entity?



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Chapter 2: Who has to consolidate the special purpose entity?

In accounting for securitizations, there are two baseline questions to answer:

- Do I have to consolidate the special purpose entity(ies) involved?
- Have I sold the transferred assets for accounting purposes?

Both US Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS) require a reporting entity, as part of the derecognition assessment, to consider whether the transfer includes a transfer to a consolidated subsidiary. Therefore, logically, the first step in determining whether sale accounting has occurred is to determine if a securitization entity requires consolidation by the transferor.

Because many securitizations involve more than one transfer, and consolidated affiliates often prepare their own separate company financial statements, the consolidation and sale questions will often need to be considered more than once for a transaction. As one might expect, different answers may be appropriate at different stages in the securitization or for different financial reporting purposes, depending on the facts and circumstances.

What accounting guidance applies?

For companies applying GAAP, the consolidation guidance is included in [ASC 810, Consolidation](#)—in particular, the variable interest entity (VIE) subsections. Not all special purpose entities (SPEs) are VIEs, but generally, all securitization SPEs are VIEs. A VIE does not usually issue equity instruments with voting rights (or other interests with similar rights) with the power to direct the activities of the entity, and often the total equity investment at risk is not sufficient to permit the entity to finance its activities without additional forms of credit enhancement or other financial support. If an entity does not issue voting or similar interests or if the equity investment is insufficient, that entity's activities probably are predetermined or decision-making ability is determined contractually. Because securitization entities are typically insufficiently capitalized, with little or no true “equity” for accounting purposes, and are rarely designed to have a voting equity class possessing the power to direct the activities of the entity, they are generally VIEs. The investments or other interests that will absorb portions of a VIE's expected losses or receive portions of its expected residual returns are called variable interests.

In February 2015, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2015-02, *Amendments to the Consolidation Guidance*. While the ASU did not introduce any new models, its changes eliminated two of the existing models (FIN 46(R) and EITF 04-5), requiring all legal entities to be evaluated as either a VIE or a voting interest entity. Further, under the ASU, the evaluation of whether a VIE should be consolidated is still based on whether the reporting entity has both (1) power and (2) potentially significant economics. Under IFRSs, the primary source of guidance on determining when and how to prepare consolidated financial statements is IFRS 10, *Consolidated Financial Statements*, which contains a single, control based model for determining consolidation of a legal entity. In other words, IFRS 10 does not require an analysis of whether a legal entity is a VIE or a voting interest entity, which adds complexity to the analysis under GAAP.



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Who must consolidate the securitization entity?

The first step in determining who should consolidate the securitization entity is identifying all the parties to the deal and identifying which parties have a variable interest in the SPE. While there is no requirement for the transaction parties to compare their accounting conclusions (but, theoretically, only one entity should conclude that it has control), each participant needs to understand the various rights and obligations granted to each party in order to conclude as to its own accounting for its interest in the SPE.

The consolidation models under both GAAP and IFRS are largely similar and are based on control. ASC 810 requires identifying “the primary beneficiary,” which is the party that has a “controlling financial interest” because it has both: (1) the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance, and (2) the obligation to absorb losses of the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE. Under IFRS 10, an investor controls an entity if the investor has: (1) power over the investee, (2) exposure, or rights, to variable returns from its involvement with the investee, and (3) the ability to use its power over the investee to affect the amount of the investor’s return.



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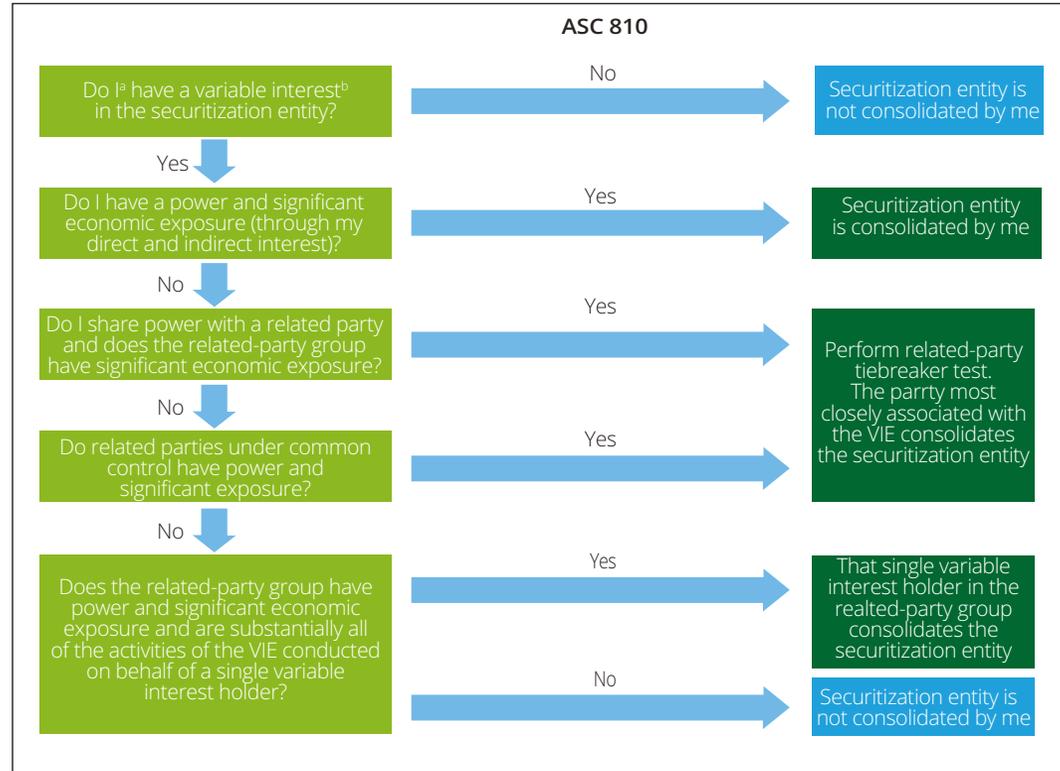
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Chapter 2: Who has to consolidate the special purpose entity?

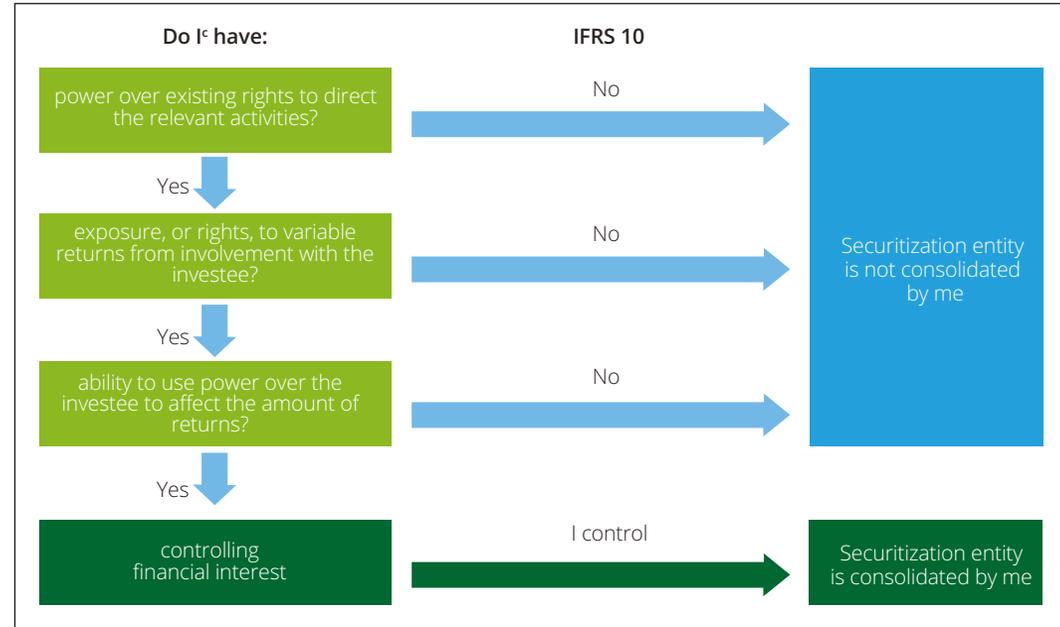
GAAP consolidation decision tree



^a In addition to their own activities and variable interests, reporting entities must also consider the activities and variable interests of both related parties and those parties deemed “de facto agents” in ASC 810.

^b Some servicing fee and decision-making arrangements may not constitute a variable interest in a VIE, as discussed later in this chapter.

IFRS consolidation decision tree



^c In addition to their own activities and variable interests, reporting entities must also consider the activities and variable interests of both related parties and those parties deemed “de facto agents” in IFRS 10.



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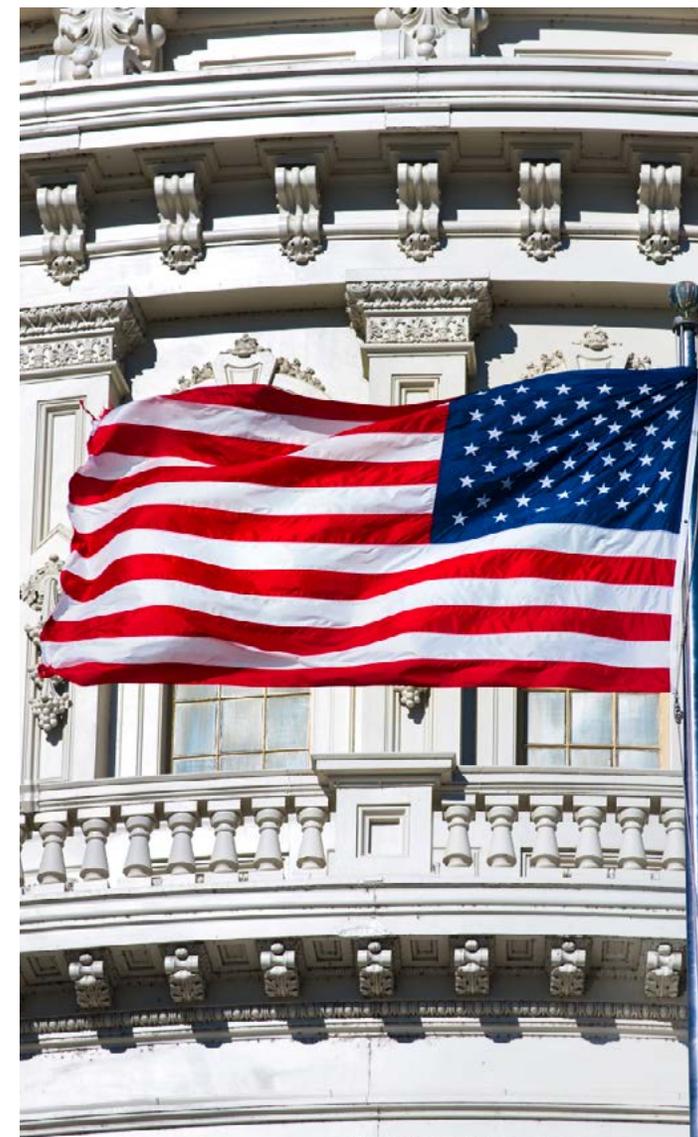
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ASC 810 provides that only substantive terms, transactions, and arrangements, whether contractual or non-contractual, shall be considered. Judgment, based on consideration of all facts and circumstances, is needed to distinguish substantive terms, transactions, and arrangements from non-substantive ones. James L. Kroeker, the former Securities and Exchange Commission (SEC) chief accountant and current FASB vice chairman, told auditors and preparers “to remain vigilant when evaluating the substance, or lack thereof, of elements of transactions included to achieve specific accounting results” for off-balance sheet transactions.¹ While not as explicit, IFRS 10 also states that only substantive rights over an investee are considered and provides examples of factors to consider in determining whether a right is substantive (such as penalties or incentives that would deter a holder from exercising its rights).

Only one reporting entity is expected to control a securitization entity. Although several deal participants could have variable interests, typically only one would have the power to direct the activities that most significantly impact the entity’s economic performance. Further elaboration on interpreting what it takes to have variable interests that are potentially significant under GAAP and ability to affect returns through power under IFRS is provided later in this chapter.

If a securitization entity must be consolidated, all of its assets and liabilities (to third parties) are included in the consolidated balance sheet of the party that consolidates, not just their proportionate ownership share. Accounting equity in a consolidated securitization entity held by a third-party investor is shown as a non-controlling interest in the consolidated financial statements. And it is important to remember that all intercompany transactions, such as servicing or other fee arrangements between the securitization entity and the entity that consolidates, have to be eliminated in consolidation.



¹ Speech by James L. Kroeker *Chief Accountant, Office of the Chief Accountant: Remarks Before the 2009 AICPA National Conference on Current SEC and PCAOB Developments.*



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Chapter 2: Who has to consolidate the special purpose entity?

Step 1: Power—identifying the most important activities

In securitizations, the economic performance of the entity is generally most significantly impacted by the performance of the underlying assets. Sometimes, in structures like commercial paper (CP) conduits, management of liabilities (e.g., selecting the tenor of CP) will also significantly impact the performance of the entity, but generally not most significantly. Some of the factors that might impact the performance of the underlying assets might be beyond the direct control of any of the parties to the securitization (like voluntary prepayments) and therefore don't enter into the power analysis. The activity that most significantly impacts the performance of the underlying assets is typically the management by the servicer of the inevitable delinquencies and defaults that occur; or, in a managed collateral loan obligation, the activities of the collateral manager in selecting, monitoring, and disposing of collateral assets.

When analyzing who has the power to direct those activities, questions that have to be answered include:

- Do I hold the power unilaterally?
- Or do other parties, including related parties and entities under common control, also have relevant rights and responsibilities? For example:
 - Is there another party or other parties that direct other important activities of the trust? If so, which activities are the most important?
 - Is there another party that has to consent to every important decision?
 - Is there another party that can direct me to take certain actions?
 - Is there another party that can replace me without cause?

- Is there another party or other parties that direct the same activities as me, but with a different portion of the trust's assets?
- **And**, is my right to exercise power currently available or contingent on some other event(s) occurring?

Kick-out (removal) rights

GAAP and IFRS include similar concepts with respect to kick-out or removal rights, but they are framed in slightly different contexts within each respective consolidation model. Substantive kick-out rights (i.e., those that can be exercised at will and not upon a contingent event) held by a single party result in the party performing the relevant activities not having power because it could be removed from that role at the whim of the party holding the removal right. A kick-out right would generally be considered substantive if there are no significant barriers to the exercise of such right. Barriers to exercise include, but are not limited to:

- Conditions that make it unlikely they will be exercisable, for example, conditions that narrowly limit the timing of the exercise.
- Financial penalties or operational barriers associated with replacing the decision-maker that would act as a significant disincentive for removal.
- The absence of an adequate number of qualified replacement decision-makers or inadequate compensation to attract a qualified replacement.

When might a servicer or collateral manager not have power?

Situation	See related guidance topic below
The servicer can be replaced without cause by a single unrelated party	Kick-out rights (GAAP)/ Principal-Agent (IFRS)
All important servicing decisions require the consent of one or more unrelated parties	Participating rights and shared power
The servicer services less than a majority of the assets in the VIE	Multiple parties having power
The activities of the servicer are administrative in nature and there is a special servicer	Power to direct contingent on other events



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- Lack of a mechanism for the holder to exercise its kick-out right. For example, the right can be exercised only at an investor meeting, but meetings cannot be initiated by the holder.
- The inability of the parties holding the rights to obtain the information necessary to exercise them.

GAAP incorporates the concept of kick-out or removal rights as part of the power determination. If a single participant (other than a related party) has the substantive right to unilaterally remove the party that directs the entity's most significant activities, that right, in and of itself, may indicate that the holder of the kick-out right has power over the securitization entity, but only if that right is substantive and can be exercised at will (i.e., not solely upon an event of an objectively determinable breach of contract or insolvency by the service provider).

IFRS raises the issue of kick-out rights or removal rights in the determination of whether a party is acting as a principal to a transaction or as an agent on behalf of others (as further discussed later in this chapter). If a single party is able to exercise the kick-out right without cause, then that fact in isolation is indicative of the decision-maker being an agent and not having control.

So how do these concepts apply to securitization structures? It is common in commercial mortgage-backed securities (CMBS) transactions for a controlling classholder, which is defined in the transaction documents as the party that holds the majority of a subordinated class of the issuer's securities, to be able to remove the special servicer in the transaction without cause.

In many cases, the controlling classholder is the same as or affiliated with the special servicer, so this provision would not have an effect on the consolidation analysis in those situations. If a vote of the holders of the subordinated class of the issuer's securities was needed in order to replace the service provider, and there was more than one unrelated holder of those securities, then the kick-out right would not, in isolation, be enough to conclude that the special servicer does not have power and control. But if the controlling classholder were a single party (say the primary servicer) that could remove the special servicer at will, then the special servicer would not be deemed to have control because control lies with the single party that is the controlling classholder. However, replacement of a special servicer only upon an objectively determinable breach of contract or insolvency is considered a protective right (which would not provide a party with power), not a participating right.

Participating rights and shared power

Under GAAP, participating rights are the ability to block actions through which a reporting entity exercises the power to direct the activities of an entity that most significantly impact the entity's economic performance. Protective rights are rights designed to protect the interests of the party holding those rights without providing that party with control. IFRS does not define participating rights, but acknowledges the concept of protective rights and that such rights would not provide power to that party.

So what does that mean? If a single participant can veto all important decisions made by the unrelated servicer, that right, if considered substantive, might cause the service provider to



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not have the “power,” and power would be shared between the service provider and the participant holding the veto right (unrelated parties). If, in addition to being able to veto servicer decisions, a single participant could direct the servicer on what actions to take on defaulted loans, the consolidation burden might shift to that single participant. It is unusual in securitization transactions for any single participant to have the ability to block servicer actions, other than in certain limited cases, such as when a monoline insurer is paying out losses. This may cause a shift in power.

The requirement to obtain consent is considered a substantive participating right when the consent is required for all of the activities that most significantly impact the entity’s economic performance. When the consent relates only to activities that are unimportant or only to certain of the significant activities, the consent might be considered a protective right, however power would not be considered shared. In addition, an enterprise would need to closely analyze the governance provisions of an entity to understand whether the consent requirements are substantive (e.g., the consequences if consent were not given).

Multiple parties having power

The concept of multiple parties having power can manifest itself in two ways:

- **Multiple parties performing different activities.** It is possible that in certain securitizations, one service provider might be engaged to perform asset management and another service provider to perform funding management. In those situations, one must determine which activity most

significantly affects the economic performance of the entity. Judgment will be required based on an analysis of all of the facts and circumstances. This concept is consistent in both the GAAP and IFRS consolidation models.

- **Multiple parties performing the same activities.** Both GAAP and IFRS have similar concepts that if multiple unrelated parties must jointly consent over decisions related to directing the relevant activities of an entity, power is shared and no party would consolidate. However, ASC 810 includes a concept not specifically addressed in IFRS 10, that when multiple parties individually perform the same activities over separate pools of assets, the party that would consolidate would be the party that has unilateral decision-making over a majority of the assets.

What if the power to direct is contingent upon the occurrence of other events?

GAAP

When a party can direct activities only upon the occurrence of a contingent event (such as a servicer, who, except for a borrower default, performs only administrative tasks), the determination of which party has power will require an assessment of whether the contingent event initiates the most significant activities of the entity (i.e., the entity’s most significant activities only occur when the contingent event happens) or results in a change in power (i.e., power shifts from one party to another upon the occurrence of a contingent event) over the most significant activities of the entity (in addition, the contingent event may change what the most significant activities of the entity are).

Determining whether the contingent event initiates the most significant activities of the entity or results in a change in power will be based on a number of factors, including:

- The nature of the activities of the entity and its design.
- The significance of the activities and decisions that must be made before the occurrence of the contingent event, compared with the significance of the activities and decisions that must be made once the contingent event occurs. If both sets of activities and decisions are significant to the economic performance of the entity, the contingent event results in a change in power over the most significant activities of the entity. However, if the activities and decisions before the contingent event are not significant to the economic performance of the entity, the contingent event initiates the most significant activities of the entity. It’s important to clarify that just because the contingent event initiates the most significant activities, that does not mean that no one had power until the contingency event occurs. Rather, the party with power initiated by the contingent event would have power throughout the life of the entity (both before and after the contingent event occurs).

If a transaction participant concludes that the contingent event initiates the most significant activities of the entity, all of the activities of the entity (including the activities that occur after the contingent event) would be included in the evaluation of whether they have the power to direct the activities that most significantly affect the entity’s economic performance. In such instances, the



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party that directs the activities initiated by the contingent event would be the enterprise with the power to direct the activities that most significantly affect the economic performance of the entity.

If the transaction participant concludes that the contingent event results in a change in power over the most significant activities of the securitization entity, the deal party must evaluate whether the contingency is substantive. This assessment should focus on the entire life of the VIE. Some items to consider in assessing whether the contingent event is substantive include:

- The nature of the activities of the entity and its design.
- The terms of the contracts the entity has entered into with the variable interest holders.
- The variable interest holders' expectations regarding power at inception of the arrangement and throughout the life of the entity.
- Whether the contingent event is outside the control of the variable interest holders of the entity.
- The likelihood that the contingent event will occur (or not occur) in the future. This should include, but not be limited to, consideration of history of whether a similar contingent event in similar arrangements has occurred.

So how about some examples?

In CMBS, and potentially other asset classes, it is common that upon delinquency or default by the borrower or when default is reasonably foreseeable, the responsibility for servicing of the loan is transferred from the primary servicer to a special

servicer. In such cases, the activities that the primary servicer has the power to direct are typically administrative in nature and do not significantly impact the entity's economic performance.

Thus, the primary servicer would not typically have power. But can the special servicer have power even at the outset of the transaction given that there were no loans in special servicing? The answer is yes. Because the activities performed by the primary servicer are not considered significant to the economic performance of the securitization entity and it is considered likely that the special servicer will be performing services during the life of the securitization entity, the special servicer is considered, from the outset, to have the power to direct the relevant activities. Another important consideration is whether the special servicer can be replaced and by whom. If the primary servicer or another party can unilaterally remove the special servicer, then that party may have power instead.

Another example is that of a monoline insurer, who has guaranteed the senior class of a securitization against losses once all subordinated classes have been written down to zero. In certain transactions, upon the occurrence of such events, the power of the monoline insurer increases in ways such as gaining the ability to replace the servicer or to start directing the servicer in the actions it should take on defaulted loans. The occurrence of the contingent event would likely result in a change in power over the most significant activities of the securitization entity and a change in primary beneficiary.

Yet another example would be the controlling classholder in a securitization entity initially being the holder of the majority of the most subordinated class. However, if losses are such that the subordinated class is reduced below some prespecified level, then the controlling classholder is changed to the holder of the majority of the next class (e.g., a mezzanine class). The occurrence of the contingent event might result in a change in power and a change in which party consolidates.



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IFRS

IFRS 10 has similar concepts with respect to power upon contingent events and specifically addresses the issue in the context of predetermined activities (**see section below for further discussion around predetermined activities**). In practice, virtually all structured entities that operate in a predetermined way have relevant activities. Relevant activities are not necessarily activities that require decisions to be made in the normal course of the entity's activities; such decisions may be required only when particular circumstances arise or events occur. A structured entity that operates in a largely predetermined way may be designed so that the direction of its activities and its returns are predetermined unless, or until, particular circumstances arise or events occur. In such cases the decisions about the entity's activities when the specified circumstances or events occur are the relevant activities of the structured entity because they can significantly affect the returns of the structured entity. The fact that the right to make decisions is contingent on particular circumstances arising or an event occurring does not in itself affect the assessment as to whether an investor has power over the structured entity. The particular circumstances or events need not have occurred for an investor with the ability to make those decisions to have power over the structured entity.

Are there situations in which entities will not have ongoing activities that significantly affect their economic performance?

GAAP

In limited situations, the ongoing activities performed throughout the life of a securitization entity, though they may be necessary for the entity's continued existence (e.g., administrative activities in certain re-securitization entities, such as re-securitizations of real estate mortgage investment conduits [RE-REMICs]), may not be expected to significantly affect the entity's economic performance. In such situations, determination of the primary beneficiary will need to focus on the activities performed and decisions made at the securitization entity's inception as part of the design, because in these situations the initial design had the most significant impact on the economic performance of the entity.

However, when the ongoing activities of a securitization entity are expected to significantly affect the entity's economic performance, a reporting entity will need to focus the power analysis on those ongoing activities.² That is, it would not be appropriate to determine the primary beneficiary solely on the basis of decisions made at the entity's inception as part of the entity's design when there are ongoing activities that will significantly affect the economic performance of the entity. In addition, **as discussed below**, an evaluation of involvement in design will generally only be determinative when one reporting entity (or related-party group) has an economic interest that is disproportionately greater than its ongoing, stated power to direct the activities of the securitization entity.

ASC 810-10-25-38F states that an enterprise's involvement in the design of an entity "may indicate that the enterprise had the opportunity and the incentive to establish arrangements that result in the enterprise being the variable interest holder with ... the power to direct the activities that most significantly impact [the VIE's] economic performance." However, it also notes that involvement in design does not, in itself, establish that enterprise as the party with power. In many situations, several parties will be involved in the design of an entity and an analysis of the decisions made as part of the design would not be determinative or would not result in the identification of a primary beneficiary.

ASC 810-10-25-38G states, in part that "consideration should be given to situations in which an enterprise's economic interest in a variable interest entity, including its obligation to absorb losses or its right to receive benefits, is disproportionately greater than its stated power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance."

Thus, in situations in which the ongoing activities of a securitization entity are not expected to significantly affect the entity's economic performance and one enterprise (or related-party group) holds an economic interest that is so significant that the other interest holders, as a group, do not hold more than an insignificant amount of the fair value of the entity's interests or those interests do not absorb more than an insignificant amount of the entity's variability, it would generally be appropriate to conclude that the enterprise (or an enterprise within the related-party group) with that significant economic interest made the decisions at the inception of the entity or that the decisions were essentially made on the enterprise's behalf. Therefore, in such

² In addition, in certain financial structures, a single reporting entity may have the unilateral ability to liquidate the entity. Such ability may indicate that the reporting entity has the power to direct the activity that most significantly affects the economic performance of the entity.



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situations, it may be appropriate to conclude, after all facts and circumstances associated with the entity have been considered, that the enterprise (or the enterprise within the related-party group) has a controlling financial interest in the entity. In addition, when analyzing the design of a securitization entity whose ongoing activities are not expected to significantly affect its economic performance, an enterprise should use judgment to determine whether the economic interest of an enterprise (or related-party group) is so significant that it suggests the decisions made during the design of the entity were made by that enterprise (or related-party group) or were made on its behalf.

Note that when the primary beneficiary analysis is based solely on the design of an entity, the determination of whether one enterprise (or related-party group) absorbs all but an insignificant amount of the variability in an entity depends, in part, on a consideration of the entity's expected losses and expected residual returns. By focusing on expected losses and expected residual returns, a party with a small overall ownership percentage in an entity could be exposed to a significant amount of an entity's variability (e.g., the holder of a residual interest when there is a large amount of senior interests). Similarly, a party with a large overall ownership percentage in an entity may not be exposed to a significant amount of an entity's variability (e.g., if the party holds senior interests in an entity whose capitalization also includes substantive subordinated and residual interests).

In re-securitizations in which there are multiple underlying asset groups with no cross-collateralization, these determinations are made on a group-by-group basis, because each group would generally be considered a "silo."

IFRS

Under IFRS 10, the fact that a structured entity operates in a largely predetermined way does not necessarily mean that the entity has no relevant activities. In practice, virtually all structured entities that operate in a predetermined way have relevant activities.

A structured entity operating in a largely predetermined way will most commonly be established to invest in assets that are expected to provide a predictable level of return with little or no ongoing input from investors. However, decisions outside the predetermined parameters may need to be made when that return fails to materialize, such as the decision on how to pursue recovery in the event of default for a portfolio of mortgage loans. Such decisions significantly affect the returns of the securitization entity and, therefore, they are the relevant activities of the entity. Consequently, the analysis of who has power over the securitization entity should focus on the ability to make those decisions.

IFRS 10:BC80 provides an example of a receivables securitization where the primary purpose of the entity is to allocate credit risk to the holders of the beneficial interests.³ The design of

the entity is such that the only relevant activity that can be directed, which significantly affects the returns of the entity, is managing receivables upon default. An investor that writes a put option on the receivables that is triggered when the receivables default might have the current ability to direct the activities that significantly affect the returns. The design of the entity ensures that the investor has decision-making ability when such decision-making is required. In this scenario, the terms of the put agreement are integral to the overall transaction and the establishment of the investee.

The fact that an investor is involved in the design of an investee does not necessarily mean that the investor has decision-making rights to direct the relevant activities of the investee. Often, several parties are involved in the design of an investee and the final structure of the investee includes whatever is agreed to by all those parties. Consequently, an investor's involvement in establishing an investee would not, in isolation, be sufficient evidence to determine that the investor has power over the entity.

However, in those extremely rare situations when there are no decisions to be made on relevant activities after the formation of a structured entity, the initial design of the entity may be the relevant activity that significantly affects the returns of the structured entity. Consequently, in determining whether an investor has power over the structured entity, the activities performed and decisions made as part of the entity's design at formation should be assessed carefully.

³ Beneficial interests are defined as rights to receive all or portions of specified cash inflows received by a trust or other entity, including, but not limited to, all of the following: (i) senior and subordinated shares of interest, principal, or other cash inflows to be passed-through or paid-through; (ii) premiums due to guarantors; (iii) commercial paper obligations; and (iv) residual interests, whether in the form of debt or equity.



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In making this assessment, an investor should consider the significance of its interest in the investee and its involvement in the design of the investee (including an assessment of the scope of its decision-making authority during the design process). The more significant an investor's (1) interest and (2) involvement in the design of the investee, the more indicative it is that the investor had the ability and incentive to make decisions for its own benefit and, therefore, that it has power over the investee.

Step 2: Variable interests in an entity

The second step in the consolidation assessment under GAAP and IFRS is very similar. That step requires consideration of whether an entity is exposed to variable returns. Under both standards, variable returns can include only upside benefit (a performance fee), downside risk (a guarantee) or both (a debt or equity investment).

Where the models differ is how the variable interest is considered. GAAP simply looks at whether the variable returns have the potential to be significant. IFRS doesn't directly consider whether the variable interest is significant. Instead, IFRS 10 looks at whether the power the decision-maker has can influence its variable returns, and whether that makes the decision-maker a principal to a transaction or just an agent acting on behalf of others. ASC 810 does not yet include principal/agent guidance⁴ like IFRS 10 (see [Chapter 13](#)). Instead, ASC 810 includes a list of

⁴ The principal/agent evaluation is integrated within the determination of a variable interest and the primary beneficiary.

⁵ The quantitative approach described in the definitions of the terms expected losses, expected residual returns, and expected variability is not required and should not be the sole determinant as to whether a reporting entity meets such conditions.

criteria to consider in determining whether a fee received by a service provider doesn't represent a variable interest in an entity.

Fees paid to decision-makers or service providers (GAAP)

The determination of whether a decision-maker's fee arrangement is a variable interest has a significant impact on the consolidation conclusion, because if it is determined that a decision-maker's fee arrangement is not a variable interest, the decision-maker would be acting as a fiduciary for the legal entity. Before ASC 810-10 was amended by ASU 2015-02, six criteria had to be met before a reporting entity could conclude that a decision-maker's or service provider's fee does not represent a variable interest. ASU 2015-02 eliminated the criteria related to the fee's priority level and significance. Accordingly, the evaluation of whether fees paid to a decision-maker or service provider are a variable interest focuses on whether all of the following are met:

- The fees are compensation for services provided and are commensurate with the level of effort required to provide those services.
- The decision-maker or service provider does not hold other interests in the securitization entity that individually, or, in the aggregate, would absorb more than an insignificant amount of the entity's expected losses⁵ or receive more than an insignificant amount of the entity's expected residual returns.
- The service arrangement includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length.

In addition, ASU 2015-02 amended the application of the criteria in ASC 810-10-55-37(c) to allow a reporting entity to exclude interests held by certain of its related parties (including de facto agents) when evaluating its economic exposure as part of determining whether, on the basis of its relationship with the related party, its decision-making arrangement represents a variable interest.

Specifically, interests held by a decision-maker's or service provider's related parties (or de facto agents) that are not under common control are only to be included in the evaluation of whether the decision-maker's or service provider's fee arrangement is a variable interest when the decision-maker or service provider has a variable interest in the related party. If the decision-maker or service provider has a variable interest in the related party, it would include its economic exposure to the legal entity through its related party on a proportionate



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basis. For example, if a decision-maker or service provider owns a 20 percent interest in a related party, and that related party owns a 40 percent interest in the legal entity being evaluated, the decision-maker's or service provider's interest would be considered equivalent to an 8 percent direct interest in the legal entity. However, if the decision-maker or service provider did not hold the 20 percent interest in its related party, it would not include any of the related party's interest in its evaluation.

By contrast, interests held by a decision-maker's or service provider's related parties (or de facto agents) that are under common control should be included at their full amounts in the evaluation of whether the decision-maker's or service provider's fee arrangement represents a variable interest when (1) the decision-maker or service provider has an interest in the related party or (2) the interest is held by the related party in an effort to circumvent consolidation.

For fees that qualify for evaluation under the three criteria, if such fees do not meet all of the conditions above, then those fees are variable interests and the decision-maker or service provider would proceed to the next steps in the GAAP consolidation decision tree presented earlier in this chapter. The decision-maker must also determine whether that variable interest is a variable interest in the securitization entity as a whole, or whether it relates to particular specified assets of

the entity. If the variable interest relates to specified assets representing more than half of the total fair value of all of the assets within the securitization entity, or if the decision-maker holds another variable interest in the entity as a whole, then the variable interest would be deemed to be a variable interest in the securitization entity and the decision-maker or service provider would proceed to the next steps in the same decision tree referenced above.

In addition, fees or other arrangements that expose the decision-maker or service provider to risk of loss in the VIE would not be eligible for evaluation under the three conditions above. Instead, such fees are considered variable interests. Examples include:

- a. Fees related to guarantees of the value of the assets or liabilities of a VIE
- b. Obligations to fund operating losses
- c. Payments associated with written put options on the assets of the VIE
- d. Similar obligations, such as some liquidity commitments or agreements (explicit or implicit), that protect holders of other interests from suffering losses in the VIE

Meaning of 'insignificant' in the analysis of fees paid to a decision-maker or service provider

ASC 810-10 does not define the term "insignificant" as used in ASC 810-10-55-37(c). However, as a general guideline, if the expected losses absorbed or expected residual returns received through variable interests (other than the fee arrangement) in the potential VIE exceed, either individually or in the aggregate, 10 percent or more of the expected losses or expected residual returns of the VIE, the condition in ASC 810-10-55-37(c) is not met, and the decision-maker or service provider fee would be considered a variable interest. However, because of the subjective nature of the calculation of expected losses and expected residual returns, 10 percent should not be viewed as a bright-line threshold or safe harbor. In light of these considerations, the reporting entity will need to apply professional judgment and assess the nature of its involvement with the VIE.

The analysis under ASC 810-10-55-37(c) deals with the expected outcome of the VIE. Therefore, when analyzing a decision-maker or service provider fee under this criterion, a reporting entity would identify and weigh the probability of the various possible outcomes in determining the expected losses and expected residual returns of the VIE. However, the reporting entity may not be required to prepare a detailed quantitative analysis to reach a conclusion under ASC 810-10-55-37(c). For example, if a decision-maker holds 100 percent of the residual interest in a legal entity (and the residual interest is substantive), a reporting entity may qualitatively conclude that holding all of a substantive residual



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interest would represent more than an insignificant amount of the legal entity's expected losses or expected residual returns. Conversely, if a decision-maker holds less than 10 percent of the residual interest in a legal entity, the reporting entity may qualitatively conclude that holding less than 10 percent of the residual interest would not represent more than an insignificant amount of the legal entity's expected losses or expected residual returns.

In accordance with ASC 810-10-25-38H, if fees paid to the decision-maker or service provider are both commensurate and at market⁶, such fees should not be considered for purposes of the economics test of ASC 810-10-25-38A(b). A reporting entity that does not have a variable interest in a VIE (e.g., the entity's only involvement in the VIE is limited to a fee arrangement that has been determined not to be a variable interest) would never be the VIE's primary beneficiary.

However, if an enterprise determines that a fee paid to a decision-maker or service provider is a variable interest after considering the conditions above, the decision-maker or service provider will need to assess whether its interest represents an obligation to absorb losses of the entity or a right to receive benefits from the entity that could potentially be significant to the entity.

⁶ Specifically, the fees are (i) compensation for services provided and commensurate with the level of effort required to provide the services and (ii) part of a service arrangement that includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length.

⁷ Professional Accounting Fellow Arie Wilgenburg. "Speech by SEC Staff: Remarks before the 2009 AICPA National Conference on Current SEC and PCAOB Developments." AICPA SEC Conference. Washington, D.C. December 7, 2009.

Potentially significant variable interest (GAAP)

ASC 810-10 describes a significant variable interest as one that either obligates the reporting enterprise to absorb losses or provides it a right to receive benefits from the VIE that could potentially be significant to the VIE. No bright line exists to determine whether the variable interest is significant. Instead, the reporting entity should consider both quantitative and qualitative factors, including⁷:

1. The purpose and design of the legal entity
2. Terms of characteristics of the financial interest
3. The reporting entity's business purpose for holding the variable interest

There may be situations in which a party with a variable interest will not have a right to receive benefits or the obligation to absorb losses of the securitization entity that could potentially be significant to the securitization entity. For example, a service provider's fee may represent a variable interest because the service provider holds another interest that may absorb more than an insignificant amount of the VIE's expected losses or residual returns. Assuming the fee is both commensurate and at market, the fee would not be considered in the economics test of ASC 810-10-25-38A. The service provider would evaluate only the other interest, which will not always represent a benefit or obligation that could be potentially significant to the entity.

As another example, a service provider's right to receive a fixed fee may represent a variable interest because the fee is not commensurate or not at market. Similarly, the variable interest will not always represent a benefit or obligation that could potentially be significant to the entity. While not included in the FASB Accounting Standards Codification, this was discussed in the Basis for Conclusions when FAS 167 was issued, which noted that the servicer may be able to conclude, on the basis of the magnitude of the fixed percentage, that the fee could not ever potentially be significant to the entity because the fee would remain a constant percentage of the entity's assets. On the other hand, a fee that was considered insignificant under the criteria discussed above and the implicit probability notion might be considered potentially significant, as further discussed below.

The variable interest entity subsection of ASC 810 does not define "economic performance," but it does indicate that an enterprise must assess the entity's purpose and design when evaluating the power to direct the activities of the entity. This assessment includes a consideration of all risks and associated variability that are absorbed by any of the entity's variable-interest holders. However, the quantitative calculations of expected losses and expected residual returns are not required. An enterprise should not consider probability when determining whether it has a variable interest that could be potentially significant. Therefore, even a remote possibility that an enterprise could absorb losses or receive benefits that could be significant to the entity causes the enterprise to meet such condition.



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A relatively small first loss piece might not have the potential to absorb a significant amount of losses, but might have the potential to receive significant benefits. On the other hand, a large senior class might not have the potential to receive significant benefits because the interest is capped, but has the potential to absorb more losses than the smaller subordinated classes.

Am I a principal or am I an agent to the securitization? (IFRS)

For IFRS, an entity with decision-making rights has to consider whether it is acting as a principal or an agent. Likewise, an investor is required to determine whether another entity with decision-making rights is acting as an agent on behalf of the investor. An investor may delegate its decision-making to an agent on certain specific issues (e.g., a special servicer that handles mortgage defaults) or on all relevant activities (a mortgage servicer that handles cash collections, distributions to note holders, and mortgage defaults).

A decision-maker is an agent when it is primarily engaged to act on behalf and for the benefit of others (the principal[s]). An agent does not control an investee by exercising its decision-making powers. However, a decision-maker is not an agent simply because other parties can benefit from the decisions that it makes; the decision-maker must also consider its own benefits and risks in determining whether it is truly an agent.

IFRS 10 states that, when a single party holds a substantive right to remove the decision-maker and can remove the decision-maker without cause, this, in isolation, is sufficient to conclude that the decision-maker is an agent. For a removal right to be considered substantive, one must determine that there are no barriers or disincentives to exercise, including consideration of the timing of the removal right. In the absence of single-party kick-out rights, the decision-maker is required to consider the overall relationship between itself, the investee being managed, and other parties involved with the investee. Each of the following factors should be considered in making the principal/agent assessment.



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In certain instances, some factors may be stronger indicators than others and should receive greater weighting in assessing whether a decision-maker is a principal or an agent.

The scope of the decision-maker's authority over the investee.

The scope of decision-making authority is evaluated by considering: (1) the activities that are permitted according to the decision-making agreement(s) and specified by law; and (2) the discretion that the decision-maker has when making decisions about those activities. This assessment requires the decision-maker to consider the purpose and design of the securitization entity, the risks to which the securitization entity was designed to be exposed (i.e., credit risk of the securitized asset pool), the risks it was designed to pass on to the parties involved, and the level of involvement the decision-maker had in the design of the investee. IFRS 10 notes that when a decision-maker is significantly involved in the design of the investee (including the determination of the scope of decision-making authority), this may indicate that the decision-maker had the opportunity and incentive to obtain rights that result in the decision-maker having the ability to direct the relevant activities. So what does that mean for securitizations? There generally should not be entities where the decisions are preprogrammed and therefore no one has power. Furthermore, the decision-maker being involved in the design of the securitization entity may indicate the decision-maker is acting in a capacity as a principal to the securitization entity.

The rights held by other parties. Substantive rights held by others may impact the decision-maker's ability to direct the relevant activities of a securitization entity. As mentioned above,

if a single party can remove the decision-maker without cause, this, in isolation, is sufficient to conclude that the decision-maker is acting as an agent. If multiple parties are required to act together to remove the decision-maker (e.g., simple-majority kick-out rights), those rights are not, in isolation, conclusive in determining that a decision-maker acts primarily as an agent. The greater the number of parties required to act together to exercise the kick-out rights, and the greater the size and variability of the decision-maker's other variable interests (i.e., remuneration and other interests), the lower the weighting this factor should receive in the analysis. Substantive rights held by other parties that restrict a decision-maker's ability to exercise its rights (e.g., when a decision-maker is required to obtain approval from a small number of other parties for its actions) should be considered in a manner similar to removal rights. The basis for conclusions of IFRS 10 also notes that some other rights (such as some liquidation rights) may have the same effect on the decision-maker as removal rights. If those other rights meet the definition of removal rights, they should be treated as such regardless of their label.

The remuneration to which the decision-maker is entitled in accordance with the remuneration agreement(s). The greater the size and variability of the decision-maker's remuneration relative to the expected returns from the securitization entity, the more likely it is the decision-maker is a principal. For a decision-maker to be considered an agent, its remuneration must be commensurate with the services provided and include only market-based terms, conditions, and amounts (unless, of course, single-party kick-out rights exist and then the other criteria are not relevant). However, these two factors alone

are not enough to make one an agent. The purpose of this requirement is to consider whether the remuneration for the decision-maker is truly compensation solely for its services as an agent.

The decision-maker's exposure to variability of returns from other interests that it holds in the investee.

A decision-maker that holds other interests in a securitization entity (e.g. the super senior tranche or the equity tranche) should consider its exposure to variability of returns in assessing whether it is an agent. Holding other interests in the securitization entity indicates that the decision-maker may be acting as a principal. In evaluating its exposure to variability of returns from other interests, the decision-maker should consider (1) the greater the size and variability of its economic interests (including its remuneration and other interests in aggregate), the more likely the decision-maker is a principal; and (2) whether its exposure to variability is different from other investors and, if so, whether this might influence its decision-making. This may be the case when the decision-maker holds subordinated interests in a securitization entity, or provides other forms of credit enhancement such as a liquidity facility to a CP conduit. The decision-maker should evaluate its exposure relative to the total variability of returns of the securitization entity, primarily based on returns expected from the activities of the entity, but also not ignoring the decision-maker's maximum exposure to variability of returns of through other interests that the decision-maker holds.



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Related-Party considerations

In performing the primary-beneficiary analysis, a reporting entity must carefully consider related-party relationships. A reporting entity that concludes individually that it has not met both the power criterion and the economics criterion may still be required to consolidate a VIE solely as a result of interests held by its related parties. In addition, the term “related parties” includes certain other parties that are acting as de facto agents or de facto principals of the reporting entity. Both GAAP and IFRS require consideration of involvements of related parties, or de facto agents, in the consolidation assessment.

In performing the primary-beneficiary analysis, a reporting entity must carefully consider related-party relationships. If an entity concludes that individually it has not met both the power criterion and the economics criterion it may still be required to consolidate a VIE solely as a result of interests held by its related parties. In addition, the term “related parties” includes certain other parties that are acting as de facto agents or de facto principals of the reporting entity. Their interests are treated similarly to related-party interests in the performance of the primary-beneficiary portion of the VIE analysis.

A reporting entity is always required to assess whether it individually meets both characteristics (the power criterion and the economics criterion) of a primary beneficiary after considering the guidance in the aggregation of interests for evaluating the economics criterion section below. If a reporting

entity concludes that it does not meet the criteria for a primary beneficiary, but that the related-party group (including de facto agents) meets the criteria as a group, the reporting entity may be required to determine which party is most closely associated with the VIE and is required to consolidate the VIE.

It is noteworthy that at the 2014 AICPA National Conference on Current SEC and PCAOB Developments the staff discussed whether related parties under common control are always required to perform the related-party tiebreaker test to determine whether stated power is substantive. The staff noted that while entities must carefully consider situations involving related parties under common control to determine whether stated power is substantive, “the staff does not believe there is a requirement to consider the related party tie-breaker guidance or that [such] guidance is necessarily determinative unless no party in the common control group individually meets both characteristics of a primary beneficiary.”⁸

When evaluating whether a single decision-maker that meets the power criterion also meets the economics criterion, the reporting entity must consider its direct interests and indirect interests (i.e., those held through its related parties and de facto agents) in the VIE. If the single decision-maker meets the economics criterion through its direct interests, it is not necessary to further consider its indirect interests. The reporting entity would only consider its related party’s or de facto agent’s interests in the determination of whether it has met the economics criterion if the reporting entity has an interest in

the related party. If the reporting entity does not have a direct interest in the related party, it would not be appropriate to attribute the related party’s interests to the reporting entity. In addition, the effects of interests held by a related party will be different depending on the reporting entity’s relationship with the related party. Specifically, whether those interests are included in the economics criterion determination on a proportionate basis or in their entirety will depend on whether the related parties or de facto agents are entities under common control of the reporting entity.

Under ASC 810, when no single party has both the power over the relevant activities and a potentially significant economic interest, but members of a related party group, or related parties under common control, would meet both of those criteria, then an assessment is performed to determine which party within the related party group, or related party under common control, is considered most closely associated with the entity and therefore should consolidate. ASC 810 provides the following four criteria to consider in making this assessment:

- The existence of a principal-agency relationship between parties within the related party group
- The relationship and significance of the activities of the entity to the various parties within the related party group
- A party’s exposure to the expected losses and/or residual returns of the entity
- The design of the entity

⁸ Christopher F. Rogers, Professional Accounting Fellow, Office of the Chief Accountant, Remarks before the 2014 AICPA National Conference on Current SEC and PCAOB Developments, Dec. 8, 2014.



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IFRS 10 is less prescriptive when it comes to related parties or de facto agents, requiring that when assessing control, consideration should be given to the nature of the relationships with other parties and whether those parties are acting on the investor's behalf.

Aggregation of interests for evaluating the economics criterion

In evaluating whether the economics criterion has been met, a reporting entity would consider only interests held by its related parties (including de facto agents) under common control if the decision-maker has a direct interest in those related parties. In contrast, if the decision-maker does not hold an interest in its related parties, it would not include any of its related-party interests in its evaluation. However, if the decision-maker has a direct interest in the related parties, the effect of variable interests that are held by a decision-maker's related parties that are not under common control is significantly different from the effect of those under common control. That is, if the related parties are not entities under common control, a decision-maker should include its indirect interests held through its related parties (or de facto agents) on a proportionate basis (rather than in their entirety).

In addition, a reporting entity should generally consolidate a VIE if (1) the reporting entity is a related party to a single decision-maker that does not, individually, have both characteristics of a controlling financial interest, (2) no other party in the related-party group is required to consolidate the VIE, and (3) substantially all of the activities of the VIE either involve or are conducted on behalf of the reporting entity. In this instance,

the related-party decision-maker acts as agent to the reporting entity, which is principal and absorbs all of the variability of the VIE. As stated in ASC 8101-10-25-38G, the level of reporting entity's economics may be indicative of its power. Therefore, consideration should be given when the reporting entity's economics are disproportionately greater than its stated power over the VIE.

Reconsideration of who controls

The variable interest entity guidance in ASC 810 requires that an enterprise continually reconsider its conclusion regarding which interest holder is the entity's primary beneficiary. A change in the determination of whether an entity is required to consolidate could occur as a result of any of the following events or circumstances:

- There is a change in the design of the entity (e.g., a change in the governance structure or management, a change in the activities or purpose of the entity, or a change in the primary risks that the entity was designed to create and pass through to variable interest holders).
- The entity issues additional variable interests or retires or modifies the terms of the variable interests.
- There is a change in the counterparties to the variable interests of the entity (e.g., a reporting entity acquires or disposes of variable interests in a VIE, and the acquired/ disposed-of interest, in conjunction with the reporting entity's other involvement with the entity, causes the reporting entity to gain/lose the power to direct the activities that most significantly affect the entity's economic performance).

- A significant change in the anticipated economic performance of an entity (e.g., as a result of losses significantly in excess of those originally expected for the entity) or other events (including the commencement of new activities by the entity) result in a change in the reporting entity that has the power to direct the activities that most significantly affect the entity's economic performance.
- Two or more variable interest holders become related parties or are no longer considered related parties, and such a related-party group has (had) both the power to direct the activities of the entity and the obligation (right) to absorb losses (benefits) that could potentially be significant to the entity, but neither related party individually possesses (possessed) both characteristics.
- A contingent event occurs that transfers the power to direct the activities of the entity that most significantly affect an entity's economic performance from one reporting entity to another reporting entity.
- There is a troubled debt restructuring.



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Because continual reconsideration is required, the securitization transaction participant may need to determine when, during the reporting period, the change in primary beneficiary occurred. If a deal party determines that it is no longer the primary beneficiary of a securitization entity, it would need to deconsolidate from the date that the circumstances changed and recognize a gain or loss.

Similarly, IFRS 10 requires an investor to reassess whether or not it controls an investee when facts and circumstances indicate that there are changes to one or more of the three elements of control (i.e., power, variable interest holder, and ability to use that power to influence the amount of variable returns). IFRS 10:B85 states that an investor's initial assessment of control or its status as a principal or an agent would not change simply because of a change in market conditions (e.g., a change in the investee's returns driven by market conditions), unless the change in market conditions changes one or more of the three elements of control ... or changes the overall relationship between a principal and an agent.



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Does my securitization meet the sale criteria under GAAP?



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When is a securitization accounted for as a sale?

People often describe a securitization as being either a sale or a financing, and the Financial Accounting Standards Board (FASB) has confirmed that is the intended result of the guidance articulated in [ASC 860](#), Transfers and Servicing. More specifically, ASC 860 stipulates that a transfer⁹ of an entire financial asset, a group of entire financial assets, or a participating interest in an entire financial asset needs to be evaluated for relinquishment of control over those transferred assets.

In performing this evaluation, the question to be answered is whether a transferor (including its consolidated affiliates) has surrendered control over the transferred financial assets. Therefore, it is important for the transferor to first complete its analysis with respect to the securitization special purpose entity's (SPE) consolidation prior to evaluating the transfer of financial assets for its conformity with the requirements for sale accounting treatment.

⁹For accounting purposes, the term "transfer" has a very specific meaning. It relates to non-cash financial assets only and involves a conveyance from one holder to another holder. Examples include selling a receivable, pledging it as collateral for a borrowing or putting it into a securitization vehicle. The definition excludes transactions with the issuer or maker of the financial instrument, such as originating a receivable, collecting it or restructuring it, such as in a troubled debt restructuring.

In reaching a determination on whether control over the transferred financial assets has been surrendered, facts such as the transferor's or any of its consolidated affiliates' continuing involvement with the transferred assets, as well as other arrangements between the parties to the transaction that were entered into either contemporaneously with, or in contemplation of, the transfer must be considered in the analysis.

Sale accounting criteria

For a financial asset transfer (e.g., a securitization of a financial asset or participating interest in a financial asset) to be accounted for as a sale, the transferor must surrender control over the assets transferred.

Control is considered to be surrendered in a securitization only if all three of the following conditions are met: (1) the assets have been legally isolated, (2) the transferee has the ability to pledge or exchange the assets, and (3) the transferor otherwise no longer maintains effective control over the assets.

1. Legal isolation. The transferred assets have to be isolated—put beyond the reach of the transferor, or any consolidated affiliate of the transferor, and their creditors (either by a single transaction or a series of transactions taken as a whole)—even in the event of bankruptcy or receivership of the transferor or any consolidated affiliate.

This is a facts and circumstances determination, which includes (1) judgments about the kind of bankruptcy or other receivership into which a transferor or affiliate might be placed, (2) whether a transfer would likely be deemed a true sale at law, and (3) whether the transferor is affiliated with the transferee.



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In contrast to the “going concern” determination, the transferor must address the possibility of bankruptcy, regardless of how remote insolvency may appear given the transferor’s credit standing at the time of securitization, and irrespective of an entity’s credit rating. That said, it is not enough for the transferor merely to assert that it is unthinkable that a bankruptcy situation could develop during the relatively short term of the securitization.

When thinking about the notion of legal isolation, consider an example of the typical two-step securitization structure:

- **Step 1:** The seller/company transfers assets to an SPE that, although wholly owned, is designed in such a way that the possibility that the transferor or its creditors could reclaim the assets is remote. This first transfer is designed to be judged a true sale at law, in part because it does not provide excessive credit or yield protection to the SPE.
- **Step 2:** The SPE transfers the assets to a trust or other legal vehicle with a sufficient increase in the credit and yield protection on the second transfer (provided by a subordinated retained beneficial interest or other means) to merit the high credit rating sought by investors.

The second transfer may or may not be judged a true sale at law and, in theory, could be reached by a bankruptcy trustee for the SPE. However, the first SPE’s charter forbids it from undertaking any other business or incurring any liabilities, thus removing concern about its bankruptcy risk. The charter of each SPE must also require that the company be maintained as a separate concern from the parent to avoid the risk that the assets of the SPE would be substantively consolidated with the parent’s assets in a bankruptcy proceeding involving the parent. It is important to note that this structure is often very important to the attorneys’ analysis.

The accounting conclusion as to whether the SPEs should be consolidated for financial statement purposes may factor into the attorneys’ reasoning as to whether the assets have been isolated from a transferor’s creditors in the event of transferor bankruptcy, but should not be determinative. Thus, it is perfectly acceptable to have the SPE in Step 1 consolidated for accounting purposes, but for the investors to still receive assurance in the form of the lawyers’ letters that the assets have been sold in a “true sale.” Said another way, legal isolation must be determined from the perspective of the transferor and all of its consolidated affiliates. However, consolidated affiliates excludes those entities that are designed to be bankruptcy-remote (i.e., SPEs that have no other business purpose).¹⁰ Further, while the legal analysis with respect to legal isolation may evaluate the entities distinctly, the accounting analysis with respect to consolidation still needs to be performed.

A legal opinion may not be required if a transferor has a reasonable basis to conclude that the appropriate legal opinion(s) would be given if requested. For example, the transferor might reach a conclusion without consulting an attorney if (1) the transfer is a routine transfer of financial assets that does not result in any continuing involvement by the transferor, or (2) the transferor had experience with other transfers with similar facts and circumstances under the same applicable laws and regulations.

For entities that are subject to other possible bankruptcy, conservatorship, or other receivership procedures (e.g., banks subject to receivership by the Federal Deposit Insurance Corporation) in the United States or other jurisdictions, judgments about whether transferred financial assets have been isolated need to be made in relation to the powers of bankruptcy courts or trustees, conservators, or receivers in those jurisdictions.

Ability of transferee to pledge or exchange the transferred assets.

When the transferee is a securitization vehicle that is constrained from pledging or exchanging the transferred assets, each third-party holder of its beneficial interests must have the right to pledge or exchange those beneficial interests.

Any restrictions or constraints on the holder’s rights to monetize the cash inflows (the primary economic benefits of financial assets) by pledging or selling those beneficial interests have to be carefully evaluated to determine whether the restriction

¹⁰ As stated in ASC 860-10-40-5(a): “For multiple step transfers, a bankruptcy-remote entity is not considered a consolidated affiliate for purposes of performing the isolation analysis.”



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precludes sale accounting, particularly if the restriction provides more than a trivial benefit to the transferor, which it is presumed to do. As explained in ASC 860, the FASB believes that, in the absence of evidence to the contrary, a condition imposed by a transferor that constrains the transferee presumptively provides more than a trivial benefit to the transferor.

An important factor in the analysis is whether the transferor has continuing involvement in the transferred assets. When FAS 140 was written, its Basis for Conclusions stated that “transferred assets from which the transferor can obtain no further benefits are no longer its assets and should be removed from its statement of financial position,” as would be the case if the transferor has no continuing involvement in the transferred assets. Examples of continuing involvement include:

- Servicing responsibilities
- Recourse obligations other than standard representations and warranties
- Management’s responsibilities
- Full or partial equity ownership of the vehicle containing the transferred assets
- Other participations in future cash flows

The assessment of whether the continuing involvement is such that a constraint on the transferee would ultimately provide more than a trivial benefit to the transferor requires judgment. Even if it is not a transferor-imposed constraint, the constraint must be evaluated if the transferor is aware of it.

Holder of an SPE’s securities are sometimes limited in their ability to transfer their interests, due to a requirement that permits transfers only if the transfer is exempt from the requirements of the Securities Act of 1933. The primary limitation imposed by [Rule 144A](#) of the Securities Act, that a potential secondary purchaser must be a sophisticated investor, does not preclude sale accounting, assuming that a large number of qualified buyers exist. Neither does the absence of an active market for the securities.

2. Surrender effective control. The transferor, its consolidated affiliates, or its agents cannot effectively maintain control over the transferred assets or third-party beneficial interests related to those transferred assets through:

- An agreement that requires the transferor to repurchase the transferred assets before their maturity (in other words, the agreement both entitles and obligates the transferor to repurchase as would, for example, a forward contract or a repo).
- The ability to unilaterally cause the SPE to return specific assets, other than through a cleanup call, that conveys more than a trivial benefit to the transferor.
- An agreement that permits the transferee to require the transferor to repurchase the transferred assets that is priced so favorably that it is probable that the transferee will, in fact, require the transferor to repurchase them.

The accounting literature precludes sale accounting if the transferee has any contractual mechanism to require the transferor to take back specific assets on terms that are potentially advantageous through a put option that, when it is written, is deep in the money. In these cases, the transferor maintains effective control because it has priced the transferee’s option on terms so favorable that it is probable that the transferee will require the transferor to repurchase. If the put option is priced at fair value, or, when it is written, is priced sufficiently out of the money so that it is probable that it will not be exercised, then the option would not preclude sales treatment.

What if I fail to comply with the sale criteria?

If the securitization does not qualify as a sale, the proceeds (other than beneficial interests in the securitized assets) are accounted for as a liability—a secured borrowing. The assets will remain on the balance sheet with no change in measurement, meaning that no gain or loss is recognized. With no gain or loss recognized, the assets should be classified separately from other assets that are unencumbered.

The securities relating to the transferred assets that are legally owned by the transferor or any consolidated affiliate (i.e., the securities that are not issued for proceeds to third parties) do not appear on the transferor’s consolidated balance sheet. They are economically represented as being the difference between the securitization-related assets and the securitization-related liabilities on the balance sheet.



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Ongoing accounting for a securitization, even if treated as a financing, requires many subjective judgments and estimates, and could still cause volatility in earnings due to the usual factors of prepayments, credit losses, and interest rate movements. After all, the company still effectively owns a residual. Securitizations accounted for as financings are often not that much different economically than securitizations that qualify for sale accounting treatment. Therefore, the excess of the securitized assets (which remain on balance sheet) over the related funding (in the form of recorded securitization debt) is closely analogous economically to a retained residual.



Who is considered to be the transferor in a “rent-a-shelf” transaction?

Often, a commercial or investment bank will “rent” its Securities and Exchange Commission shelf registration statement to an unseasoned securitizer that does not have one. The loan originator first sells the loans to a depositor, which is typically a wholly-owned, bankruptcy-remote, special-purpose corporation established by the commercial or investment bank. The depositor immediately transfers the loans to a special-purpose trust that issues the securities sold to the investors. The loan originator often takes back one or more (usually subordinated) tranches.

In this situation, even though the depositor subsidiary of the commercial or investment bank transferred the loans to the trust issuer, it was doing so more as an accommodation to the loan originator and was not taking the typical risk as a principal. If the securitization transaction with outside investors for some reason failed to take place, the depositor would not acquire the loans from the originator. Accordingly, it is the loan originator that would be considered the transferor for purposes of applying the sale criteria to the securitization.

ASC 860 emphasizes the role of agent in evaluating transactions. As defined, an agent is a party that acts for and on behalf of another party; thus, in the preceding scenario, the depositor would be acting as an agent. Generally speaking, transactions involving a third-party intermediary acting as agent on behalf of a debtor, the actions of the intermediary shall be viewed as those of the debtor in order to determine whether there has been an exchange of debt instruments or a modification of

terms between a debtor and a creditor. On the other hand, commercial or investment banks often purchase whole loans from one or more loan originators (sometimes servicing retained) and accumulate those loans to be securitized using the dealer’s shelf when and how the dealer chooses. In this situation, the commercial or investment bank would be considered the transferor for purposes of applying the sale criteria to the securitization.

When trying to determine whether an entity is acting as a principal or an agent in a transaction, securitizers may wish to consider the principal/agent guidance in [ASC 470-50-40](#) on debt modifications and [ASC 605-45-45](#) on revenue recognition by analogy.

If you don’t put it to me, can I call it from you?

The accounting rules governing puts are easier than those that govern calls. It’s interesting (and to some, counterintuitive) that options allowing investors to put their bonds back to the transferor generally do not preclude sale treatment (but be sure to check with legal counsel, as put options complicate the legal true sale analysis). The rules here are consistent with the theory that the seller has relinquished control over the transferred assets, and that the transferee has obtained control, even if only temporarily. But a put option that is sufficiently deep-in-the-money when it is written, causing it to be probable that the transferee will exercise it, is problematic. These puts are viewed as the economic equivalent of a forward contract or repurchase agreement.



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Put options have been used successfully in transactions to create guaranteed final maturities of short-term tranches to achieve “liquid asset” treatment for thrifts or “money market” treatment for certain other classes of investors, but a number of detailed accounting requirements must be considered. Also, hybrid adjustable rate mortgages have been securitized with a put exercisable at the point when the loans turn from a fixed to an adjustable rate. When a securitization with a put feature is accounted for as a sale, the transferor has to record a liability equal to the fair value of the put obligation.

Analyzing call options continues to be the area that probably is the most conceptual, confusing, and prone to misinterpretation. ASC 860 describes several types of calls, with each potentially having a different effect on the sale vs. financing determination:

- **Attached calls** are call options held by the transferor that become part of and are traded with the transferred asset or beneficial interest.
- **Embedded calls** are issuer call options held by the maker of a financial asset included in a securitization that is part of and trades with the financial asset. Examples are call options embedded in corporate bonds and prepayment options embedded in mortgage loans. A call might also be embedded in a beneficial interest issued by an SPE.
- **Freestanding calls** are calls that are neither embedded in nor attached to an asset subject to that call. For example, a freestanding call may be written by the transferee and held by the transferor of an asset but not travel with the asset. Freestanding calls (other than cleanup calls) are not commonly found in securitization transactions.

- **Conditional calls** are call options that the holder does not have the unilateral right to exercise. The right to exercise is conditioned on the occurrence of some event (not merely the passage of time) that is outside the control of the transferor, its affiliates, and its agents.
- **Cleanup calls** are options held by the servicer or its affiliate (which may be the transferor) to purchase the remaining transferred financial assets if the amount of outstanding assets or beneficial interests falls to a level at which the cost of servicing those assets or beneficial interests becomes burdensome in relation to the benefits of servicing. Note that some readers think that “10 percent” is synonymous with a cleanup call. However, the amount 10 percent does not appear anywhere in the ASC 860 Glossary definition of a cleanup call. That said, this analysis should be performed when the servicing arrangement commences, and should focus on when servicing is burdensome.
- **In-substance call** options are deemed to exist when the transferor has the right to cause the transferee to sell the assets and (1) has a right (such as a right of first refusal) to obtain the assets, or (2) has some economic advantage providing it, in-substance, with the practical right to obtain the asset because it is not penalized by paying more than the fair value of the asset. Examples of such advantages include ownership of the residual interest and a total return swap with the transferee.

- **Removal of accounts provisions (ROAP):** ROAPs permit the transferor to reclaim assets, subject to certain restrictions. In revolving deals, exercise of a ROAP often does not require payment of any consideration, other than reduction of the transferor’s received interest (the seller’s interest). ROAPs are commonly, though not exclusively, used in revolving transactions involving credit cards.



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Calling all calls?

As previously discussed, rights or obligations to reacquire specific transferred assets or beneficial interests which both constrain the transferee and provide more than a trivial benefit to the transferor preclude sale accounting. Consider, for example, a transaction where the beneficial interest holders agree to sell their interests back to the transferor at the transferor's request for a price equal to the holders' initial cost plus a stated return. In the absence of evidence to the contrary, a condition imposed by a transferor that constrains the transferee presumptively provides more than a trivial benefit to the transferor. Here, the transferor has the ability to reacquire the assets from the transferee at an amount potentially below current fair value; therefore, any such arrangement would be viewed as providing more than a trivial benefit to the transferor. On the other hand, if the call option's strike price was set equal to fair market value on date of exercise, it is less likely that the transferor would be viewed as retaining more than a trivial benefit, whereas a fixed price call option could allow the transferor to reacquire the asset at less than its fair value. Other facts and circumstances may further impact this analysis—for example, if the assets are not readily obtainable, the transferee may be constrained.

Further, if the transferor holds a fixed-price call option to repurchase any loans it chooses from the portfolio transferred, then sale accounting is precluded for the transfer of the entire portfolio (even if the option is subject to some specified limit, assuming all loans in the pool are smaller than such limit). This conclusion is based on the fact that the transferor can unilaterally remove specific assets at its sole election, and thus control has not been transferred.

How 'conditional' must a conditional call be?

ASC 860 makes a distinction between call options that are unilaterally exercisable by the transferor and call options for which the exercise by the transferor is conditioned upon an event outside its control. If the conditional event is outside its control, the transferor is not considered to have retained effective control. An example of a conditional call would be a right to repurchase defaulted loans. Another example would be a right to call the remaining beneficial interests subject to a put option, which is exercisable only in the event that holders of at least 75 percent of the securities put their interests. Once the condition is met and if there is more than a trivial benefit to the transferor, the assets under option are to be brought back on balance sheet, regardless of the transferor's intent, until the option expires. When the assets under option are brought back on balance sheet, the transferor treats them as if they were newly purchased.

While later codified in ASC 860, *FASB Implementation Guide Q&A 140—A Guide to Implementation of Statement 140 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* did not directly provide any guidance regarding the impact on sale accounting of a call option that is conditioned upon an event that is outside the transferor's control, but is likely to occur. As a result, ASC 860 remains without a directly on-point example.

A hypothetical example follows: A transferor sells beneficial interests to third parties, but retains the right to reacquire those beneficial interests if the London Interbank Offered Rate (LIBOR) increases at any time during the life of the beneficial interests. Although the transferor has no control over the future level of LIBOR, it is highly likely that the call will become exercisable sometime during the life of the beneficial interests, perhaps very soon. Thus, most accountants would likely object to sale accounting because the contingency is not substantive. In contrast, depending on what level of LIBOR is set as the strike price, the option could be considered a conditional call because there is less certainty about whether the strike price will ever be reached. Separately, these types of options may also impact the views of the lawyers.



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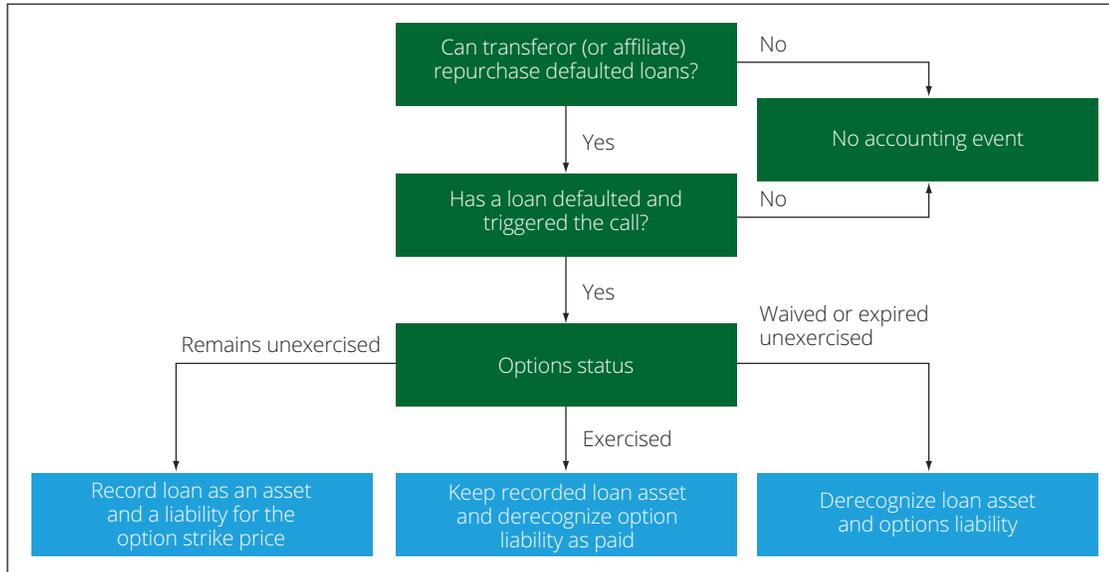
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Accounting for default call options



And batting cleanup

A transferor that is not the servicer is not permitted to hold the cleanup call. The underpinning for this is the notion that only a servicer is burdened when the amount of outstanding assets falls to a level at which the cost of servicing the assets becomes excessive—the defining condition of a cleanup call. Any other party would be motivated by some other economic incentive in exercising a call. A servicer cleanup call on beneficial interests

is permitted because the same sort of burdensome costs vs. benefits may arise when the beneficial interests fall to a small portion of their original level. It should be noted, however, that the threshold test for this type of cleanup call is still the burden, or cost, to the servicer, not the benefit of keeping the transaction outstanding; presumably, the cost to the servicer in servicing the transaction differs from the costs associated with the servicing of the assets.

Can I still hold on to the ROAPs?

ROAPs permit the transferor to reclaim assets, subject to certain restrictions. In revolving deals, exercise of a ROAP often does not require payment of any consideration, other than reduction of the seller’s interest. As a general rule, a ROAP for random removal of excess assets is permitted if the ROAP is sufficiently limited so that the transferor cannot remove specific assets (e.g., the ROAP is limited to the amount of the transferor’s interest and to one removal per month).

ROAPs are used for a variety of business reasons. A bank might have an affinity relationship with an organization—say, the Association of Friends and Families of Overworked Accountants (AFFOA). If the bank securitizes member balances, it might become necessary to remove them from the deal if the bank loses the relationship with AFFOA. The balances would then be transferred to the credit card originator and then onto the new bank that holds the affinity relationship.

Can I account for a transaction as part sale/part financing?

ASC 860 makes it clear that the effective control criteria apply to:

- Transfers of entire financial assets,
- Transfers of a group of entire financial assets, and
- Transfers of participating interests.



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Consequently, if there is not a transfer of effective control over the entire pool of receivables placed into a securitization transaction, then the entire transaction is accounted for as a financing. Additionally, transferors must transfer a pool in its entirety; they may receive beneficial interests in the transferred assets, but only if the interests are issued by an unconsolidated transferee.

What about participations?

Banks often issue participations in loans that they have originated, and the requirements for the appropriate accounting for those transactions have always looked to the application of the guidance governing transfers of financial assets. Only participating interests, as defined below, are eligible for sale accounting:

- a. **Pro rata ownership interest:** From the date of the transfer, the participation represents a proportionate (pro rata) ownership interest in an entire financial asset. The percentage interest held by the transferor may vary over time, while the entire underlying financial asset remains outstanding as long as the resulting portions held by the transferor and the transferee(s) meet the other characteristics of a participating interest.
- For example, if the transferor's interest in an entire financial asset changes because it subsequently sells another interest in the entire financial asset, the interest held initially and subsequently by the transferor must meet the definition of a participating interest.

- b. **Proportionate division of cash flows:** From the date of the transfer, all cash flows—including both principal and interest—received from the underlying financial asset are divided proportionately among the participating interest holders in an amount equal to their share of ownership.

Compensation for services performed, such as servicing, shall not be included in this determination, provided those cash flows are not subordinate to the proportionate cash flows of the participating interest and are not significantly above an amount that would be considered market rate. These fees should include the profit that would be demanded in the marketplace. Finally, any cash flows received by the transferor as proceeds of the transfer of the participating interest shall be excluded from the determination of proportionate cash flows, provided that the transfer does not result in the transferor receiving an ownership interest in the financial asset that permits it to receive disproportionate cash flows.

- c. **No subordination:** The rights of each participating interest holder, including the transferor in its role as a participating interest holder, have the same priority, and no one interest holder's interest is subordinated to another's. That priority may not change in the event of bankruptcy or other receivership of the transferor, the original debtor, or any other participating interest holder. Participating interest holders may have no recourse to the transferor (or its consolidated affiliates or its agents) or to each other, other than standard representations and warranties, ongoing contractual obligations to service the entire financial asset and administer

the transfer contract, and contractual obligations to share in any set-off benefits received by any participating interest holder. No participating interest holder is entitled to receive cash before any other participating interest holder under its contractual rights as a participating interest holder. If one of the participating interest holders is the servicer of the asset, and that entity receives cash first in that role as compensation, it would not violate this requirement.

- d. **Disposition of the underlying asset:** No party has the right to pledge or exchange the underlying financial asset unless all participating interest holders agree to pledge or exchange the underlying financial asset.

If the transferor transfers an entire financial asset in portions that do not individually meet the participating interest definition, sale accounting criteria shall only be applied to the entire financial asset once all portions have been transferred.

One might wonder how a third-party guarantee affects the evaluation of a participating interest. The transfer of a portion of a financial asset represents a participating interest if, among other things, the participating interest holders do not have recourse to any other participating interest holder (other than standard representations or warranties, as defined in ASC 860, and obligations to service, administer, and share in setoff benefits). ASC 860 indicates that cash flows subject to a third-party guarantor do not fail the analysis of a participating interest because the third-party guarantee is considered a "separate unit of account." The FASB's conclusion is based on its belief that



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a third-party guarantee represents a separate arrangement in which the guarantor will assume ownership of the participating interest in the event of default (i.e., upon default, the third-party guarantee no longer exists, because the guarantor assumes the ownership of the participating interest and the rights and obligations of the other participating interest holders do not change).

Many securitizations of trade receivables traditionally relied on a structure in which a company transferred a pool of receivables to a bankruptcy-remote entity, which then issued a senior undivided beneficial interest in the pool to a multi-seller commercial paper conduit. The bankruptcy-remote entity is part of the transferor's consolidated group. Consequently, using

the criteria set forth above, the undivided beneficial interest issued in the pool to the conduit needs to be evaluated to see if it meets the definition of a participating interest. Because the interest is "senior," the undivided beneficial interest would not meet the definition of a participating interest. Because ASC 860 mandates that transfers of entire assets, an entire pool of assets, or participating interests only can be subjected to the sale criteria, sellers of trade receivables using this structure would be precluded from accounting for their transactions as sales. Of course, one alternative would be to sell the entire pool of assets in exchange for the same amount of cash and some sort of receivable from the conduit. See [Chapter 5](#) for an illustrative example.

What is 'an entire financial asset?'

The emphasis in ASC 860 that the requirements for sale accounting must be applied only to a financial asset in its entirety, a pool of financial assets in its entirety, or participating interests highlights that, inherent in this concept, is that a financial asset (or pool of assets) may not be divided into components prior to transfer unless all of the components meet the definition of a participating interest. What, then, is an "entire" financial asset—what is the unit of account?

Here are some examples:

- A loan to one borrower in accordance with a single contract that is transferred to a securitization entity shall be considered an entire financial asset.

- Similarly, a beneficial interest in securitized financial assets after the securitization process has been completed shall be considered an entire financial asset.
- In a transaction in which the transferor creates an interest-only (IO) strip from a loan and then transfers the IO strip, the IO strip does not meet the definition of an entire financial asset.
- In contrast, if an entire financial asset is transferred to a securitization entity that it does not consolidate and the transfer meets the conditions for sale accounting, the transferor may obtain an IO strip as proceeds from the sale. An IO strip received as proceeds of a sale is an entire financial asset for purposes of evaluating any future transfers that could then be eligible for sale accounting.

If multiple advances are made to one borrower in accordance with a single contract (such as a line of credit, credit card loan, or a construction loan), an advance on that contract would be a separate financial asset if the advance retains its identity, does not become part of a larger loan balance, and is transferred in its entirety. However, if the advances lose their separate identity as part of a larger loan balance, then a participating interest in that larger balance may be eligible for sale accounting.

Overall, the legal form of the asset, and what the asset conveys to its holders, are the principal considerations in determining what constitutes an entire asset.



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How do securitizations fare under IFRS?



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Chapter 4: How do securitizations fare under IFRS?

International securitization accounting—IAS 39 and beyond

The derecognition criteria under US Generally Accepted Accounting Principles (GAAP) was discussed in [Chapter 3](#). But what about transfers involving companies following international standards? The securitization accounting framework under International Financial Reporting Standards (IFRS) is included within IAS 39,¹¹ *Financial Instruments: Recognition and Measurement*.

Does IAS 39 use the same control-based approach as ASC 860?

No. While [ASC 860](#), *Transfers and Servicing*, focuses on whether a transferor has surrendered control over a financial asset, IAS 39 applies a combination of risks and rewards and control tests. The risks and rewards tests seek to establish whether, having transferred a financial asset, the entity continues to be exposed to the risks of ownership of that asset and/or the benefits that it generates. The control tests are designed with a view to

understanding which entity controls the asset (i.e., which entity can direct how the benefits of that asset are realized).

The use of both types of tests is often criticized for being a mix of two accounting models that can create confusion in application. IAS 39 addresses this criticism by providing a clear hierarchy for application of the two sets of tests: risks and rewards tests are applied first, with the control tests used only when the entity has neither transferred substantially all the risks and rewards of the asset nor retained them.

Inherent in the IAS 39 derecognition model is the notion of “stickiness”; it is more difficult to remove an asset from an entity’s balance sheet than it is to recognize that asset in the first place. Derecognition cannot be achieved by merely transferring the legal title to a financial asset to another party. The substance of the arrangement must be assessed in order to determine whether an entity has transferred the economic exposure associated with the rights inherent in the asset (i.e., its risks and rewards) and, in some cases, control of those rights.

What is the IAS 39 framework for derecognition following a transfer?

Whether a transfer qualifies for derecognition does not directly depend on whether the transfer is directly to investors in a single step or goes through a special purpose entity (SPE) that transfers assets or issues beneficial interests to investors. Securitizers first consolidate all subsidiaries according to [IFRS 10](#) (see [Chapter 2](#)) and then evaluate the transaction in its totality. Whether the transfer qualifies for full, partial, or no derecognition will depend on the proportion of risk and rewards transferred to the investors compared to the amount retained by the transferor:

- If substantially all the risks and rewards of ownership of the financial asset are transferred, the transferor derecognizes the financial asset and recognizes separately as assets or liabilities any rights and obligations created or retained in the transfer.
- If substantially all the risks and rewards of ownership of the financial asset are retained (i.e., the transferor continues to absorb most of the likely variability in net cash flows), the transferor continues to recognize the financial asset and an associated liability for the proceeds.

¹¹ In 2014, the IASB issued an amended financial instruments standard in IFRS 9, *Financial Instruments* that will eventually replace IAS 39. The amended standard addresses classification and measurement criteria for financial assets, recognition and derecognition of financial assets and credit impairment. IFRS 9 has an effective date of January 1, 2018, with early adoption permitted. See [Chapter 13](#) for more discussion.



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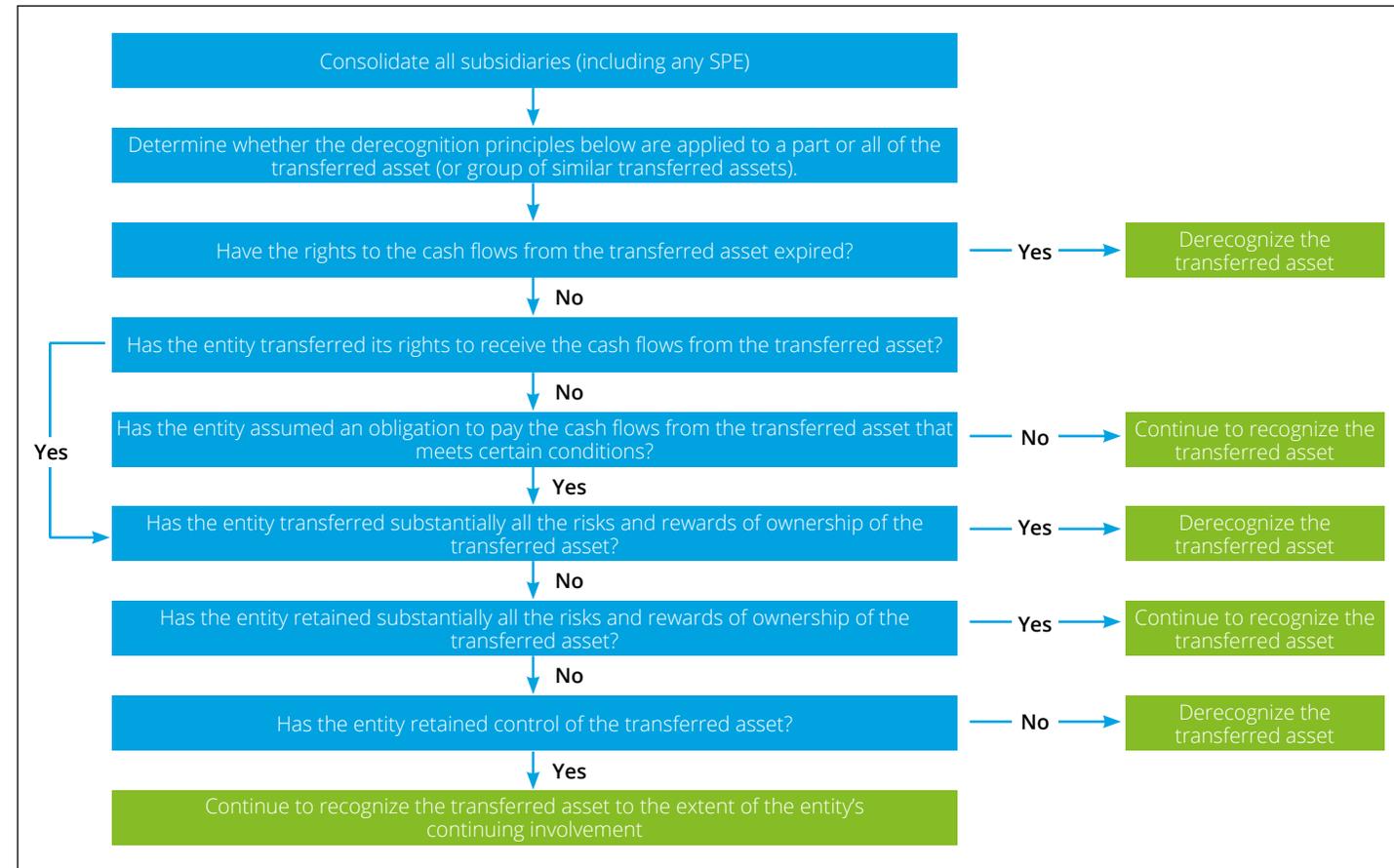
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- If neither the transferee nor the transferor has substantially all the risks and rewards of ownership (e.g., a significant amount, but not substantially all, of the risks and rewards has been passed), the transferor either:
 - Derecognizes the transferred assets as in (1) above, if the transferor has not retained control of the financial assets or
 - Continues to recognize the financial assets only to the extent of its continuing involvement in them, if the transferor has retained control of them.

IAS 39 derecognition decision tree



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Step 1—Have I consolidated all subsidiaries, including any SPEs?

See [Chapter 2](#) for a discussion of the consolidation requirements under IFRS.

Step 2—Do I look at the entire asset or just the transferred portion?

The second step is determining exactly what is being considered for derecognition purposes. Specifically, this involves determining whether a whole financial asset, a group of financial assets, a part of a financial asset, or a part of a group of similar financial assets, is being evaluated for derecognition.

A part of a financial asset (or a group of similar financial assets) is considered separately for derecognition only if it comprises (1) specifically identified cash flows (e.g., an interest-only [IO] or principal-only strip), (2) a fully proportionate (pro rata) share of the cash flows (e.g., rights to 90 percent of all cash flows of a financial asset), or (3) a fully proportionate (pro rata) share of specifically identified cash flows (e.g., 90 percent of the cash flows of an IO strip). In all other cases, the financial asset (or assets) is considered in its entirety.

For example, if an entity transferred to a securitization trust all the principal and all but 1 percent of the interest flows from a pool of financial assets, and the retained interest strip was *pari passu* with the transferred interest cash flows, the transferred interest receipts and all of the principal would be the financial asset for which the transfer would be evaluated. On the other hand, if the 1 percent interest strip was subordinated for purposes of providing credit enhancement to the investors'

principal, then the entire asset (e.g., pool of loans) would be the financial asset for which the transfer would be evaluated. These conclusions are not affected by whether the trust issued to outside investors various classes of beneficial interests to achieve credit or time tranching.

IAS 39 does not provide guidance on what makes assets “similar.” Similar generally means that the two instruments have contractually specified cash flows similar in amounts, timings, and risk characteristics. Consideration should be focused on the similarity of terms such as prepayment features, interest rates, and currency denomination. By definition, there will always be some differences between similar instruments—otherwise they would be identical. A portfolio of mortgages transferred by a bank is often deemed to contain similar financial assets. Similarly, a portfolio of corporate bonds transferred by a bank is often deemed to contain similar financial assets. However, no two portfolios are ever precisely alike. A transfer of a portfolio of mortgages would need to be assessed separately from a transfer of a portfolio of corporate bonds even if the two transfers are made at the same time.

Step 3—Have the rights to the cash flows from the asset expired?

A financial asset is derecognized when the rights to the cash flows from that asset expire. The rights to the cash flows expire when, for example, a financial asset reaches its maturity and there are no further cash flows arising from that asset, or a purchased option reaches its maturity unexercised. An entity may have a right to receive certain or all cash flows from a financial asset over a specified period of time, which may be

shorter than the contractual maturity of that financial asset. In that case, the entity's right to the cash flows expires once the specified period expires.

Step 4—Have I transferred my rights to receive the cash flows from the asset?

A transfer may involve transferring the contractual rights to the cash flows of a financial asset, or it may involve retaining the contractual rights to the cash flows, but assuming a contractual obligation to pass on those cash flows to other recipients (i.e., a pass-through arrangement). In a pass-through arrangement, the transaction is treated as a transfer of a financial asset if, and only if, all of the following conditions are met:

- There is no obligation to pay amounts to the eventual recipients unless equivalent collections are received from the original asset.
- The terms of the transfer arrangement prohibit selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows (i.e., no control of the future economic benefits associated with the transferred asset).
- An obligation exists to pass on or remit the cash flows that it has collected on behalf of the eventual recipients *without material delay* and is prohibited from reinvesting the cash flows received in the short settlement period between receiving them and remitting them to the eventual recipient in anything other than cash or cash equivalents and any interest earned on such investments must be passed on to the eventual recipients.



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Outright transfers of contractual rights to cash flows of financial assets generally result in the derecognition assessment being a bit more straightforward. Assessments of pass-through arrangements typically tend to be a bit more challenging. Following are a few issues that arise in consideration of each scenario.

Outright transfers of contractual rights

What if I don't transfer legal title to the asset(s)?

In 2006, the IASB considered a number of derecognition issues, including whether any transfer in which legal ownership of the asset is not transferred can be considered an outright transfer of contractual rights under paragraph 18(a) of IAS 39. In other words, would the pass-through test be applicable to all transfers in which legal ownership of the financial asset is not transferred? The IASB indicated that a transaction in which an entity transfers all the contractual rights to receive the cash flows, without necessarily transferring legal ownership of the financial asset, would not be treated as a pass-through pursuant to paragraph 18(b) of IAS 39 and would be considered an outright transfer of contractual rights. An example might be a situation in which an entity transfers all the legal rights to specifically identified cash flows of a financial asset (e.g., a transfer of the interest or principal of a debt instrument). Conversely, application of the pass-through test would be required in situations in which the entity does not transfer all the contractual rights to cash flows of the financial asset, such as disproportionate transfers. The IASB's view on this issue would mean that a transfer of all the legal rights to cash flows for a full proportionate interest in an

asset (say, 50 percent, of all cash flows), even though legal title of the asset was not transferred to the transferee, the transferor would apply the outright transfer test to the transfer and, therefore, would avoid the pass-through tests in paragraph 18(b).

What if the transfer involves conditions?

The IASB has also previously considered whether conditional transfers should be treated as pass-through transactions. Conditions attached to a transfer could include provisions ensuring the existence and value of transferred cash flows at the date of transfer or conditions relating to the future performance of the asset. The IASB indicated that such conditions would not affect whether the entity has transferred the contractual rights to receive cash flows. However, the existence of conditions relating to the future performance of the asset might affect the conclusion related to the transfer of risks and rewards (as further discussed below) as well as the extent of any continuing involvement by the transferor in the transferred asset.

Can I retain servicing rights?

IAS 39:18(a) focuses on whether an entity transfers the contractual rights to receive the cash flows from a financial asset. The determination as to whether the contractual rights to cash flows have been transferred is not affected by the transferor retaining the role of an agent to administer collection and distribution of cash flows. Retention of servicing rights by the entity transferring the financial asset does not, in itself, cause the transfer to fail the requirements in IAS 39:18(a). However, careful



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judgment must be applied to determine whether the entity providing servicing is acting solely as an agent for the owner of the financial asset (i.e., whether it has transferred all risks and rewards). The existence of servicing does not prevent an entity from transferring the contractual rights to the cash flows of the asset.

A transferor may retain the right to a part of the interest payments on transferred assets as compensation for servicing those assets. The part of the interest payments that the entity would give up upon termination or transfer of the servicing contract is allocated to the servicing asset or servicing liability. The part of the interest payments that the entity would not give up is an IO strip receivable. For example, if the entity would not give up any interest upon termination or transfer of the servicing contract, the entire interest spread is an IO strip receivable. The fair values of the servicing asset and IO strip receivable are used to allocate the carrying amount of the receivable between the part of the larger asset that is derecognized and the part that continues to be recognized. If there is no servicing fee specified or the fee to be received is not expected to compensate the entity adequately for performing the servicing, a liability for the servicing obligation is recognized at fair value.

Pass-through arrangements

Does the possibility of default by the transferor matter?

The likelihood that the transferor will default under a pass-through arrangement as a result of a default on other creditor obligations is not considered an impediment to meeting the pass-through criteria because the transferor is assumed to be a going concern. In most instances, the transferee will limit this risk by ensuring that the transferred assets reside in a bankruptcy-remote SPE so that the wider credit risk of the transferor is not borne by the transferee.

What about inclusion of credit enhancement?

A transferor may provide credit enhancement in a transfer arrangement so that it suffers the first loss on the asset up to a specified amount. In these circumstances, if the debtor fails to pay, the transferor absorbs the first loss fully, with the eventual recipient suffering a loss only after the first loss has been fully absorbed. A credit enhancement may be in the form of overcollateralization or may be in the form of purchasing a subordinated interest in a consolidated SPE (in the latter case, the entity is applying the pass-through tests at a consolidated level). Providing credit enhancement will not in itself result in failure of the pass-through tests if all cash received by the transferor on transferred assets is paid on to the eventual recipient, although the credit enhancement may result in failure of derecognition due to the transferor retaining substantially all the risks and rewards of ownership of the assets (see further discussion below on consideration of retaining risk and rewards). The pass-through tests must be considered prior to considering the entity's exposure to risk and rewards.

If a greater amount of cash is realized on the assets than is needed to pay the eventual recipient (i.e., the eventual recipient's initial investment is fully paid), then the entity will retain the remainder of the cash and will not pass it on. In all cases, the entity passes any cash it collects on behalf of the eventual recipients.

How is 'without material delay' interpreted? "Without material delay" does not mean instantaneously, nor does it imply an extended length of time. The contractual arrangement will need to be considered in full in order to make an assessment as to whether the timeframe between the collection of cash flows on the underlying assets and the point at which they are passed on to the eventual recipients is material in the context of the contractual arrangements of the transfer.

In some arrangements, the cash collected on the underlying assets occurs sporadically throughout a period of time. For example, if an entity retains the rights to the cash flows arising on a group of credit card receivables, the payments arising on those credit cards are likely to occur on any given day throughout the month. The contractual arrangement of the transfer may require that those cash flows are remitted to the eventual recipients weekly, monthly, quarterly, or even annually. There is a trade-off between passing on the cash flows almost as soon as they arise and the administrative burden that goes along with passing on those cash flows. It is likely that half-yearly payments to the eventual recipients (and certainly annual payments) would be considered to be subject to a material delay because the conditions specified above fail and, therefore,



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derecognition would be inappropriate in these circumstances. It appears reasonable that the entity can invest the cash flows from the assets for up to three months without breaching the condition that all cash flows must be passed to the eventual recipient without material delay.

Any significant delay in passing on the cash flows of a transferred asset alters the credit risk characteristics for the eventual recipient when compared to the original transferred asset. The holder is exposed not only to the original transferred asset, but also to additional credit risk from the reinvestment of the cash flows from the original asset.

How does this apply to revolvers?

In a revolving structure, cash received on the assets is reinvested in buying new receivables assets. In other words, cash revolves into new assets instead of being returned immediately to the investors. Upon maturity, the reinvested assets are used to repay the beneficial interest holders. Such revolving structures do not meet the pass-through tests because they involve a material delay before the original cash is passed onto the eventual recipients and the reinvestment would typically not be in cash or cash equivalents.



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Step 5—Have I transferred substantially all of the risks and rewards of ownership of the asset?

Determining the extent to which the risks and rewards of the transferred asset have been transferred and retained is critical in determining the accounting outcome for a transfer. The greater the risks and rewards retained, the greater the likelihood of continued recognition. The degree to which risks and rewards have been transferred and its effect on the accounting outcome can be illustrated as follows.

When an entity transfers substantially all of the risks and rewards of ownership of the financial asset, the asset should be derecognized. The entity may have to recognize separately any rights and obligations created or retained in the transfer.

IAS 39 provides three examples of transferring substantially all the risks and rewards of ownership (1) unconditionally selling a financial asset, (2) selling a financial asset together with an option to repurchase the financial asset at its fair value at the time of repurchase, and (3) selling a financial asset together with a put or

call option that is deeply out of the money (i.e., an option that is so far out of the money it is highly unlikely to go into the money before expiring). In the first example, it is clear that there has been a transfer of all the risks and rewards of ownership of the asset. In the second example, the entity has sold the asset and, although it can call the asset back, this can only be done at the fair market value of the asset at the time of reacquisition. The entity is in the same economic position as having sold the asset outright, with the ability to go into the market to reacquire the asset (i.e., it has transferred the full price risk of the asset). In the third example, the option is highly unlikely ever to be exercised and has very little value, which is substantially the same economic position as an unconditional sale.

There is no bright line provided in IAS 39 as to what is meant by a transfer of “substantially all” of the risks and rewards of ownership, and a significant degree of judgment is required when applying the risks and rewards test. There are other references in IAS 39 to various yardsticks that need to be met when applying certain paragraphs. For example, when comparing the old and new terms of a financial liability, the terms are considered to be “substantially different” if the present value of the cash flows under the new terms is at least 10 percent different from the discounted present value of the remaining cash flows of the original financial liability. While IAS 39 does not apply the 90 percent test to derecognition of financial assets, it would seem imprudent to conclude that substantially all the risks and rewards of ownership have been transferred when the computations show that the entity still retains more than 10 percent of the exposure to the variability in present value of the expected future cash flows post-transfer.

More risk/rewards transferred to investors ↑	Situation		Accounting
	Substantially all risks/rewards transferred		Derecognize old assets
	Transferred and retained risks/rewards are both less than substantially all	Control passed—transferee can unilaterally sell entire asset	Recognize any new assets/liabilities
		Control retained	Recognize assets & liability up to continuing involvement level plus any retained interest
Substantially all risks/rewards retained		Recognize all assets, proceeds are liability	



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IAS 39 acknowledges that in many cases it will be clear whether or not substantially all of the risks and rewards of ownership have been transferred. When it is unclear, then an entity will have to evaluate its exposure before and after the transfer by comparing the variability in the amounts and timing of the net cash flows of the transferred asset. If the exposure to the present value of the future net cash flows from the financial asset does not change significantly as a result of the transfer, then the entity has not transferred substantially all of the risks and rewards of ownership.

Typical risks included in a risk and reward analysis are interest rate risk, credit risk (i.e., risk of default), prepayment risk, late-payment risk, and currency risk. The overall securitization has liquidity risk associated with the fact that there is a mismatch in the timing of cash inflows and outflows. It is important to recognize that liquidity risk arising in the securitization entity from differences in the contractual timing of cash flows of the assets and the notes issued to acquire the assets is not part of the transferred asset. This compares to late-payment risk and credit default risk, which are inherent in the asset. However, if an asset pays late, the transferee may not be able to meet its obligations under the notes. This liquidity risk is not part of the transferred asset because it arises only when the assets are placed inside the securitization entity. The liquidity risk associated with late-payment risk is, therefore, not included in the transferor's risk and rewards assessment in determining derecognition for the transferor. However, the impact of liquidity

risk would be included as part of the risks and rewards analysis of the securitization entity in determining whether an entity should consolidate the entity. Derivatives are also often included in contractual arrangements that transfer financial assets and may affect the analysis of whether the risks and rewards of those assets have been transferred. Their presence and contractual terms may not be obvious and careful review of all the terms of the transfer agreement is required.

The computational comparison is an expected value approach (i.e., all reasonably possible outcomes should be considered, with a greater weight given to those outcomes that are more likely to occur and considering all risks inherent in the expected cash flows) using a discount rate based on appropriate current market interest rates. There is no example in IAS 39 of the methodology to be used in performing the risks and rewards assessment. Whichever methodology is used, it should be applied consistently to all transfers that are similar in nature (i.e., one can't simply "cherry pick" the methodology that indicates the desired degree of transfer of risks and rewards). A common approach is to use a standard deviation statistic as the basis for determining how much variability has been transferred and retained by the transferor.

To apply this approach, the transferor will need to consider various future scenarios that will impact the amount and timing of cash flows of the transferred assets and calculate the present value of these amounts both before and after the transfer. In the

case of a transfer of debt instruments, scenarios will incorporate, among other factors:

- Changes in the amount of cash flows due to changes in the rate of default by the borrower and recovery of any collateral in the case of default
- Changes in the timing of when cash flows are received due to changes in prepayments rates

The expected cash flows on the transferred assets will be allocated to the transferor and the transferee based on the rights and obligations following the transfer. For example, if the transferor guarantees part of the transferred assets or invests in a subordinated loan, a subordinated IO strip or excess spread issued by the transferee, this will result in some of the exposure to the assets coming back to the transferor.

The transferor will need to assess the probability of the various scenarios occurring so that it can take the various present values described above and multiply them by those probabilities in order to determine probability-weighted present values. These values are used for calculating the standard deviation, which can be thought of as the exposure, or volatility, that the transferor has to the transferred asset both before and after the transfer. This will form the basis for judging whether the transferor has retained or transferred substantially all the risks and rewards of ownership of the transferred assets.



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Example:

Entity A has a portfolio of similar prepayable fixed rate loans with a remaining maturity of two years, and a coupon and effective interest rate of 10 percent. The principal and amortized cost is \$10,000. On 1/1/X0, Entity A transfers the loans for cash consideration of \$9,115 to Entity B, an entity not consolidated in Entity A's consolidated financial statements. In order to acquire the loans, Entity B issues a senior note, linked to the performance of the transferred assets, to third parties where the holders of the notes obtain the right to \$9,000 of any collections of principal plus interest thereon at 9.5 percent. Entity A agrees to retain rights to \$1,000 of any collections of principal plus interest thereon at 10 percent, plus the excess spread of 0.5 percent on the remaining \$9,000 of principal. Collections from prepayments are allocated between the transferor and the transferee proportionately in the ratio of 1:9, but any defaults are deducted from Entity A's retained interest of \$1,000 until that interest is exhausted. Entity A's retained interest is, therefore, subordinate to the senior notes because it suffers the loss of any defaults on the transferred assets prior to the holders of the senior notes. Interest is due on the transferred assets annually on the anniversary of the date of transfer.

In order to determine the extent to which Entity A has retained the risks and rewards of the transferred assets, Entity A considers a number of scenarios where amounts and timings of cash flows on the transferred assets vary and assigns a probability for each scenario occurring in the future. For illustration purposes, only four scenarios are included in the table that follows, although, in practice, a larger number of scenarios is likely to be required. A risk-free rate of 8.5 percent is used to determine net present values.

Probability-weighted present value (using 8.5% risk-free discount rate) ¹²				
Scenario	Probability	Total Loans	Transferred Senior	Retained Subordinate & IO
1	20%	\$2,000	\$1,800	\$200
2	30%	3,041	2,725	316
3	30%	3,079	2,747	332
4	20%	1,980	1,817	163
Total		\$10,100	\$9,089	\$1,011

Probability-weighted squared deviations ¹³				
Scenario	Probability	Total Loans	Transferred Senior	Retained Subordinate & IO
1	20%	\$2,000	\$1,584	\$24
2	30%	403	10	538
3	30%	8,003	1,374	2,746
4	20%	8,000	3	7,683
Variance		\$18,406	\$2,971	\$10,991
Standard deviation (square root of variance)		\$136	\$55	\$104

¹² For example, under Scenario 2, the loan pays a total of \$11,000 one year from today. Of that amount, \$9,855 is paid to the senior interests and \$1,145 is retained by the subordinated interests. The present values of those amounts, discounted for 1 year at 8.5 percent, are \$10,138, \$9,083 and \$1,055, respectively. Weighting each by the 30 percent probability assigned to Scenario 2 gives us \$3,041, \$2,725 and \$316, respectively.

¹³ For example, the deviation of the total loan amount in Scenario 1 from the overall average is the difference between \$10,000 and \$10,100, which equals \$100. Squaring that deviation gets us to \$10,000 and weighting it by the 20 percent probability of Scenario 1 yields \$2,000.

The net present values for each scenario are multiplied by the probability of each scenario to determine a probability-weighted present value. The variance before and after the transfer is determined using the probability-weighted present values as illustrated below.



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Entity A determines whether substantially all of the risks and rewards of ownership of the transferred assets are retained by dividing the variability retained after the transfer by the variability of the portfolio as a whole ($\$104/\$136 = 76$ percent). Consequently, Entity A concludes that substantially all the risks and rewards of ownership are neither transferred nor retained. Entity A would then need to address whether it has control of the transferred asset (described in detail further below) to determine whether Entity A can derecognize the asset in full or continue to recognize its continuing involvement in the transferred assets.

It is worth noting that the sum of variability of Entity A after the transfer ($\$104$) plus variability of the senior note holders ($\$55$) is greater than the variability of the portfolio as a whole ($\$136$). This arises because the portfolio of loans as a whole has less risk due to the diversification of the loans within the portfolio. Some of this diversification is reversed when the portfolio is split into pieces. More complex mathematical techniques can be applied to show Entity B's variability to the loans after transfer that include the diversification effect that exists in the portfolio prior to the transfer. Such techniques are beyond the scope of this manual.

If a transfer results in a financial asset being derecognized in its entirety, but the transferor obtains a new financial asset or assumes a new financial liability, or a servicing liability, the transferor recognizes those new assets, liabilities, or servicing at fair value, and any resulting gain or loss is reflected in current earnings. If the asset derecognized was part of a larger financial

asset, the carrying amount of the larger asset is allocated between the part sold and the part retained based on their relative fair values as of the transfer date.

Step 6—Have I retained substantially all of the risks and rewards of ownership?

The previous section discussed how to perform the “substantially all” risks and rewards assessment. If substantially all of the risks and rewards of ownership of a financial asset has been retained, one would continue to recognize that financial asset.

IAS 39 provides examples of retaining substantially all the risks and rewards of ownership:

- a. Selling and repurchasing the same financial asset where the repurchase price is a fixed price or the sale price plus a lender's return
- b. Lending securities
- c. Selling a financial asset together with a total return swap that transfers the market risk exposure back to the seller
- d. Selling a financial asset together with a deep in-the-money put or call option (i.e., an option that is so far in the money that it is highly unlikely to go out of the money before expiring)
- e. Selling short-term receivables with a guarantee to compensate the transferee for credit losses that are likely to occur

Derivatives commonly found in transfers of financial assets include put options, call options, forward or repurchase contracts, forward sales contracts, and swap agreements. Put options provide the transferee with the right to require the transferor to repurchase some or all of the financial assets that were sold (e.g., to repurchase delinquent receivables). Call options provide the transferor with the right to repurchase some or all of the financial assets sold to the transferee. Forward or repurchase agreements require the transferee to sell and the transferor to buy some or all of the financial assets that were sold before their scheduled maturity. Forward sales contracts require the transferor to sell and the transferee to buy additional financial assets in the future. Swap agreements effectively change one or more cash flows of the underlying transferred assets (or debt issued by a special purpose entity). For example, an interest rate swap may convert a variable rate asset to a fixed rate assets.



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Derivatives can operate automatically or require exercise by one of the parties; they can be exercised freely or only after the occurrence of a future event. Such a future event may be certain of occurring (e.g., the passage of time), or may be conditional upon another event (e.g., a loan becoming delinquent). For conditional events, the certainty of occurrence varies—their occurrence may be considered to be probable, possible, or remote. The exercise price of a derivative can be fixed above, below, or equal to the market value of the financial assets at inception or it can be variable, equal to the market value at exercise date, or the result of a formula that is a function of market conditions or other future events. Derivatives can be combined to form different types of derivatives. Each of these factors impacts the extent to which risks and rewards have been retained by the transferor.

A fixed-price repurchase transaction, in essence, establishes a lending arrangement where the transferor is always going to reacquire the asset in the future. The fixed price is usually set to reflect the cost of borrowing over the period of the transaction. Because the transferor is required to reacquire the asset for a fixed price, the transferor is exposed to the market risk of the asset. The same analysis would apply to a securities lending transaction.

A sale of a financial asset combined with a total return swap that transfers the market risk of the asset back to the transferor also establishes what, in essence, is a lending arrangement. Under the terms of total return swaps, the transferor usually pays an amount equivalent to a borrowing rate to the transferee over

time and the transferee will settle with the transferor amounts based on the performance of the asset. For example, in the transfer of an equity security with a total return swap, if the equity price goes up, the transferor receives the benefits of the rise in value of the transferred equity security from the transferee and pays an amount equivalent to a borrowing rate to the transferee. And if the equity security price decreases, the transferor pays an amount equivalent to a borrowing rate and, in addition, pays an amount equivalent to the fall in value of the equity security. The transferor continues to be exposed to the market risk in the equity security price after the transfer and therefore has retained substantially all of the risks and rewards of ownership of the asset.

When an entity sells an asset, but retains the right to buy the asset back at a price that is sufficiently low that the option is highly likely to be exercised (e.g., a deep in-the-money option), the entity retains substantially all the risks and rewards of ownership. Similarly, when an entity sells an asset and gives the transferee the right to put the asset back at a sufficiently advantageous price so that the option is likely to be exercised, the entity retains substantially all the risks and rewards of ownership. However, the same analysis is not appropriate when the option is not deep in-the-money and further derecognition tests should be applied.

If the transferor has retained substantially all the risks and rewards of ownership, derecognition of the financial asset does not occur and the transferor continues to recognize the transferred asset in its entirety. The transferor also records a

financial liability for the consideration received. Going forward, the transferor continues to recognize any income on the transferred asset and any expense incurred on the financial liability. The asset and liability are not offset and there is no offsetting of income from the transferred asset against expense incurred from the associated liability. If the transferred asset is measured at amortized cost, the option in IAS 39 to designate a financial liability at fair value through profit or loss is not permitted for the associated liability.

For transfers that do not qualify for derecognition, the transferor's contractual rights or obligations related to the transfer are not accounted for separately as derivatives if doing so would result in recognizing both the derivative and either the transferred asset or the liability arising from the transfer twice. For example, a call option retained by the transferor may prevent a transfer of financial assets from being derecognized and, therefore, would not be separately recognized as a derivative asset. Also, the transferee does not recognize the transferred asset as its own asset. The transferee derecognizes the consideration paid and recognizes a receivable from the transferor. If the transferor has both a right and an obligation to reacquire control of the entire transferred asset for a fixed amount (such as under a repurchase agreement), the transferee may account for its receivable as a loan or receivable.



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Step 7—I have neither transferred nor retained substantially all risk and rewards. What now?

If an entity has neither transferred nor retained substantially all of the risks and rewards of ownership of transferred assets, an assessment as to whether or not it has retained control of the asset is then required. A financial asset is controlled when an entity has the ability to sell the asset. When the transferee has the practical ability to sell the asset in its entirety to an unrelated third party and is able to exercise that ability unilaterally and without the imposition of additional restrictions on the transfer, the transferee controls the asset and, therefore, the transferor must have relinquished control.

When the transferred asset is traded in an active market, the transferee generally has the practical ability to sell the asset. This is because there is a ready market and the transferee can repurchase the asset if and when it is required to return the asset back to the transferor. However, the fact that the transferred asset is traded in an active market is not in itself sufficient to conclude that the transferee has the “practical ability” to sell the asset. For example, the settlement terms of repurchase, which are driven by the market conventions, may differ significantly from the settlement terms in the transfer agreement such that the transferee will not be able to gain access to the asset quickly enough to deliver the asset to the transferor so as to comply with the contractual provisions of the transfer agreement. In this case, the transferee is forced to hold the asset in order to ensure that it can deliver the asset back to the transferor when required.

Other factors may affect the entity’s practical ability to sell an asset:

- A financial asset that would satisfy the call option or forward contract may have to be purchased from a third party at a price significantly above its estimated fair value, thus indicating that the assets are not liquid.
- Financial assets available to satisfy the call option or forward contract may be held by one or a small number of investors, thus indicating that the assets are not liquid.
- The quantity of financial assets necessary to satisfy the call option or forward contract may be too large compared to that traded in the market, and the terms of the transfer do not allow delivery of the assets over a period of time.

Intuitively, the wider the range of assets that may be used to satisfy the call option, the more likely it is that the entity has the practical ability to sell the asset. For instance, assets identical to those originally transferred may not be readily obtainable but, if the call option permits delivery of assets that are similar to the transferred assets, they may be readily obtainable. When a call option permits settlement in cash as an alternative to delivering the financial asset, and the cash settlement alternative does not contain an economic penalty rendering it unfeasible, the transferee has the practical ability to sell the asset as cash is a readily obtainable asset.

Unilateral and unrestricted ability to sell means that there can be no strings attached to the sale. If the transferee has to attach a call option over the asset when it sells it, or introduce conditions over how the asset is serviced, in order to satisfy the terms of the original transfer, then “strings” exist and the test of practical ability is not met.

The “strings” can be created by other instruments that form a contractual part of the transfer arrangement and are sufficiently valuable to the transferee, so that if the transferee were to sell the asset, it would rationally include similar features within that sale. For example, a guarantee may be included in the initial transfer and may have such potential value to the transferee that the transferee would be reluctant to sell the asset and forgo any payments that may fall due under the guarantee.

The transfer agreement may have an explicit restriction that prohibits the transferee from selling the asset. When that restriction is removed or lapses, and, as a result, the transferee has the practical ability to sell the asset, derecognition would be appropriate.

The fact that the transferee may or may not choose to sell the asset should not form part of the decision-making process; it is the transferee’s practical ability to do so that is important.

If control of the financial asset is not retained, the financial asset is derecognized, and any rights and obligations created or retained in the transfer would be separately recognized. If control of the financial asset is retained, the financial asset should continue to be recognized to the extent of the continuing



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involvement in the financial asset. Continuing involvement represents the extent to which the transferor continues to be exposed to the changes in the value of the transferred asset. A corresponding liability is also recognized and measured in such a way that the net carrying amount of the asset and the liability is:

- The amortized cost of the rights and obligations retained, if the asset is measured at amortized cost, or
- The fair value of the rights and obligations retained, if the asset is measured at fair value.

The liability that is recognized at the date of transfer will not necessarily equate to the proceeds received in transferring the asset, which would ordinarily be the case if the asset continued to be fully recognized and the proceeds received were recognized as a collateralized borrowing. In some cases, the liability appears to be the “balancing figure” that results from applying the specific guidance for continuing involvement accounting. IAS 39 acknowledges that measuring the liability by reference to the interest in the transferred asset is not in compliance with the other measurement requirements of the Standard. This requirement for consistent measurement of the asset and the associated liability means that the entity is not permitted to designate the liability as at fair value through profit or loss if the transferred asset is measured at amortized cost.

The entity cannot offset the asset and the associated liability, and any subsequent changes in the fair value of the asset and the liability are measured consistently. Any income on the asset to the extent of the entity’s continuing involvement and any expense incurred on the associated liability are also not offset.

When an entity transfers assets, but retains a guarantee over the transferred assets that absorb future credit losses, and that guarantee (as well as other continuing involvement) results in the transferor neither transferring nor retaining substantially all the risks and rewards of ownership, the transferor must recognize the guarantee as part of its continuing involvement. Assuming, for illustrative purposes only, that the guarantee represents the transferor’s only continuing involvement in the transferred asset, then:

- The transferred asset at the date of transfer will be measured at the lower of (i) the carrying amount of the asset and (ii) the maximum amount of the consideration received in the transfer that the entity could be required to repay, and
- The associated liability is measured initially at the amount in (ii) above plus the fair value of the guarantee.

The initial fair value of the guarantee is recognized in profit or loss on a time-proportion basis in accordance with [IAS 18](#), Revenue and the carrying amount of the asset is reduced by any impairment losses.

What are some common forms of ‘continuing involvement?’

Clean-up calls. The servicer of transferred assets, which may be the transferor, may hold either of two types of options to reclaim previously transferred assets. A removal-of-accounts provision is an option to repurchase assets, usually subject to certain limitations on how the particular assets are selected for call, how frequently, and in what total amount the call can be exercised. A clean-up call is an option to purchase remaining transferred assets when the amount of outstanding assets falls to a specified level at which the cost of servicing those assets becomes burdensome in relation to the benefits

of servicing. Provided that such a removal-of-accounts provision or clean-up call results in the transferor neither retaining nor transferring substantially all the risks and rewards of ownership and the transferee cannot sell the assets, it precludes derecognition only to the extent of the amount of the assets that is subject to the call option.

Amortizing interest rate swaps. A transferor may transfer a fixed-rate financial asset that is paid off over time, and enter into an amortizing interest rate swap with the transferee to receive a fixed interest rate and pay a variable interest rate. If the notional amount of the swap amortizes such that it equals the outstanding balance on the transferred financial assets at any point in time, the swap would generally result in the transferor retaining substantial prepayment risk. As such, the transferor



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either continues to recognize the entire transferred asset or continues to recognize the transferred asset to the extent of its continuing involvement. However, if the amortization of the notional amount of the swap is not linked to the principal amount outstanding of the transferred asset, such a swap would not result in the transferor retaining prepayment risk on the asset. Therefore, it would not preclude derecognition of the transferred asset if the payments on the swap are not conditional on interest payments being made on the transferred asset, and the swap does not result in the transferor retaining any other significant risks and rewards of ownership.

Subordinated retained interests and credit guarantees. The transferor may provide credit enhancement by subordinating some or all of its interest retained in the transferred asset. Or, the transferor may provide a credit guarantee that could be either unlimited or limited. If the transferor retains substantially all the risks and rewards of ownership of the transferred asset, the asset continues to be recognized in its entirety. If the transferor retains some, but not substantially all, of the risks and rewards of ownership and has retained control, the transferor continues to recognize the assets to the extent of the amount of cash or other assets that the transferor could be required to pay.



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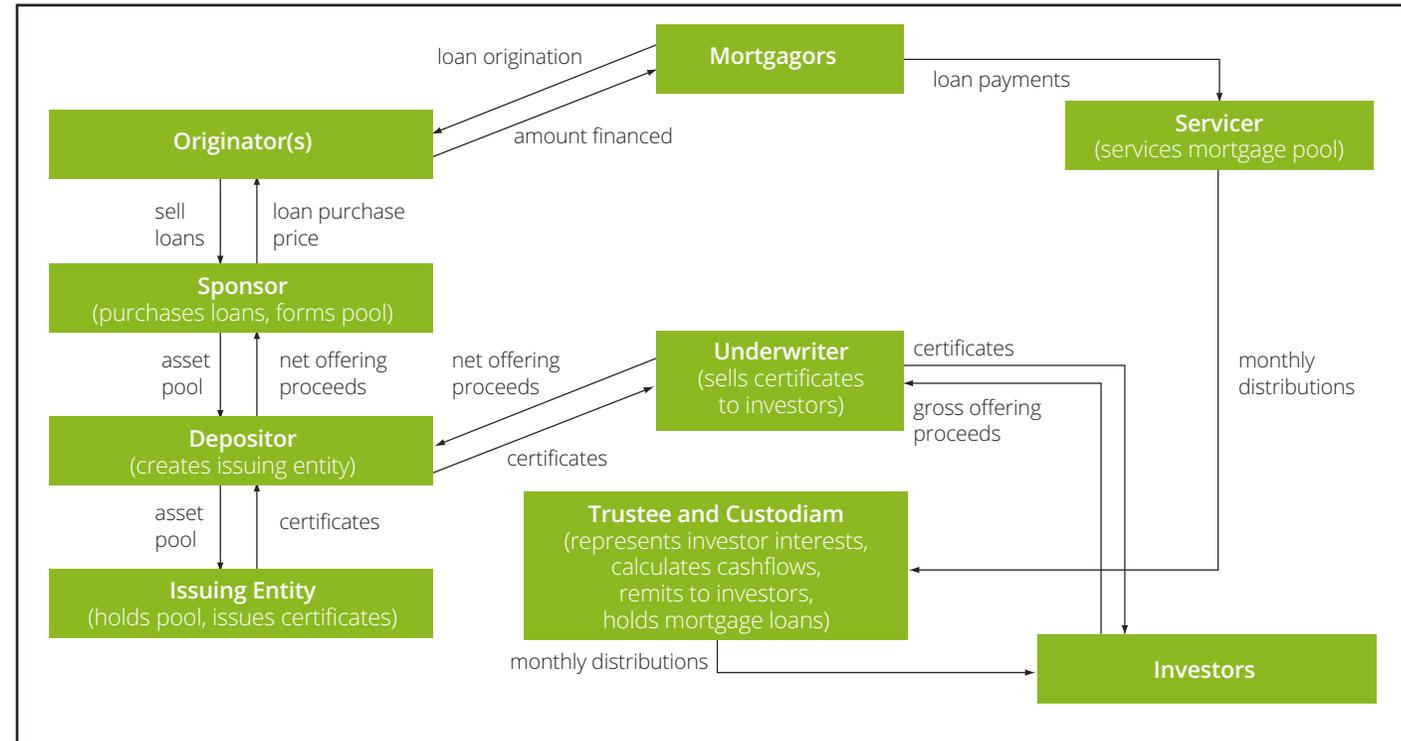
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Chapter 5: How about some examples?

Private label mortgage-backed securities—the traditional two-stepper

“Private label” (i.e., non-governmental-agency-guaranteed) residential mortgage securitizations would typically have the structure shown below. Notwithstanding all the boxes, this structure would be referred to as the prototype “two-step” securitization transaction. The sponsor, which may or may not be the originator, forms the pool of loans and transfers them to the depositor, which is a bankruptcy-remote special purpose entity (SPE). The depositor, which traditionally has been consolidated with the transferor/sponsor for accounting purposes, transfers the pool to the issuer, which issues the bond classes back to the depositor, which, in turn, surrenders them to the underwriter to be sold to investors.



**What role does the originator play besides origination?
What is the impact if originator is servicer? What happens
if the originator holds bottom classes or if the originator
holds bottom classes and is the servicer?**

US Generally Accepted Accounting Principles (GAAP) analysis

In most securitizations, the transferor/sponsor is intimately involved in the design of the transaction; therefore, it is likely that one of the primary purposes of this transaction is to facilitate the liquidity needs of the transferor. Thus, it is important to identify (1) which of the parties have a variable interest in the deal that would potentially expose them to the obligation to absorb losses or to receive benefits that could be significant to the issuer, (2) what are the activities that would most significantly impact the economic performance of the issuer, and (3) which entity is in control of those activities?

Often, the transferor/sponsor retains the servicing function, for which it receives a fee. A transferor/sponsor may also retain an interest in the equity tranche of the issuer (as well as possibly one or more of the subordinate classes).

The servicing fee could be considered a variable interest (after considering the guidance in ASC 810-10-55-37 on whether fees are considered a variable interest) if the transferor/sponsor holds the equity tranche or the servicing fees paid to the transferor/sponsor are not commensurate and at market.¹⁴ On the other hand, the fees would not be a variable interest if the transferor/sponsor (1) receives fees commensurate with the level of effort required to provide services, (2) the transferor/sponsor does not hold other interests that individually, or, in the aggregate, would absorb or receive more than an insignificant amount of the entity's expected losses or residual returns, and (3) the terms and conditions are customarily present in arrangements for similar services negotiated at arm's length.

With respect to activities that would most significantly impact the economic performance of the issuer, many believe that the default-management function has the most significant impact on the economic activities of the trust. In residential mortgage-backed securities (RMBS), the servicer has the ability to work with the obligor in granting loan workouts or forbearance. The servicer also would generally be responsible for selling the underlying property should the obligor default and the real estate become the property of the issuer trust.

Assuming the transferor/sponsor retains the servicing function and holds a variable interest that could potentially absorb losses or receive benefits that may be significant to the issuer, the transferors/sponsors of private label RMBS would generally meet both tests.¹⁵ Accordingly, they would be deemed the primary

beneficiary of the issuer trust, and thus the consolidator of the trust. As a result, they will keep the mortgage loans and issued bond classes on their books, thus "grossing up" both sides of the balance sheet and precluding gain on sale or establishment of a servicing asset.

A closer look at fees paid to decision-makers or service providers

GAAP emphasizes whether decision-maker or service provider fees are commensurate and at market when evaluating whether such fees (1) are variable interests and (2) should be included in the economics test in ASC 810-10-25-38A(b). It is common for servicers in securitizations and other loan transfers to receive more than "adequate compensation" for their servicing of the financial assets. However, this does not necessarily lead to a conclusion that the fees are not commensurate or at market. Under ASC 860-50, if a servicer is entitled to compensation considered above adequate, a servicing asset must be recorded. The amount in excess of adequate compensation may still be considered commensurate and at market. The reporting entity should evaluate the arrangement, including whether (1) it was negotiated at arm's length, (2) there are more than insignificant unrelated investors in the securitization, (3) the arrangement is consistent with other arrangements entered into with unrelated parties or other arrangements in the marketplace, and (4) there are other benefits or elements embedded in the fee arrangement unrelated to the services provided.

¹⁴ Specifically, the fees are (i) compensation for services provided and commensurate with the level of effort required to provide the services and (ii) part of a service arrangement that includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length.

¹⁵ In accordance with ASC 810-10-25-38H, fees paid to the servicer that are both commensurate and at market should not be considered for purposes of the economics test of ASC 810-10-25-38A(b).



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Although adequate compensation would be considered commensurate and at market because the fee is, by definition, consistent with “the amount demanded by the marketplace to perform the specific type of servicing,” because in practice unrelated market participants determine the service provider fee (e.g., servicers for government-sponsored entity trusts generally receive 25 basis points), an amount in excess of adequate compensation may still be considered commensurate and at market. Conversely, if a servicer recognized a servicing liability at inception (i.e., the fees are below adequate compensation), those fees generally would not be commensurate or at market; therefore, they would be deemed a variable interest and included in the analysis of whether the servicer has satisfied the economics criterion.

Not all fees that are commensurate and at market can be excluded from the evaluation of whether the economics criterion has been met. If the fee arrangement is designed to expose a reporting entity to risk of loss in the potential variable interest entity (VIE), such as a guarantee, the fees will be included in the reporting entity's economics-criterion evaluation. In other words, a fee arrangement that exposes a reporting entity to risk of loss in a potential VIE should never be eligible for exclusion from the evaluation of whether (1) the reporting entity has met the economics criterion or (2) is a variable interest. This serves as a safeguard to ensure that if an arrangement is structured as

a means to absorb risk of loss that the entity was designed to pass on to its variable interest holders, the arrangement will be included in the consolidation analysis. Therefore, even if such fees are otherwise “commensurate” and “at market,” they would not be eligible for (1) exclusion from the primary beneficiary evaluation or (2) the fee arrangement evaluation under ASC 810-10-55-37.

Therefore when evaluating whether the fees are a variable interest, a decision-maker or service provider should carefully consider the design of the VIE to determine whether the fee arrangement actually compensates for absorbing a risk that the entity was designed to pass to its variable interest holders. For example, the fee arrangement may be substantially a fee-for-service contract and have certain protections that are customary and standard, but it does not expose the decision-maker or service provider to any of the primary risks for which the VIE was designed to pass. In this case, the fees received are not compensating for the exposure to risk of loss in the VIE, so they would be eligible for assessment as a variable interest under ASC 810-10-55-37.

International Financial Reporting Standards (IFRS) analysis

As discussed in [Chapter 2](#), the consolidation models under GAAP and IFRS for securitization trusts are largely similar with a few notable exceptions. In [IFRS 10](#), the consolidation considerations focus on (1) power over the relevant activities, (2) exposure to variable returns, and (3) the ability to utilize that power to influence the amount of returns received.

As noted above, in a private label RMBS, default management is typically the activity that most significantly impacts the economics of the trust. And the servicer, which is generally the transferor/sponsor, is typically the one responsible for default management. So the servicer meets the first criteria, but does it meet the second and third criteria?

IFRS 10 does not have specific criteria on when a fee does not represent a variable interest. Instead, a servicing fee would be considered exposure to variable returns in criteria of the consolidation model. However, criteria (ability to utilize power to influence returns) introduces the concept of a party that is acting in the capacity of an agent, rather than a principal to a transaction. So the servicer would have to consider the principal-agent guidance discussed in [Chapter 2](#) in determining whether it meets criterion 3. The holding of a significant portion of a subordinated interest (such as the equity tranche) may be indicative of the sponsor being a principal to the transaction rather than an agent and therefore the sponsor would be required to consolidate the issuer trust.



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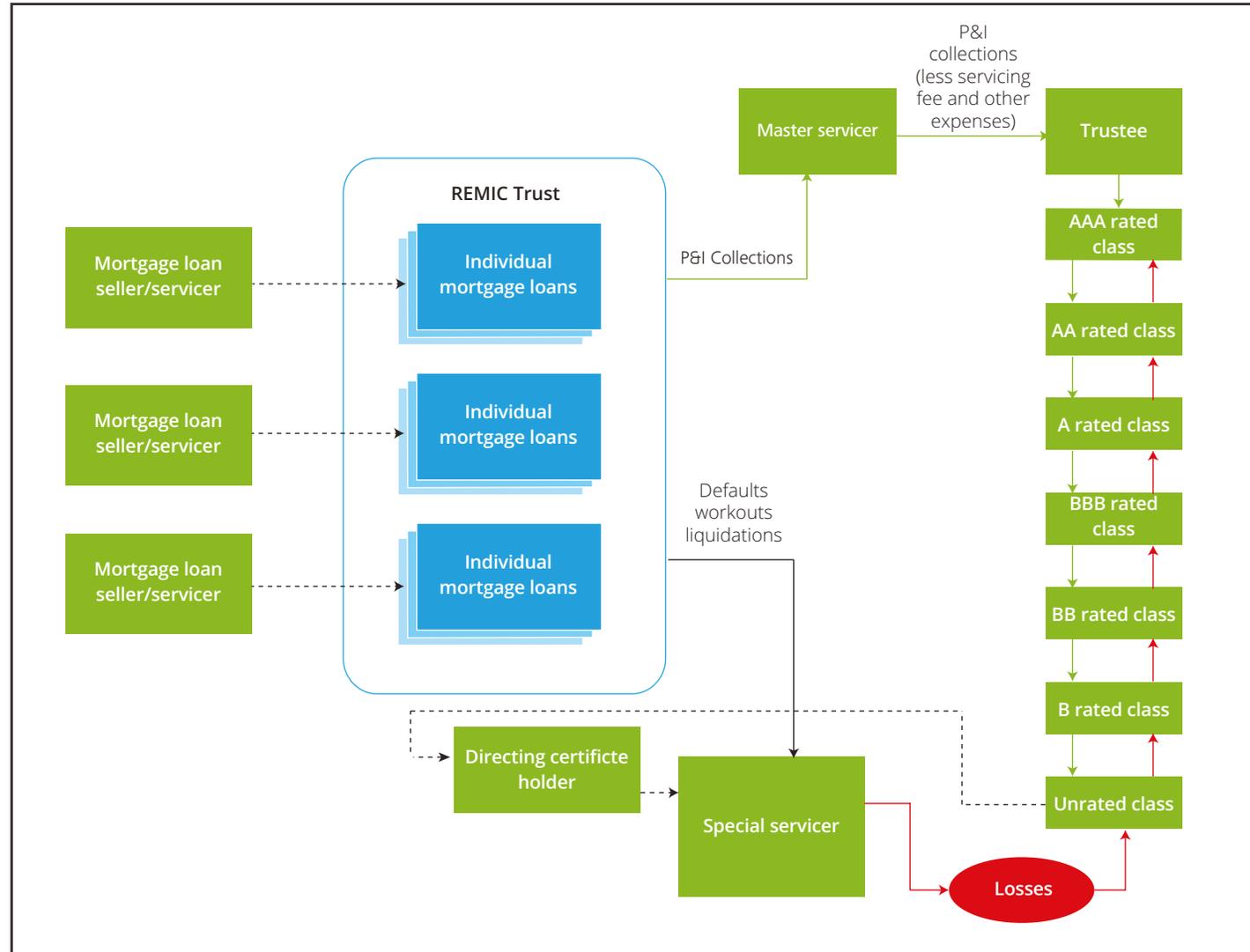
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Commercial mortgage securitization—where the transferor may not be the primary beneficiary



Like their RMBS cousins, commercial mortgage-backed securitizations (CBMS) generally have the same parties present in the transaction: the transferor of the loans, the servicer, underwriters and trustees, and the issuer of the notes, which is typically set up as a real estate mortgage investment conduit trust. However, given the complexities of working out troubled commercial mortgages and managing the underlying properties, these transactions also typically include a special servicer should the obligor default.

Typically, commercial mortgage loan securitizations involve mortgages with individually large principal balances. If the borrower or property encounters financial or operational difficulties, experienced workout specialists are needed to maximize ongoing cash flows from the loan or prevent further deterioration in value. When commercial mortgage loans are securitized, a special servicer with the relevant expertise and experience is hired to take over from the servicer and perform these functions with respect to each loan that becomes a troubled loan. The special servicer may have a subordinated beneficial interest in the securitized assets and/or a right to call defaulted loans. Sometimes, the special servicer is the same entity as the primary servicer.

When a loan is assigned to the special servicer, a range of responses is available. Absent any external constraints, the possible responses fall into the following general categories: the special servicer on behalf of the trust could (1) modify the terms of the existing loan, (2) commence foreclosure proceedings, or (3) sell the loan for cash (either in the markets or in response to a call by the special servicer or a subordinated interest holder).



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Thus, in evaluating who is in control of the activities that have the most significant impact on the trust's economic performance (under both ASC 810 and IFRS 10), it is generally difficult to avoid the conclusion that the special servicer fits that role.

What happens if the special servicer is not a mortgage loan seller, but buys the subordinate bonds? What happens if the special servicer does not hold the subordinate bonds?

In CMBS, the special servicer is typically not the transferor of the mortgages. Additionally, the special servicer may, but does not always, also hold a subordinate class of bonds; the special servicing fee also may vary with the economic results of the trust, thus providing an incentive to the special servicer to maximize loan performance. In the event that a special servicer holds an interest in the equity tranche fees paid to the special servicer would represent a variable interest under ASC 810-10-55-37(c). If the special servicer (1) received fees that were only commensurate and at market, (2) did not hold an interest in equity tranche, and its other interests individually, and/or in the aggregate, and (3) does not absorb or receive more than an insignificant amount of the entity's expected losses or residual returns, then the fees would not be considered a variable interest.

Holding a significant subordinate position in the transaction, in combination with the default management required in the role of special servicer (and absent any kick-out rights held by a single noteholder), would likely lead to the conclusion that the special servicer would control and, therefore, consolidate, even if the special servicer were not the original transferor. Under ASC 810, the special servicer would have power, and the significant subordinated interest could provide a potentially significant variable interest. (Under GAAP, if the fees paid to the special servicer is both commensurate and at market, they would not be considered in the economics test of ASC 810-10-25-38A.) Under IFRS 10, the special servicer would also have power, and the combination of the fee and the significant subordinated interest would lead to a conclusion that the special servicer was a principal, rather than an agent, in the transaction.

CMBS transactions also generally have the concept of a controlling classholder, and this controlling classholder often may have the discretion to remove the special servicer. Often, the special servicer may hold the class of bonds, which also makes it the controlling classholder, but typically the transaction documents provide for the circumstance where losses erode the controlling classholder's interest, and thus the next more senior class of noteholders would become the controlling classholder. In a scenario such as this, the continual assessment assumption underlying both GAAP and IFRS may result in the identification of a new party becoming the primary beneficiary, assuming the next, more senior class of notes was held by a single party.



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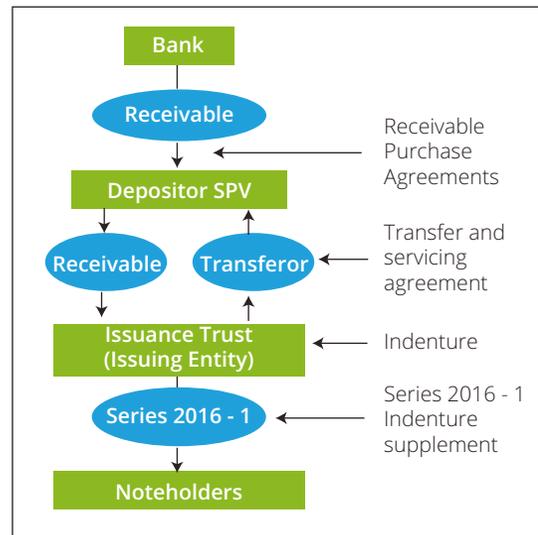
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Revolving securitizations

Credit cards

Credit card securitizations have some unique considerations. Unlike mortgage securitizations, in which a static pool of long-term loans is placed into a structure, credit cards are assets whose maturities are substantially shorter than a mortgage loan. Often, a pool of credit card receivables will turn over in a period as short as 18 to 24 months. Since the tenor of the receivables is much shorter than the life of the issued bonds, credit card securitizations are called “revolving securitizations”; the transferor may, for some extended period of time, use collections from the issuer trust as proceeds in the purchase of new receivables, thus replacing those that have been entirely collected.



During this revolving period, bondholders receive interest on their holdings, but not principal. At a time defined in the transaction, based on the estimated time it would take to collect a static pool of receivables, the revolving period will end and principal collections will accumulate in an account held in the issuer trust. This is called the accumulation period. Finally, when it is time for the deal to unwind, collections that have been accumulated are used to pay the bondholders during a period that is called the amortization period. Obviously, triggers are built into these structures, and if some adverse event happens, the revolving period stops early and the deal starts to unwind. This is called an early amortization event.

Credit card securitizations are unique in that the transferor, which is the bank that issued the credit cards and has the receivables, will often transfer them directly into a master trust, which is a bankruptcy-remote vehicle designed to issue different series of bonds at different intervals. Such a structure raises questions as to whether the issuance of series of bonds should be viewed as “silos” (a similar concept under both GAAP and IFRS), or whether it is the trust as whole that needs to be evaluated for consolidation. Therefore, issuers of credit card securitizations should look to the degree of cross-collateralization, if any, that exists among the series in order to determine if the master trust essentially represents a single entity, or an entity that comprises a series of silos or separate entities requiring individual consolidation consideration.

Currently, because most credit card securitizers retain servicing as well as the account relationship with the customers, and have variable interests in the master trust through its seller’s interest, interests in cash collateral accounts, interest-only strip, and servicing fee, the credit card bank would be identified as the party that controls and, therefore, consolidates under both GAAP and IFRS.



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Asset-backed commercial paper conduits



Most commonly, when people think about securitization, there is a tendency to think that the transferred assets are interest-bearing and that the sponsor of the securitization will establish a trust or use some other vehicle to issue securities directly into the markets. Well, not all financial assets are interest-bearing, and not all securitizations are term transactions sold directly into the capital markets.

Sellers of trade receivables, issuers of very senior tranches of credit card and auto loan securitizations, and transferors of asset classes that are considered to be esoteric asset classes (such as lottery receivables and life settlements) are all users of asset-backed commercial paper conduits (CP conduits). While some would contend that CP conduits were established primarily to facilitate securitizing assets with a short tenor, such as trade receivables, they now have expanded to include most asset types. By matching the liquidity and duration of the commercial paper to the underlying receivables, CP conduits greatly enhanced the access of Main Street companies and nontraditional securitizers to the capital markets.

These CP conduit deals also allow securitizers to maintain a level of confidentiality regarding their customer base. In this fashion, CP conduits allow companies to:

- Securitize their trade receivables in smaller transaction sizes
- Pay lower transaction costs
- Get better execution, even if their name is not familiar to the marketplace
- Learn about the nuances of securitization and the consequent reporting in the process

Commercial paper conduits, typically sponsored by commercial banks, have historically taken various forms, but today multiseller conduits are the norm. The sponsoring commercial bank plays some traditional roles with respect to a multiseller conduit. The bank generally markets the transactions with the sellers of the receivables, and is actively involved in the deal's structuring. Additionally, the bank usually acts as the administrator of the conduit, for which it receives a fee. Finally, the bank generally also extends credit enhancement and liquidity facilities to the conduit, although some of that exposure may be syndicated out to other banks.



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What is the originator's accounting analysis for revolvers?

A typical originator of trade or other receivables in a revolving securitization will first transfer the financial assets to a bankruptcy-remote SPE (the "seller" in the above diagram). These SPEs typically issue interests in the receivable pools to a CP conduit, which then issues the commercial paper. The proceeds of the issuance are forwarded to the originator's SPE from the conduit, and that is the cash which that SPE uses to purchase the receivables from the transferor. Most CP conduits protect themselves from credit defaults in the underlying receivables by requiring a fair degree of overcollateralization. This could be done in a variety of ways, such as the conduit purchasing a senior interest in the pool of receivables or with the purchase price paid to the seller being settled in a combination of cash and a deferred purchase price note (contingent upon the performance of the underlying receivables) issued by the conduit.

Consolidation of the SPE

Because of the overcollateralization required by the CP conduit, the SPE needs additional financing for its receivables purchased from the originator either in the form of a note or a capital contribution from the originator. As a result, the SPE established and discussed above would be consolidated by the seller under both GAAP and IFRS because the originator has a variable interest in the entity through its note or capital contribution and certainly exhibits power over the SPE's activities through retention of servicing. Because the SPE is consolidated, the consideration focuses on the accounting for the transfer of interests in the receivables to the conduit.

Consolidation of the Conduit

The commercial paper issued by the conduit is typically cross-collateralized by all receivable interests acquired by the conduit, so no silos exist under either GAAP or IFRS. As a result, the CP conduit would be analyzed in its entirety.

As noted above, the sponsoring commercial bank serves many key roles with respect to the CP conduit, such as determining which originators participate in the program and overall structuring of the conduit. Thus, from the bank's perspective, it is an active participant in directing the economic activities of the conduit: it finds the deals, structures the transactions, and administers the conduit. The bank also has variable interests in the conduit in the form of the extended credit and liquidity lines as well as the fees that it receives from administration. (The administration fees would not be considered in the economics test of ASC 810-10-25-38A if they are both commensurate and at market.) Through its variable interests in credit and liquidity lines, the bank typically has the obligation to absorb losses and to receive benefits from the vehicle. Consequently, under both GAAP and IFRS, most commercial banks consolidate the conduits that they sponsor.

So if the originators of the receivables also perform servicing of the receivables, why would one of them not consolidate the CP conduit? Well, the originators would still need to perform their own assessment as to the activities they perform and what variable interests they may hold. The first step in this analysis

(for both GAAP and IFRS) is to determine whether the CP conduit should be considered for consolidation in its entirety, or whether any specified assets or silos exist and should be considered separately.

GAAP provides in ASC 810-10-25-55 that "a variable interest in specified assets of a VIE [variable interest entity]... shall be deemed to be a variable interest in the VIE only if the fair value of the specified assets is more than half of the total fair value of the VIE's assets or if the holder has another variable interest in the VIE as a whole." ASC 810-10-25-57 goes on to say that "a reporting entity with a variable interest in specified assets of a VIE shall treat a portion of the VIE as a separate VIE if the specified assets (and related credit enhancements, if any) are essentially the only source of payment for specified liabilities or specified other interests." ASC 810-10-25-58 further discusses silos: "a specified asset (or group of assets) of a VIE and a related liability secured only by the specified asset or group shall not be treated as a separate VIE if other parties have rights or obligations related to the specified asset or to residual cash flows from the specified asset. A separate VIE is deemed to exist for accounting purposes only if essentially all of the assets, liabilities, and equity of the deemed VIE are separate from the overall VIE and specifically identifiable. In other words, essentially none of the returns of the assets of the deemed VIE can be used by the remaining VIE, and essentially none of the liabilities of the deemed VIE are payable from the assets of the remaining VIE." As previously noted, CP conduits typically involve



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cross-collateralization where the issued commercial paper is collateralized by all of the assets rather than specific assets of the conduit. If each of the originators' assets represents less than 50 percent of the total assets of the CP conduit, then no silos exist and the originators would not have a variable interest in the CP conduit as a whole. Without a variable interest (assuming no related parties hold a variable interest), the originators would not consolidate the CP conduit. Therefore under GAAP, the question next shifts to whether the transfer of receivable interests to the conduit meet the derecognition requirements. IFRS also has a concept of "silos" and treating a portion of an entity as a deemed separate entity. IFRS 10:B77 states that a silo exists if "specified assets of the investee (and related credit enhancements, if any) are the only source of payment for specified liabilities of, or specified other interests in, the investee. Parties other than those with the specified liability do not have rights or obligation related to the specified assets or to residual cash flows from those assets" Similar to the analysis under GAAP, because of the cross-collateralization that typically exists within a CP conduit, there would be no silos that should be separately considered. IFRS 10 does not have the majority concept that exists under GAAP in determining whether a variable interest in the whole entity exists. However, as noted in [Chapter 2](#), IFRS 10 includes an example of a multiseller CP conduit and notes that the most relevant activities of the CP conduit are performed by the sponsoring bank, rather than by any of the individual originators.

Transfer of receivables to the conduit

GAAP

The considerations around participating interests now come into play. As discussed in [Chapter 3](#), to be considered a participating interest, the cash flows must be divided proportionately with no difference in priority or subordination among the cash flow holders.

For transfers of a senior interest in the receivables to the CP conduit, because these transactions are structured to leave the sellers in a first-loss position, such subordination runs counter to the requirement that all holders of interests in the pool must have the same priority without subordination. As a result, derecognition of the transferred senior interest would be precluded.

However, a transfer on an entire interest in the receivables that involves a combination of cash and a deferred purchase price note (contingent upon the performance of the underlying receivables) issued by the conduit may still meet the derecognition criteria. The basis of conclusion of the Statement of Financial Accounting Standards No. 166 *Accounting for Transfers of Financial Assets an amendment of FASB Statement No. 140* (FAS 166) noted in paragraph A18 that "in a transfer of an entire financial asset or a group of entire financial assets, the assets obtained may include a beneficial interest in a transferred financial asset that is similar to a component, but only if a transferor transfers and surrenders control over the entire original financial asset or the group of entire financial assets." However, the transaction must still conform to the requirements

in ASC 860-10-40-5. With respect to legal isolation, both the true sale and non-consolidation opinions traditional to term securitizations are needed. As is traditionally the case, the legal documents serve as the basis for determining if control over the receivables has been ceded.

One common area of trouble that will result in a transaction not achieving sale treatment is a seemingly benign feature that allows the SPE to prepay the conduit at any time. By definition, the SPE should have only three sources of cash: (1) proceeds from the conduit's issuance of commercial paper, (2) collections, and (3) cash coming from the transferor. In the prepayment scenario, it would make no sense for the conduit to issue more commercial paper in order for the SPE to use the proceeds to pay off existing commercial paper—this trade would leave the SPE and the conduit in the same position. Using cash from collections is a perfectly logical thing for the SPE to do; after all, having the receivables liquidate and using the collections to pay the investor is inherent in any securitization. It is when the originator has the ability to infuse the SPE with cash in order for it to make the prepayment that the analysis gets complicated. This may be viewed as effective control, because the transferor would have the ability to get the receivables back in exchange for its cash.



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IFRS

Proceeding through the [IAS 39](#) decision tree, the first thing to consider would be whether the transfer is a portion or an entire financial instrument. Like GAAP, the IFRS requirements for transfers of part of a financial asset focus on their being specifically identified cash flows, fully proportionate cash flows, or both. Given the similarities of the criteria for transfers of portions of financial assets, the analysis would be largely the same (i.e. the focus is on whether a senior interest is transferred or whether an interest in all the receivables is transferred with some other form of overcollateralization in place).

However, IFRS has another, major stumbling block when it comes to transfers with revolvers. When moving down the IAS 39 decision tree flowchart, after considering whether the rights to the cash flows have expired, one then moves to considering whether the rights to receive the cash flows of the asset have been transferred. One of the key considerations in this step is whether the entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay. This requirement to remit the cash flows back to the investors poses an inherent problem for structures of a revolving nature, where the cash collections are reinvested back in to the pool of receivables rather than returned to investors. Such structures do not meet the pass-through tests in IAS 39 because they involve a material delay before the original cash is passed on to the eventual recipients and the reinvestment would not qualify as cash or cash equivalents. This view has been confirmed by the IFRS Interpretation Committee.

Collateralized loan obligations (CLOs)—what’s an asset manager to do?

CLOs are unique securitizations in that there is not a transferor of assets to the SPE. Instead, the SPE purchases the assets, senior syndicated loans, from the open market using proceeds first from a warehouse line and then with proceeds from the sale of its securities (which are used to pay off the warehouse line and purchase any remaining assets needed). The CLO SPE issues notes and preferred shares or subordinated notes into the capital markets. The SPE typically employs a trustee to protect the noteholders’ interests, and a collateral administrator (often the same party as the trustee) to provide back-office support and an independent board of directors. The SPE also employs a collateral manager (typically the bank or asset manager that sponsors the SPE), which performs different functions for a CLO than a servicer does for a typical securitization. Here, the collateral manager is charged with managing the composition of the issuer’s collateral such that specific measures and concentrations of assets are in compliance with the transaction documents. Consequently, the collateral manager determines which assets need to be replaced in a transaction for credit or other reasons, and determines which assets may be purchased to add to the issuer’s portfolio. In addition, during the CLO’s reinvestment period, the collateral manager invests principal proceeds received from the underlying loans in new loans.



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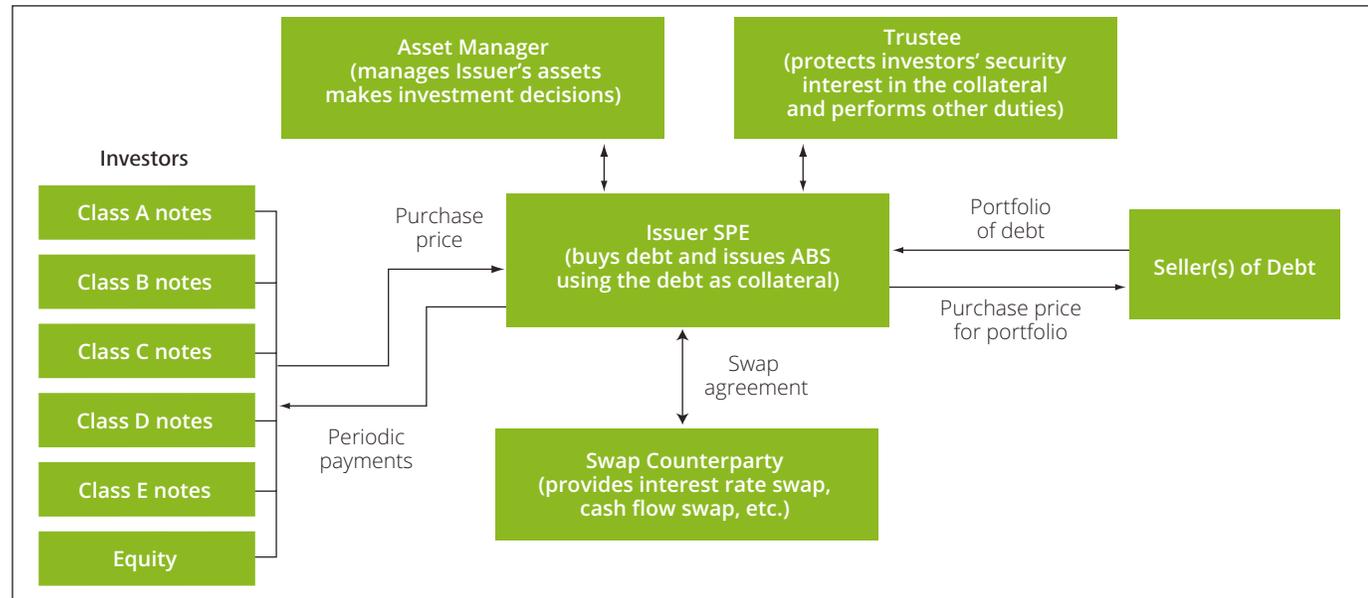
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Will the collateral manager consolidate the CLO?



GAAP

Assume that an asset manager creates a CLO and retains a portion (say, 35 percent) of the equity tranche of securities. The senior and mezzanine securities are distributed to several investors. The equity class provides credit support to the higher tranches and was sized to absorb a majority of the expected losses of the CLO. For its role as collateral manager, the asset manager receives remuneration, including a senior management fee paid senior to the notes; a subordinate management fee, which is paid senior to the CLO's preferred shares; and an incentive fee (typically, a percentage of residual cash flows

after the equity holders have received a specified internal rate of return). The fees paid to the asset manager represent a variable interest according to ASC 810-10-55-37 because the asset manager holds an equity tranche. The fees would not be a variable interest if the asset manager was receiving fees commensurate and at market, it did not hold the equity tranche, and its related parties did not hold any variable interests in the VIE that absorbed a more than insignificant amount of the VIE's expected losses or expected residual returns.

The asset manager will generally be the entity that has the power to direct activities that most significantly impact the CLO's economic performance. Through its ability to determine which assets are acquired and which assets are sold, the asset manager is in a unique position to direct the activities that most significantly impact the economic activities of the CLO.

While only one party will have power over the relevant activities, several of the CLO investors may have investments that create an obligation to absorb potentially significant expected losses or to receive potentially significant expected benefits from the performance of the issuer trust.

Assuming the fee paid to the asset manager is both commensurate and at market, such fee would not be considered in the economics test of ASC 810-10-25-38A. The asset manager would evaluate its exposure through the equity tranche of securities when considering whether it has rights to receive benefits or obligations to absorb losses that could potentially be significant to the issuer trust.

As a result, the asset manager would have power over the relevant activities of the CLO and a potentially significant variable interest through its equity tranche investment. Therefore, it would be considered the primary beneficiary and need to consolidate the CLO under GAAP. Accounting for a consolidated CLO has its own complications. See [Chapter 13](#) for a discussion of a recent Emerging Issues Task Force consensus aimed at clarifying the accounting for consolidated CLOs, where the assets and liabilities are measured at fair value.



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Chapter 5: How about some examples?

Overall, recent changes to GAAP simplify the evaluation of whether fees paid to a decision-maker or service provider constitute a variable interest. Whereas the old model examined aspects such as fees' level of seniority, the significance of anticipated fees relative to anticipated economic performance, and fees' ability to absorb variability associated with economic performance, the new model deemphasizes these characteristics and focuses instead on whether the fees compensate for services and are commensurate with the effort required to provide them. As such, issues like fee subordination and significance to the VIE's economics are now less likely to be areas of concern when determining if fees should be considered variable interests.

Situations might evolve over a deal's life in which the asset manager no longer receives any future cash flows through its equity investment and the fee streams become the sole remaining substantive income to be earned by the asset manager. Because of ASC 810's ongoing consolidation reconsideration requirements, such change would trigger greater scrutiny of whether the asset manager's fee is a variable interest under ASC 810-10-55-37 since the remaining fee streams would be the only source of economic exposure through which to assess if the asset manager is still the primary beneficiary of the CLO.

IFRS

As discussed in [Chapter 2](#), the consolidation model under GAAP for structured entities and IFRS is very similar. Both models consider having power over the most significant activities and having a variable interest. Where they differ is in the consideration of how the entity's power impacts those variable interests, with IFRS 10 looking at whether an entity is able to use its power to influence the amount of returns from its interest (i.e., whether the entity is acting in a role of principal or agent). Using the same scenario as above, under IFRS the asset manager would also be considered to have power over the relevant activities through its decision-making over acquiring, originating, and disposing of assets within the collateral pool. The manager would also have a variable interest through its fee arrangement as well as its 35 percent equity tranche investment. So the question focuses on whether the asset manager is able to use its power to influence the amount of its returns and, in doing so, whether it is acting as a principal (i.e., on its own behalf) or strictly as an agent for the other investors in the CLO. In performing the principal-agent assessment, the fees are considered commensurate with the services provided, as they are standard CLO management fee terms. The remuneration aligns the interests of the fund manager with those of the other investors.

Although operating within the parameters set out in the CLO's legal documents, the asset manager has the current ability to make investment decisions that significantly affect investor returns. Greater emphasis is placed on the exposure to variability of returns of the fund from the asset manager's 35 percent equity interest, which is subordinate to the senior and mezzanine debt securities. Holding 35 percent of the equity tranche and the fee arrangement creates subordinated exposure to losses and rights to returns, which are of such significance that it indicates that the asset manager is a principal to the CLO and thereby controls and should consolidate.



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How do you determine gain or loss on a sale?



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Chapter 6: How do you determine gain or loss on a sale?

Simplified gain or loss calculation

Say what you want about the evolution of accounting guidance for transfers of financial assets over the years, but at least the calculation of gain or loss on sale of assets has been greatly simplified. There are three principal reasons for this:

- Achieving sale accounting and deconsolidation is now a higher hurdle than had been previously the case
- Under [ASC 860](#), one can sell only an entire financial asset, an entire pool of assets, or a participating interest; no part sale/part financing
- Retained or acquired interests are initially recorded at fair value rather than allocated cost basis

Many of the steps in the process of calculating a gain or loss on sale will sound familiar. It remains useful to remember that for a securitization that has achieved sale accounting, the transferor has sold an entire pool of assets. There are no “retained” pieces—any beneficial interests received are all proceeds.

To calculate the gain or loss, sellers must first accumulate the elements of carrying value of the pool of assets securitized, including any premiums and discounts, capitalized fees or costs, lower-of-cost-or-fair-value valuation reserves and allowances

for losses. Second, sellers must identify any assets received and any liabilities incurred as part of the securitization. Third, sellers must estimate carefully the fair values of every element received or incurred based on current market conditions. This estimate must use realistic assumptions and appropriate valuation models for only existing assets that have actually been transferred (without anticipating future transfers). Finally, for those transfers that qualify as a sale, sellers must:

- Recognize gain or loss on the assets sold by comparing the net sale proceeds (after transaction costs and liabilities incurred) to the carrying value attributable to the assets sold.
- Record as proceeds, and, on the balance sheet at fair value, any beneficial interest received in the transferred assets, which may include (1) a separate servicing asset or liability and/or (2) debt or equity instruments in the special purpose entity.
- Subtract from proceeds and record on the balance sheet the fair value of any new liabilities issued, including guarantees; recourse obligations or derivatives, such as put options written; forward commitments; and interest rate or foreign currency swaps.

Financial modeling of securitization transactions is an integral part of the accounting process, both at the date of the transaction and on an ongoing basis. Reasonable financial modeling requires quantitative processes that appropriately reflect (1) the nature of the assets securitized, (2) the structural features and terms of the securitization transaction, and (3) the applicable accounting theory. It also requires accurate data about current amounts and balances in the securitization, as well as observable market data (e.g., yield curves and credit spreads) and supportable assumptions about future events (e.g., customer prepayment behavior, default probability, and loss severity). Securitization transactions are too complex to analyze intuitively, given the level of precision required for financial reporting.



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Chapter 6: How do you determine gain or loss on a sale?

How is gain or loss calculated in that rare revolving structure that does not have to be consolidated?

Gain or loss recognition for relatively short-term receivables, such as credit card balances, drawdowns on home equity lines of credit, trade receivables, or dealer floor plan loans sold to a relatively long-term revolving securitization trust, is limited to receivables that exist and have been sold (i.e., not those that will be sold in the future pursuant to the revolving nature of the deal). Recognition of servicing assets is also limited to the servicing for the receivables that exist and have been sold.

A revolving securitization involves a large initial transfer of balances generally accounted for as a sale. Ongoing, smaller subsequent months' transfers funded with collections of principal from the previously sold balances ("transferettes") are each treated as separate sales of new assets with the attendant

gain or loss calculation, provided that these transfers meet the unit of account definition discussed above. The recordkeeping burden necessary to comply with these techniques can be quite onerous, particularly for master trusts.

The implicit forward contract to sell new receivables during a revolving period, which may become more or less valuable as interest rates and other market conditions change, is to be recognized at its fair value at the time of sale. Its value at inception will be zero if entered into at the market rate. ASC 860 does not require securitizers to mark the forward to fair value in accounting periods following the securitization. (Note: the application of derivative accounting under [ASC 815](#) may require securitizers to mark the forward to fair value in accounting periods following the securitization, but it is outside the scope of this publication, as are any considerations of electing fair value accounting [ASC 825](#), *Financial Instruments* [[ASC 825](#)]).

Certain revolving structures use a "bullet provision" as a method of distributing cash to their investors. Under a bullet provision, during a specified period preceding liquidating distributions to investors, cash proceeds from the underlying assets are reinvested in short-term investments, as opposed to continuing to purchase revolving period receivables. These investments mature to make a single lump sum or "bullet" payment to certain classes of investors on a predetermined date. In a controlled amortization structure, the investments mature to make a series of scheduled payments to certain classes of investments on predetermined dates. The bullet or controlled amortization

provision should be taken into account in determining the fair values of the beneficial interests received in the transferred assets sold, assuming that the beneficial interests are issued by an unconsolidated trust.

That said, for transferred credit card receivables, it is inappropriate to report as "loans receivable" the receivables for income related to accrued fees and finance charges income, commonly referred to as accrued interest receivable (AIR). The AIR asset should be accounted for as a beneficial interest received in the pool. ASC 860 does not specifically address the subsequent measurement of beneficial interests, other than those that cannot be prepaid contractually or settled in such a way that the owner would not recover substantially all of its recorded investment. Entities should follow existing applicable accounting standards, including [ASC 450](#), *Contingencies* ([ASC 450](#)) in subsequent accounting for the AIR asset. [ASC 450](#) addresses the accounting for various loss contingencies, including the collectability of receivables.



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Chapter 6: How do you determine gain or loss on a sale?

Is there a sample gain on sale worksheet that I can use as a template?

A term securitization example

Assumptions (all amounts are hypothetical and the relationships between amounts do not purport to be representative of actual transactions)

- Aggregate Principal Amount of Pool \$100,000,000
- Net carrying amount (principal amount + accrued interest (if it has to be remitted to the trust) + purchase premium + deferred origination costs - deferred origination fees - purchase discount - loss reserves) \$99,000,000
- Classes IO and R are acquired by transferor

Deal structure			
	Principal amount	Price*	Fair value
Class A	\$96,000,000	100	\$96,000,000
Class B	4,000,000	95	3,800,000
Class IO			1,500,000
Class R			1,000,000
TOTAL	\$100,000,000		\$102,300,000
* Including accrued interest			
Servicing asset—fair value			\$700,000
Up-front transaction costs (underwriting, legal, accounting, rating agency, printing, etc.)			\$1,000,000

Calculation of gain	
Total proceeds	
Total cash from bond classes sold (net of transaction costs)	\$98,800,000
Class IO (fair value)	1,500,000
Class R (fair value)	1,000,000
Servicing asset (fair value)	700,000
Net proceeds (with accrued interest, after transaction costs)	\$102,000,000
Net carrying amount	99,000,000
Pre-tax gain	\$3,000,000

Journal entries	Debit	Credit
Cash	\$98,800,000	
Servicing asset	\$700,000	
Class IO	\$1,500,000	
Class R	\$1,000,000	
Loans-net carrying amount		\$99,000,000
Pre-tax gain on sale		\$3,000,000

Note: In addition to this journal entry that records the gain or loss on sale, the seller would also record the selling costs identified above (i.e., \$1 million) as an expense, with an offsetting cash payment or liability.



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Chapter 6: How do you determine gain or loss on a sale?

A credit card example

Assuming that the sponsor is not consolidating, each month, during the revolving period, the investor's share of principal collections would be used to purchase transferettes, and an analysis similar to the following would be made with a new gain or loss recorded. This example illustrates the gain calculation a transferor would prepare at the transaction's inception, assuming that the transfer is to an unconsolidated entity and transaction achieves sale accounting.

Assumptions (all amounts are hypothetical and the relationships between amounts do not purport to be representative of actual transactions)

- Aggregate principal amount of pool \$650,000,000
- Carrying amount, net of specifically allocated loss reserve \$637,000,000
- Fair value of cash collateral account \$5,000,000
- Value of fixed-price forward contract for future sales \$-
- Up-front transaction costs (assumed as given) \$4,000,000

Calculation of proceeds	Principal amount	Price	Proceeds
Class A	\$500,000,000	100	\$500,000,000
Class B	25,000,000	100	25,000,000
Initial funding of cash collateral account			(7,000,000)
Beneficial interest in overcollateralization (fair value)			125,000,000
IO strip			10,000,000
Beneficial interest in cash collateral account			5,000,000
Amortization of transaction costs ¹⁶			(1,000,000)
TOTAL			\$657,000,000

Calculation of gain	
Net proceeds after transaction costs (assumes 25% allocation to the initial sale)	\$657,000,000
Net carrying amount	637,000,000
Pre-tax gain	\$20,000,000

Journal entries	Debit	Credit
Cash	\$514,000,000	
IO strip	\$10,000,000	
Cash collateral account	\$5,000,000	
Seller's interest	\$125,000,000	
Deferred transaction costs	\$3,000,000	
Pre-tax gain on sale		\$20,000,000
Loans-net carrying value		\$637,000,000

¹⁶To the extent the transaction costs incurred upfront relate to future sales to occur during the revolving period of a securitization transaction—for example, the credit card securitizations discussed herein—the cost should be deferred and expensed upon the earlier of (1) the completion of future related transactions or (2) the date the entity determines no future benefits can be derived from the deferred costs.



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Chapter 6: How do you determine gain or loss on a sale?

What about sales of participating interests?

Assume Commercial Loan Bank and Trust (CLBT) has sold an eight-tenths participating interest in a commercial loan with a carrying amount of \$20,000,000 to Partaker Bank for \$15,200,000. Additionally, CLBT has sold a 10 percent participating interest in the same loan to Group Bank for \$1,900,000. The total cash proceeds are \$17,100,000, implying that the fair value of the loan is \$19,000,000. Thus: CLBT's remaining 10 percent interest would stay on the books at a basis of \$2,000,000. This participation transaction would not give CLBT an opening to elect to carry that interest at fair value.

This example may be slightly oversimplified. In the first instance, even though they are buying their interests at the same time, Partaker and Group might pay somewhat different prices. Also, the example ignores servicing, which could result in a liability (if the servicing fee would not fairly compensate a substitute service) or a small asset (however, the fee cannot be significantly above fair compensation and still meet the participating interest definition).

Basis allocation of carrying value					
Component	Fair value	% of Total fair value	(\$20 MM X%) Allocated carrying amount	Allocated carrying amount	
				Sold	Retained
Sold to Partaker	\$15,200,000	80%	\$16,000,000	\$16,000,000	
Sold to Group	1,900,000	10	2,000,000	2,000,000	
Interest held by CLBT	1,900,000	10	2,000,000		2,000,000
TOTAL	\$19,000,000	100%	\$20,000,000	\$18,000,000	\$2,000,000
Net proceeds				\$17,100,000	
Pre-tax loss				\$900,000	

Journal Entries	Debit	Credit
Cash	\$17,100,000	
Loss on sale	\$900,000	
Loans-net carrying amount		\$18,000,000

How do I calculate fair value?

Because it would be unusual for a securitizer to find quoted market prices for many financial components arising in a securitization, the measurement process requires estimation techniques. ASC 860 discusses these situations as follows:

- The underlying assumptions about interest rates, default rates, prepayment rates, and volatility should reflect what market participants would use.
- Estimates of expected future cash flows should be based on reasonable and supportable assumptions and projections.
- All available evidence should be considered, and the weight given to the evidence should be commensurate with the extent to which the evidence can be verified objectively.

For further discussion on fair value see [Chapter 9](#).



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Caution: Should this fact pattern present itself, care should be taken in the determination of whether the transferor should consolidate the transferee and if legal isolation has been achieved.

How do I record credit risk? Is it part of the beneficial interest in the asset?

The transferor should focus on the source of cash flows in the event of a loss by the trust. If the trust can only look to cash flows from the underlying financial assets, the transferor is absorbing a portion of the credit risk through its beneficial interest, and should not record a separate obligation. However, possible credit losses from the underlying assets do affect the measurement of fair value and accounting for the transferor's beneficial interest. In contrast, if the transferor could be obligated to reimburse the trust beyond losses charged to its beneficial interest (i.e., it could be required to "write a check" to reimburse the trust or others for credit related losses on the underlying assets or the trust/ investors have the right to put assets back to the transferor), then a separate liability should be recorded at fair value on the date of transfer.



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What should I know about mortgage servicing rights?



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Chapter 7: What should I know about mortgage servicing rights?

What is a mortgage servicing right?

The coupon paid by the borrower on an originated mortgage loan includes both compensation for servicing the loan and a reasonable investment return to the lender. If a loan is held for investment by the originator, there is generally no contractual separation of the investment return from the servicing component. However, if the originator decides to sell the loan to another party, that sale can be structured with the servicing either retained or released. If the loan is sold servicing released, then the originator will receive a price to compensate them for the full market-based value of the whole loan, including servicing. Conversely, if the loan is sold and servicing is retained, there is a contractual separation of the mortgage loan coupon into the servicing component and the interest rate paid to the purchaser or new investor of the loan. This results in the potential recognition of a mortgage servicing right (MSR) asset or liability by the originator retaining the servicing component.

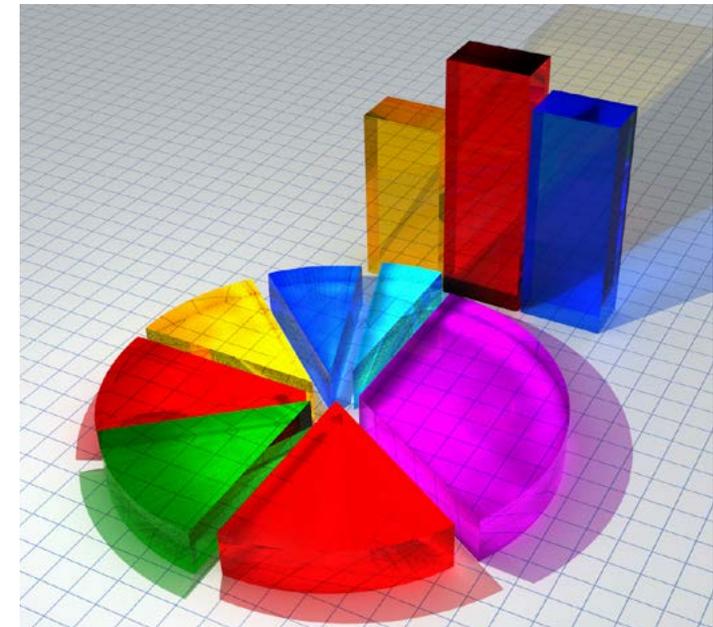
Initial recording

An entity must recognize a servicing asset or liability upon execution of a contract to service financial assets. A servicing contract is either (1) undertaken in conjunction with selling or securitizing the financial assets being serviced or (2) purchased or assumed separately. A servicing asset or liability would be recorded related to this contract to service only when there is a

contractual separation of the servicing from the loan. A servicer that also owns the loan would not record a separate servicing asset or liability. Typically, the benefits of servicing are expected to be more than adequate to compensate the servicer for performing the servicing, and the contract results in a servicing asset. However, if the benefits of servicing are not expected to adequately compensate a servicer for performing the servicing, the contract results in a servicing liability. If a servicer is just adequately compensated, no servicing asset or liability should be recorded. Adequate compensation is a market-based factor and does not necessarily consider the servicer's internal costs to service.

A servicing asset or servicing liability that requires separate recognition is required to be initially measured at fair value in accordance with [ASC 820, Fair Value Measurement](#). Fair value is defined as the price that would be received to sell the asset or would be paid to transfer a liability in an orderly transaction between market participants. The price used must be based on the principal market for the asset or liability, where the principal market is presumed to be the market in which the reporting entity normally transacts. In the absence of a principal market, participants may use the most advantageous market, which is the market that is most advantageous for the transferor, after taking into account transaction costs.

MSRs may be acquired in bulk or flow transactions: either retained as part of the transfer of a loan or through separate acquisition after separation from the related mortgage loan. The fair value recorded for an MSR retained as part of a loan transfer will impact the gain on sale of the transferred loan. Separate acquisition of an MSR may also include the acquisition of other related servicing assets, such as servicing advances



Chapter 7: What should I know about mortgage servicing rights?

and delinquent servicing fees. For the separate acquisition of an MSR, the consideration paid should be allocated to the fair value of the MSR and the relative fair value of other assets acquired in the transaction. While there are many inputs that the marketplace considers in the fair valuation of an MSR, generally, this value will comprise the net impact of (1) the cash inflows related to the benefits of servicing, such as the base servicing fee and any float or other ancillary income expected, and (2) the cash outflows related to the obligations of servicing, including cost of funds.

Subsequent measurement

Servicing assets or servicing liabilities can be accounted for subsequent to acquisition, using one of two methods: amortization or fair value.

Different elections can be made for different classes of servicing assets and servicing liabilities. Classes of servicing assets and servicing liabilities are identified based on the availability of market inputs used in determining fair value, as well as an entity's method for managing the risks of its servicing assets or servicing liabilities. For example, a company may choose to categorize their single-family residential mortgage loan servicing in a separate class from their multifamily mortgage loan servicing. Once fair value is elected for a particular class, the fair

value election is irrevocable. Servicing assets and liabilities held within an amortized cost class may be transitioned to a fair value class at the beginning of a fiscal year.

It is important to note, however, that a servicing asset may also become a servicing liability, or vice versa, as a result of changes in the relationship of contractual servicing fees to adequate compensation.¹⁷ Adequate compensation may be impacted by changes in the market based costs to service loans due to evolution in loan performance as well as other factors.

Amortization method

Under the amortization method, the MSR is amortized in proportion to and over the period of estimated net servicing income (if servicing revenues exceed servicing costs) or net servicing loss (if servicing costs exceed servicing revenues). The resulting amortized cost basis of the MSR is assessed periodically for impairment or increased obligation based on fair value at each reporting date.

Stratification

Under the amortization method, the MSR portfolio is stratified within separate tranches based on one or more predominant risk characteristics of the underlying financial assets. Characteristics may include financial asset type, size, interest rate, date of origination, term, and geographic location. This stratification should be at a granular enough level so that the loans within the stratum generally behave in a similar manner as market risk factors fluctuate.

The stratification decision shall be applied consistently unless significant changes in economic facts and circumstances indicate clearly that the predominant risk characteristics and resulting strata should be changed.

Amortized cost should be calculated for each stratum individually. Additionally, each stratum should be assessed for impairment by comparing the amortized cost to the fair value at the measurement date. If the fair value of any stratum is less than the amortized cost of that stratum, then the differential should be recorded as an impairment. If the impairment is considered temporary, it may be recognized through a valuation allowance on the balance sheet with an offsetting debit to the income statement. Subsequent changes in the fair value of the stratum may be impacted through the valuation allowance; however, the carrying value of the stratum would never be increased for fair value estimations in excess of the carrying value. If an impairment is considered other than temporary, a direct write-down of the MSR asset may be warranted.

Fair value method

An entity can also elect to use the fair value method for a class of servicing assets or servicing liabilities. Under the fair value method, each class of servicing assets or liabilities is adjusted to fair value at the reporting date and changes in the fair value are recorded in earnings in the period in which the changes occur.

The MSR market has historically never been liquid enough to provide participants with readily available quoted market prices. Trades, if any, are transacted between parties through brokers, rather than through an exchange. Therefore, companies

¹⁷ASC 860-50-20 defines adequate compensation as: "The amount of benefits of servicing that would fairly compensate a substitute servicer should one be required, which 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."



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commonly rely on valuation models to estimate the fair value of the asset or liability. Certain significant assumptions within the MSR valuation are unobservable and therefore, under ASC 820, an MSR is typically considered a Level 3 asset or liability.

There are robust disclosure requirements in [ASC 820](#) and [ASC 860](#), which include, but are not limited to, requiring information to enable users to assess the valuation techniques and inputs used to develop the fair value of the MSR (for both impairment evaluation under the amortization method and for subsequent accounting at fair value) as well as the effect of the measurements on earnings for the period.

Transfers of servicing

Sale accounting versus a financing transaction

When an MSR is transferred between parties, it may be accounted for as either an asset sale or a secured lending transaction, depending on certain key facts and circumstances.

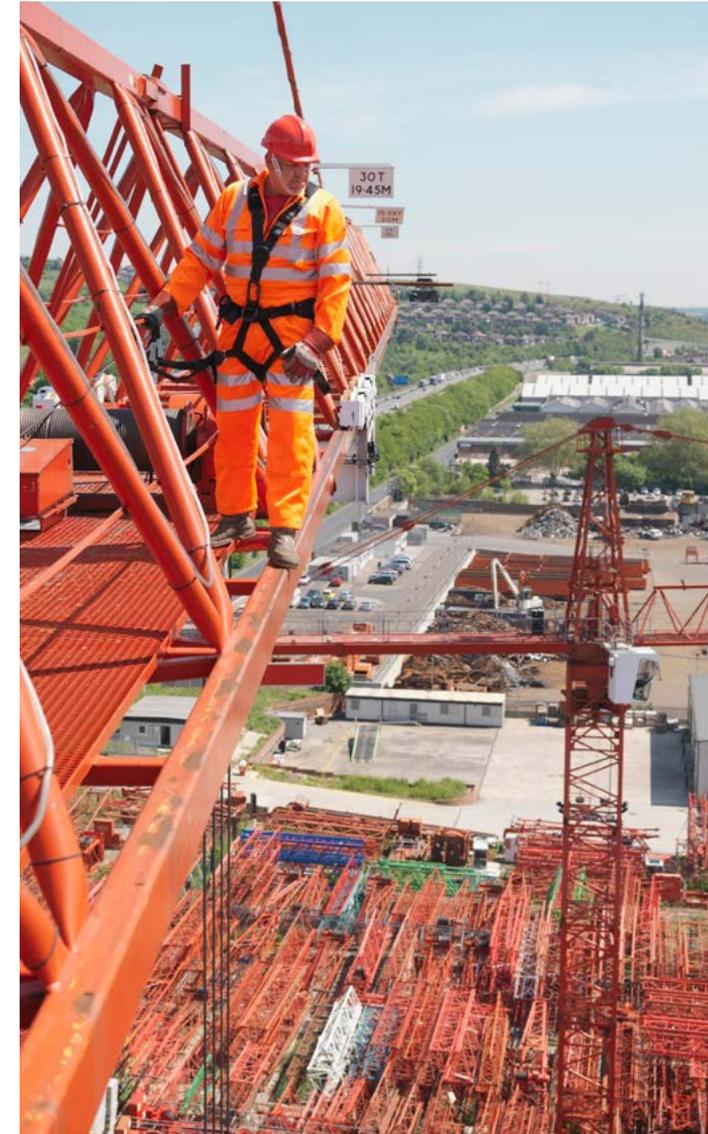
It is an important to note that under US Generally Accepted Accounting Principles (GAAP), MSRs are not considered financial assets. MSRs reflect the obligations of the servicer to perform the servicing as well as its right to the benefits of servicing for performing those obligations. The servicing fees are earned as services are provided. Because of their nature, there is unique guidance to account for transfers of servicing in [ASC 860-50-40](#).

¹⁸ASC 860 defines Recourse as “The right of a transferee of receivables to receive payment from the transferor of those receivables for any of the following: (a) Failure of debtors to pay when due, (b) The effects of prepayments or (c) Adjustments resulting from defects in the eligibility of the transferred receivables.”

Sale accounting criteria

Transferred servicing rights are accounted for as a sale if the seller achieves the following requirements:

- Whether the transferor has received written approval from the investor if required.
- Whether the transferee is a currently approved transferor-servicer and is not at risk of losing approved status.
- If the transferor finances a portion of the sales price, whether an adequate nonrefundable down payment has been received (necessary to demonstrate the transferee’s commitment to pay the remaining sales price) and whether the note receivable from the transferee provides full recourse¹⁸ to the transferee. Nonrecourse notes or notes with limited recourse (such as to the servicing) do not satisfy this criterion.
- Temporary servicing performed by the transferor for a short period of time shall be compensated in accordance with a subservicing contract that provides adequate compensation.
- Title has passed.
- Substantially all risks and rewards of ownership have irrevocably passed to the buyer.
- Any protection provisions retained by the seller are minor and can be reasonably estimated.



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Based on this guidance, among other things, significant consideration is given to whether the seller is entitled to the risks and rewards of ownership. Rewards of servicing include the right to earn servicing fees and other contractually entitled payments (e.g., ancillary income, float, etc.). Rewards can also be earned through the rights to sell the MSR for a return in the market place. Risks of servicing include the incurrence of the associated costs to service and understanding that those are not fixed, but may vary based on the needs of the particular borrower and mortgage loan. Risks also include the potential for nonpayment by the borrower and the servicer's recovery of lost fees from the investor or through the sale of the foreclosed property, depending on the contractual provisions. Recoveries in this manner can cause the servicer to incur carrying costs of capital prior to recovery.

A transfer of MSRs can qualify as a sale only if the transferee has an appropriate license to service the MSRs transferred. While the accounting guidance does not specify the type of entity that can hold an MSR, in transactions where servicing is retained, investors will typically require a licensed servicer to be the named servicer; in bulk transactions, the derecognition requirements will be applicable, thus consideration of ownership is a critical consideration in determining who records the MSR.

When the requirements for sale accounting have been met, but the transferor establishes a subservicing arrangement with the transferee, the ability to recognize the gain on sale could be impacted and deferral may be required, despite the ability to derecognize the MSR. Special attention should be given to the role the seller may play subsequent to the sales transaction.

Considerations for a financing transaction

Certain transfers of MSRs will not meet the sale accounting criteria and should be accounted for as a financing or secured borrowing. This would result in a liability recorded by the transferor in the amount of the cash received. This liability should reflect the expected future cash payments that will be passed through to the purchaser of the MSR and would not reduce to zero or be considered extinguished until the last payment is made.

While a transaction may initially be accounted for as a secured borrowing, subsequent facts may change and allow for the transaction to meet the requirements for sale accounting. These facts might include transfer of title and/or approval of the transferee as the servicer by the investor of a loan, among other possible factors.

Other considerations

For servicing liabilities subsequently measured using the amortization method, if subsequent events have increased the fair value of the liability above the carrying amount—for example, because of significant changes in the amount or timing of actual or expected future cash outflows relative to the cash outflows previously projected—the entity shall revise its earlier estimates and recognize the increased obligation as a loss in earnings.

Certain transactions could involve the sale of cash flows related to an MSR or even the sale of excess servicing. The guidance in [ASC 860-50-25](#) provides a definition for excess servicing and guidance for distinguishing servicing from an IO strip. While the sale of cash flows related to the MSR and the base servicing fees would be considered a transfer of nonfinancial assets, an excess servicing strip or IO strip in certain circumstances, could meet the definition of a financial asset and would be considered under the guidance in [ASC 860-10](#). Under the definition in the Accounting Standards Codification, excess servicing would be considered the “rights to future interest income from the serviced assets that exceed contractually specified servicing fees.” The right to this income is held outside of the servicing contract and may include rights to residual income of a securitization or an actual IO certificate. This form of excess servicing would be considered a financial asset.

Additionally, some transactions may include more than just the transfer of assets and the acquiring party may need to consider the guidance in [ASC 805, Business Combinations](#) to determine whether the acquisition should be accounted for as a business combination.



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MSRs under IFRS

GAAP separately identifies an MSR as a unique nonfinancial asset and provides specific guidance with regards to the accounting and valuation of MSRs. International Financial Reporting Standards (IFRS) identifies MSRs within the intangible asset guidance in [IAS 38, Intangible Assets](#). While the accounting for MSRs is largely similar under both bodies of accounting standards, there could be some differences, beyond the balance sheet classification, in the application of the accounting guidance. The nuances of specific transactions and structures will be determinative of any differences in conclusions.

IFRS addresses accounting for MSRs in conjunction with the accounting for other intangible assets and does not provide unique accounting for MSRs specifically. Under IFRS, acquired intangible assets should be initially recognized at “relative fair value.” Depending on the structure of the transaction relative fair value may differ from true market-based fair value.

IFRS requires an intangible asset with a finite useful life to be amortized after initial recognition over its useful life in accordance with the economic benefits to be derived from the asset. This is very similar to the amortization method under GAAP. IFRS also requires that the MSR be analyzed for impairment, however, does not require the MSR to be tranching into risk buckets for purposes of this impairment assessment. This approach could result in different carrying amounts of the MSR under GAAP vs. IFRS. In addition, IFRS does not allow for the option to measure the MSR at its full fair value subsequent to initial recognition, as does GAAP.

IFRS does not provide specific guidance on MSR transfers. However, guidance does exist in IAS 38 related to transfers of intangible assets. This guidance defers to general revenue recognition concepts under [IAS 18](#). The application of the IFRS guidance to a transfer of MSRs may result in a similar accounting conclusion; however, the potential does exist for differences. Most notably, the concept of a secured financing is not specifically mentioned in IFRS related to transfers of intangible assets. As such, when the derecognition guidance for an intangible asset is not met under IFRS, there could be differences between GAAP and IFRS.



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Chapter 8: What about the investors?

How do I account for my investments in plain-vanilla mortgage-backed securities (MBS) and asset-backed securities (ABS)?

All interests in securitized financial assets, whether purchased for cash or obtained as consideration in a transfer accounted for as a sale, should be initially recorded at fair value. In addition, the investor will need to make at least one and perhaps several accounting elections immediately upon recognizing its investment.

The first accounting election is whether the investor wants to continue to report the interest at fair value on every subsequent balance sheet, thereby recognizing unrealized gains and losses due to fair value changes currently in earnings. This “fair value option” is available for most financial instruments, including securitized financial assets. The election generally must be made on an item-by-item basis when each item is first recognized, and is irrevocable once made. The election, however, cannot be used as an alternative to consolidation. If the investor decides not to use the fair value option, then the decision of what to do requires more thought.

Most interests in securitized financial assets (including most preferred shares issued by a securitization trust and other “equity” beneficial interests) will meet the definition of a “debt security” and, therefore, are governed by the accounting guidance in Accounting Standards Codification (ASC 320), *Investments—Debt and Equity Securities*. However, at times, transferors will structure a transaction so that they obtain financial interests that do not meet the definition of a debt security. Typically, this is done by leaving the transferor’s interests represented by contractual rights under the pooling and servicing agreement or other operative transfer document and not having them embodied in any book entry security or other instrument (i.e., leaving them “uncertificated”). Nonetheless, if such interests can be prepaid or otherwise contractually settled in such a way that the holder (e.g., transferor) would not recover substantially all of its recorded investment, US Generally Accepted Accounting Principles (GAAP) requires that they be accounted for like a debt security and classified either as trading or available-for-sale (AFS). If a beneficial interest does not fall into any of the categories above, investors will need to evaluate the specific characteristics of the instrument to determine the appropriate accounting literature to apply (as well as look for possible embedded derivatives). For example, accounting for the interest as a receivable may be appropriate.



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An investor that does not avail itself of the fair value option must elect to classify debt securities as either trading, AFS, or held to maturity (HTM). For the most part, this initial classification cannot be changed so long as the holder retains the security. Only transfers from the AFS category to the HTM category are readily permitted.

Trading securities are carried at fair value with unrealized gains and losses recognized currently in earnings. Securities that are acquired to be sold in the near term, and are therefore expected to be held only for a short period of time, must be classified as trading securities. An investor may also voluntarily designate other debt securities as trading securities. Therefore, the trading category is essentially similar to the fair value option.¹⁹

AFS securities are also carried at fair value on the balance sheet. However, changes in fair value are recognized on the balance sheet, net of tax effects, in a separate component of equity known as other comprehensive income (OCI) rather than in current earnings. If an individual security's fair value declines below its amortized historical cost basis and that decline is considered to be other than temporary, the security is impaired and some or all of the charge that would otherwise appear in OCI must be recognized as a loss in earnings. This establishes a new historical cost basis for the security, which means that any

subsequent increase in fair value cannot be used to offset losses previously recognized. The analysis of other-than-temporary impairments (OTTI) is discussed further on in this chapter.

HTM securities are carried at their amortized historical cost basis, subject to write-downs for OTTIs. In order to classify a security as HTM, the holder must have the positive intent and ability to hold the security until its maturity. There are strict limits on the ability of an investor to sell HTM securities without impugning management's ability to claim the intent to hold other securities until they mature. The permissible reasons to sell or reclassify HTM securities that are most frequently applicable to holders of ABS or MBS securities are:

- Evidence of a significant deterioration in the issuer's creditworthiness, such as a credit downgrade
- A significant increase in the holder's regulatory capital requirement, causing it to downsize its portfolio
- A significant increase in the risk weights associated with the particular securities
- A sale near enough to contractual maturity so that interest rate risk is no longer a pricing factor (e.g., within three months of contractual maturity)
- Collecting a substantial portion of the principal balance outstanding at the date the security was acquired, either due to prepayments or scheduled payments over its term

In contrast, sales or reclassifications due to changes in interest rates, prepayment rates, liquidity needs, alternative investment opportunities, funding or foreign currency exchange rates are not permissible reasons to sell a security classified as HTM. The Securities and Exchange Commission (SEC) staff has expressed the view that selling even one HTM security for an impermissible reason would call into question management's ability to make a credible assertion about the intent to hold other securities to maturity. In that case, the SEC staff has indicated that all other HTM securities should be reclassified to AFS and no new securities may be classified as HTM for a period of two years (commonly referred to as the "tainting period").

Securities such as interest-only (IO) strips, which can be prepaid or otherwise contractually settled in such a way that the holder would not recover substantially all of its recorded investment, may not be classified as HTM. Hedge accounting is not available for interest rate hedges of HTM securities. On the other hand, hedge accounting is permitted for interest rate hedges of the liabilities used to fund HTM securities. Also, HTM securities may be pledged as collateral in a financing transaction (including a securitization) that does not qualify for sale treatment without calling into question management's intent to hold the security to maturity.

¹⁹ 825-10-15-4 considerably expands the availability of fair value accounting to financial liabilities and financial assets other than securities. 320-10-25-1 allows for an initial election to classify debt securities as "trading securities," even if the investor is not actively trading in the position.



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Do I have to worry about derivative accounting with MBS and ABS?

The accounting definition of a derivative is quite broad, and also applies to certain derivative characteristics embedded within so-called hybrid instruments. Given the potential complexity of various interests in securitization transactions, it might seem obvious that many securitization interests would be considered hybrid instruments, resulting in an accounting treatment that requires the embedded derivative to be split from the non-derivative host and accounted for separately.

Fortunately, the Financial Accounting Standards Board (FASB) has provided exceptions for the most common approaches used in securitization transactions to allocate both prepayment and credit risk inherent in the underlying pool of financial assets. GAAP does not require an investor in a securitization tranche to consider whether the transfer of credit risk from one securitization tranche to another merely as a result of subordination gives rise to an embedded derivative. That said, other embedded credit derivative features—for example, synthetic structures that include credit default swaps—could give rise to potentially bifurcatable derivatives.

At the end of the day, whether a securitization interest will need to be split into a non-derivative host and a derivative instrument will generally come down to whether the derivative and the host interest are considered “clearly and closely related”—for example, changes in a commodity index generally would not be considered closely related to a debt instrument. Given the fairly detailed nature of the guidance that governs that analysis, we will leave that discussion for another place and time.

How are discounts and premiums amortized?

Frequently, the initial carrying value of an interest in a securitization will not be exactly par. Whether the difference is caused by market purchase premiums or discounts, investors need to use a rational and systematic method to recognize any difference in earnings over time. This is true even if the securities are being carried at fair value on the balance sheet (e.g., as trading securities or under the fair value option) so long as interest income appears as a separate line item on the investor’s income statement. When credit and prepayment risks are not substantial, the task is somewhat easier. Even so, most MBS and ABS will often have some actual prepayment experience that will need to be dealt with.

One method is to simply amortize any premium or discount over the maximum contractual life of the position held. If prepayments cause the principal balance to decay more quickly, then a pro rata portion of the unamortized amount would be recognized in earnings in order to catch up with actual prepayments.

A second method is to begin amortizing any premium or discount based on an initial estimate of prepayments. That estimate is periodically revised as actual prepayments run faster or slower. However, in order to estimate prepayments, the underlying pool of assets needs to be large and composed of similar loans for which prepayments are probable and their amount and timing are subject to reasonable estimation.

Adjustable interest rates add an additional level of complexity. In addition to dealing with prepayments, the investor needs to deal with changes in the coupon interest rate over time. For interest rates indexed to the London Interbank Offered Rate (LIBOR) or some other market index or rate, the amortization schedule for the premium or discount can be established based on the projected cash flows using either the index or rate in effect at inception or the amortization schedule can be recalculated periodically as that index or rate changes over the life of the security. If there is an artificially high or low contractual rate in effect during the early periods, that would be leveled out over the life so long as the accreted balance does not rise to exceed the amount that would be immediately recognizable if the borrower elected to prepay (considering any prepayment or similar penalties).

The various level yield methods just mentioned do not cover securities and uncertificated interests that are of lower credit quality or could be contractually repaid in a way that the holder would recover less than substantially all of its initial investment, nor do they cover positions purchased after they have experienced significant credit deterioration. Read on for additional questions and answers covering those types of positions.



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When do I need to write-down underwater positions?

Positions that have an OTTI will require a write-down of one sort or another. At every balance sheet date, the investor needs to identify individual security positions whose fair values are “underwater,” (i.e., below their amortized cost basis), even if they are already carried at fair value as AFS securities. Once these “impaired” positions are identified, the next step is to determine whether the impairment is other-than-temporary (which does not mean “permanent”). Finally, the investor may need to estimate how much of the OTTI results from credit losses as compared to all other factors.

For debt securities such as securitization interests, OTTIs come in two basic varieties. If the investor either intends to sell a security or is more likely than not to be required to sell the underwater security before it recovers (e.g., for regulatory reasons), then the investor must write down the security to its fair value. The entire write-down is charged to earnings. Thereafter, the investor accounts for the security as if it were purchased at fair value at the date of the write-down.

Alternatively, if the investor does not intend to sell a security and it is not more likely than not that it will be required to sell the security, the impairment may nonetheless be deemed other than temporary if the investor does not expect to recover the security's entire amortized cost through the present value²⁰ of future expected cash flows. In that case, the write-down is split between the portion representing credit losses and the remainder related to all other factors. The entire write-down is

shown in the income statement along with an offsetting amount to move the portion relating to all non-credit factors to OCI. Thereafter, the amortized cost basis of the impaired positions is reduced by the credit impairment. Amounts included in OCI due to OTTI charges for HTM and AFS securities should be shown separately.

What disclosures do I need to make when I don't write down my underwater positions?

Annual financial statements should include:

- As of each balance sheet date, a table by category of investment showing investments that have been continuously in a unrealized loss position for a year or more separately from those with unrealized losses for less than a year:
 - The aggregate amount by which cost or amortized cost exceeds fair value.
 - The aggregate related fair value of investments with unrealized losses.
- As of the most recent balance sheet date, a narrative discussion of the quantitative disclosures and the information that the investor considered (both positive and negative) to provide insight into the investor's rationale for concluding that the impairments are not other-than-temporary. This discussion could include:
 - The nature of the investment(s).
 - The cause(s) of the impairment(s).
 - The number of investment positions that are in an unrealized loss position.
 - The severity and duration of the impairment(s).



- Other evidence considered by the investor in reaching its conclusion that the investment is not other-than-temporarily impaired, including, for example, default and delinquency rates, loan-to-value ratios, guarantees, subordination levels, vintage years, geographic concentrations, industry analyst reports, sector credit ratings, volatility of the security's fair value, and/or any other information that the investor considers relevant.

Investors that prepare quarterly financial statements follow a variety of customs, from repeating the complete annual disclosures updated for the current quarterly balance sheet, to providing more abbreviated information addressing only significant changes from the prior annual disclosures. However, the particular disclosures outlined above are specifically required for quarterly financial statements as well as annual ones.

²⁰ This present value calculation would be based on the yield currently being used by the investor to recognize interest income on the security.



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How do I account for securities and other interests with significant prepayment and/or credit risk?

IO strips, loans, or other receivables that can be contractually prepaid or otherwise settled in such a way that the holder would not recover substantially all of its investment are to be carried at fair value, similar to investments in debt securities classified as AFS or trading. This is true regardless of whether the asset was purchased or was obtained as consideration from a securitization, and regardless of whether the asset (the entitlement to cash flows) is certificated as a security or uncertificated.

No specific guidance precisely defines “substantially all,” but premiums of 10 percent or more warrant consideration. And, the probability of prepayment is not relevant in deciding whether this provision should apply. So, the potential for the loss of a portion of the investment would not be evaluated differently for a wide-band planned amortization class (PAC) versus a support class.

Example: The investor owns a subordinated debt class from a securitization of mortgage loans. The class has a stated principal amount and a variable rate of interest. Losses on the underlying mortgage loans in the pool are charged against this subordinated class before any losses are allocated to the senior classes. Because of this subordination feature, the security's fair value and carrying amount is significantly less than its principal amount. At inception, a certain number of prepayments and losses is expected. At the end of the first quarter, (a) the actual

interest rate on the class changes; (b) the actual prepayments and the estimate of future prepayments differ from the original expectation; and, (c) the actual losses and the estimate of future losses differ from the original expectation. The accounting method needs to be able to deal with all of these types of changes every period.

The FASB has prescribed a particular prospective method for adjusting the level yield used to recognize interest income when estimates of future cash flows on the security either increase or decrease since the date of the last evaluation (typically quarterly). Securities covered include:

- All ABS, collateralized loan obligations (CLO), commercial mortgage-backed securities (CMBS), and MBS that are not (1) guaranteed by the government, its agencies or guarantors of similar credit quality or (2) sufficiently collateralized to ensure that the possibility of credit loss (whether of principal or interest) is remote. A minimum credit rating requirement (e.g., investment grade) to be eligible for exclusion from the provision is not specified; however, the SEC staff has set that threshold at AA client agency rating or equivalent.
- All IOs, including agency IOs and any other premium securities (regardless of rating) if prepayments could cause the holder not to recover substantially all of its recorded investment.

The above securities are covered regardless of whether they are classified as HTM or AFS. If classified as trading, they are already being marked to market, but the interest income recognition guidance applies if the holder is required to report interest income separately from unrealized gains and losses in their income statement. Securities designated as notes, bonds, pass-through, or participation certificates, and even trust certificates and CLO preference shares are typically covered because they often possess the characteristics of debt rather than equity securities (see below).

How do I compute periodic interest income when there is significant prepayment and/or credit risk?

Generally, interest income recognition on investments in securitizations will be accounted for under [ASC 325-40](#). Under this model, investors (as of the purchase date) and securitizers (as of the securitization settlement date) need to estimate the timing and amount of all future cash inflows from the security using assumptions that were used in determining fair value. The excess of those future cash flows over the initial investment is the accretable yield to be recognized as interest income over the life of the investment using the effective yield method.

As with any security, investors determine the yield by solving for the internal rate of return (IRR) that equates those future cash flows back to the amount of the amortized cost of investment. At any balance sheet date, the amortized cost of the investment is equal to (1) the initial investment plus (2) the yield accreted to date less (3) all cash received to date regardless of whether labeled as interest or principal less (4) any write-down for impairment (see table entitled Sample ASC 325-40 calculation).



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Investors must update the cash flow estimates throughout the life of the investment taking into account the assumptions that marketplace participants would use in determining fair value. To determine the level yield used to accrete interest income in the following period, investors must solve for a new IRR that equates the new estimates of future cash flow back to the amortized cost amount at the latest balance sheet date.

Some residual interests generate relatively small amounts of cash to the holder in the early periods of a securitization (due to the requirement to build up credit enhancement). When applying the effective yield method to these residuals, it is likely that the carrying value of the residual will be higher at the end of the year than at the beginning of the year and that is acceptable provided the estimates of cash flow are appropriate.

In certain circumstances (e.g., when an investor acquires a securitization interest that has demonstrated evidence of credit quality deterioration since its inception), investors may need to recognize interest income on their investment in a securitization using the guidance found in [ASC 310-30](#). That guidance is similar to ASC 325-40 except that it differs in how updates to cash flow estimates affect yield. For example, after initial recognition, the estimated cash flows used to accrete interest income for a debt security are required to be updated only if (1) the estimated cash flows have increased significantly, (2) the estimated cash flows have declined (in which case, impairment would be recognized), or (3) if the actual cash flows received are significantly greater than previously projected.

How about an example of interest recognition and impairment recognition for securities with significant prepayment and/or credit risk?

Assumptions

The investor purchased a B-piece on January 1, 2016, for \$106.08. It has a face amount of \$100 and is also entitled to all of the excess interest from the net coupon on the loans over the interest paid to the senior class, subject to reimbursing the senior class for credit losses. The investor has the positive intent and ability to hold this subordinated security until maturity and has not elected to classify it as a trading security.

The assumed pre-tax yield at the date of purchase is 10.77 percent per annum based on an assumed conditional prepayment rate (CPR) of 5 and assumed losses of 100 basis points per annum on the outstanding principal amount of the loans (the “Base Case”).

As of the end of year 1, there are five alternative scenarios presented in the following table. The first is that the base case prepayment, loss, and market yield for the B-piece assumptions do not change. The other scenarios involve an increase or decrease in one or more of the assumptions as to prepayments, losses, and market yield for the B-piece.



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Sample ASC 325-40 calculation

		Scenarios for years 2 through 5				
		Base case	One	Two	Three	Four
1	Prepayment assumption	5 CPR	7 CPR	7 CPR	3 CPR	3 CPR
2	Credit loss assumption	100 bp	200 bp	200 bp	50 bp	50 bp
3	Market yield for B-piece	10.77%	12%	8%	12%	8%
4	Cash flows to B-piece*:					
5	Year 1	\$15.70	\$15.70	\$15.70	\$15.70	\$15.70
6	Year 2	13.30	11.19	11.19	14.34	14.34
7	Year 3	28.08	31.70	31.70	24.51	24.51
8	Year 4	52.23	49.24	49.24	54.44	54.44
9	Year 5	42.89	38.52	38.52	46.65	46.65
10	Total years 1 through 5	\$152.20	\$146.35	\$146.35	\$155.64	\$155.64
11	Present value of year 2 thru 5 cash flows discounted at accretable yield rate of 10.77%	\$101.80	\$97.75	\$97.75	\$103.96	\$103.96
12	Fair value at end of year 1 (PV of lines 6 thru 9 discounted at market yield in line 3)	\$101.80	\$94.79	\$104.94	\$100.74	\$111.80
13	Interest income-year 1 (investment of \$106.08 times the base case yield of 10.77%)	\$11.43	\$11.43	\$11.43	\$11.43	\$11.43
14	Preliminary amortized cost (initial investment plus interest income less year 1 cash flow)	\$101.80	\$101.80	\$101.80	\$101.80	\$101.80
15	Has there been a decrease in the present value of estimated remaining cash flows in line 11?	NA	YES	YES	NO	NO
16	Is fair value (line 12) below amortized cost (line 14)?	NO	YES	NO	YES	NO
17	Impairment to be recorded? (if line 15 and 16 are YES then line 14 minus line 12)	NO	\$7.01	NO	NO	NO
18	Amount from line 17 moved to OCI (line 11 minus line 12)		\$2.96	-	-	-
19	Balance sheet asset at end of year 1†	\$101.80	\$94.79	\$101.80	\$101.80	\$101.80
20	Amortized cost basis at end of year 1	\$101.80	\$97.75	\$101.80	\$101.80	\$101.80
21	Revised yield for year 2 (IRR of amortized cost (line 20) and cash flows years 2-5 (lines 6-9))	10.77%	10.77%	9.17%	11.59%	11.59%
22	Interest income-year 2 (line 21 times line 20)	\$10.96	\$10.53	\$9.34	\$11.80	\$11.80

* For reverse-engineers only: The deal structure used to generate the cash flows going to the B-piece was a pool of five-year loans with a principal amount of \$250 amortizing with five annual payments of \$50. Gross coupon of 12 percent on the outstanding principal (after charge-offs) less servicing fee of 1 percent of the outstanding principal (before charge-offs). The senior class had a principal amount of \$150, an interest rate of 6 percent, and was entitled to 100 percent of all scheduled and unscheduled principal payments and liquidations until retired.

† If the B-piece had been classified as AFS, the balance sheet asset amount would always be fair value. In scenarios two, three and four, the difference between fair value and amortized cost would be reflected as a debit or credit in OCI.



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What about whole loan and participating interests?

Most securitization transactions involve pools of loans. Some transferors have historically treated other uncertificated interests as still being a part of their loan portfolio. That practice will likely continue, and even become more prevalent for retained participating interests. Because a participating interest is limited to essentially a pro rata share of the cash flows, ASC 860's basis allocation process will result in a nearly pro rata basis allocation to the retained participating interest, further supporting the idea that a retained participating interest should continue to be reported as part of the loan portfolio.



Loans that an investor does not intend (or is not able) to hold for the foreseeable future or until maturity must be classified as held-for-sale and carried at the lower-of-cost-or-fair-value (LOCOFV). Premiums and discounts related to loans held for sale are not amortized and no separate allowance for credit losses is provided—it all just rolls up in the LOCOFV valuation. Loans not classified as held for sale are classified as long-term investments and carried at amortized carrying amount, subject to allowances for credit losses and evaluation for impairment. Loans moved from the held-for-sale category to the held-for-investment category are transferred at the lower-of-cost-or-market value.

Even if the retained participating interest continues to be a part of the loan portfolio, there is still a question as to whether the classification should be retained. Loans held for investment are not subject to the same restrictions on sales as securities held to maturity. While a regular pattern of sales might raise questions, an occasional well-intentioned sale of a loan held for investment is not fatal to the accounting classification of the remaining loans. Loans moved from the held-for-sale category to the held-for-investment category are transferred at the lower-of-cost-or-market value.

When can I put my investments on non-accrual status?

GAAP does not explicitly address when investments should be put on non-accrual status. Regulated entities, however, should refer to regulatory guidance in determining when non-accrual status is appropriate. In all cases, however, the non-accrual designation should not be used to circumvent the requirements to recognize impairment.

How does international accounting compare?

For investors applying International Financial Reporting Standards (IFRS), International Accounting Standard (IAS) 39 governs the accounting for investments in financial assets, including investments in securitizations.²¹ Similar to GAAP, IAS 39 requires an investor to classify investments in financial assets as either trading, AFS, or HTM (or, in certain cases, as loans and receivables). Although the classification and measurement alternatives under IFRS are similar to GAAP, the qualifying criteria for each classification differs from GAAP as demonstrated in the following table:

Like GAAP, IAS 39 provides an option for investors to account for their interests at fair value through profit or loss (i.e., a fair value option). However, unlike GAAP, IFRS require investors to meet certain qualifying criteria before they can elect the fair value option for an otherwise eligible item. Under IFRS, the fair value option may only be elected if (1) it eliminates or significantly reduces an accounting mismatch, (2) the financial asset is part of a group of assets and/or liabilities that is both managed and whose performance is evaluated on a fair value basis in accordance with a documented risk management strategy, or (3) the investor would otherwise be required to bifurcate an embedded derivative from the financial asset.

²¹ In 2014, the IASB issued an amended financial instruments standard in IFRS 9, Financial Instruments that will eventually replace IAS 39. The amended standard addresses classification and measurement criteria for financial assets, recognition and derecognition of financial assets and credit impairment. IFRS 9 has an effective date of January 1, 2018, with early adoption permitted. See Chapter 13 for more discussion.



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Comparison between IFRS and GAAP		
Topic	IFRS	GAAP
Trading (measured at fair value through profit or loss)	Financial assets that: a. Are acquired principally for the purpose of reselling in the near term; b. Are part of a portfolio of financial instruments that are managed together and for which there is evidence of recent short-term profit taking; or, c. Are derivative instruments.	Financial assets that: a. Are acquired with the intent of selling it within hours or days; or, b. The investor otherwise elects to account for the financial asset as trading.
HTM (measured at amortized cost)	Non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity and that are <i>quoted in an active market</i> .	Financial assets that are debt securities and for which the investor has both the positive intent and ability to hold the security until maturity.
Loans and receivables (measured at amortized cost)	Non-derivative financial assets with fixed or determinable payments and fixed maturity that are <i>not quoted in an active market</i> .	Not an eligible classification criteria. Under GAAP, loans are classified as either held-for-sale or held-for-investment.
AFS (measured at fair value through OCI)	Financial assets that are not classified as trading, HTM, or loans and receivables.	Financial assets that are not classified as trading or HTM.

Like GAAP, IAS 39 requires investors to determine whether their investments contain any embedded derivatives. The criteria for performing such an analysis under IFRS are essentially the same as GAAP; however, differences exist in the application guidance.

Unlike GAAP, IFRS does not contain the concept of OTTI. Instead, IAS 39 requires investors to determine whether there is any objective evidence of impairment (i.e., one or more events has had an impact on estimated future cash flows). If objective evidence of impairment exists, then the investor would recognize an impairment loss measured as follows:

- **For assets classified as HTM or loans and receivables**—as the difference between the asset’s carrying amount and the investor’s estimate of future cash flows, discounted using the asset’s effective interest rate.
- **For assets classified as AFS**—as the difference between the asset’s carrying amount and the asset’s fair value.

Also unlike GAAP, IAS 39 permits investors to reverse previous impairment losses if there is objective evidence that the amount of the impairment loss has decreased.

Interest income recognition under IFRS is similar to GAAP; that is, IAS 39 requires interest income to be recognized using the effective interest method. In addition, IAS 39 provides that for financial assets acquired at a deep discount to their par amount, investors would determine the assets’ effective interest rate in a manner that incorporates the estimate of expected credit losses.



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How do I measure and report fair value information?



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What is fair value?

ASC 820, Fair Value Measurement, sets forth guidance on how to determine the fair value measurement of assets and liabilities—including interests in securitizations (e.g., securitization certificates, interest-only strips, underlying collateral, etc.)—and also outlines the disclosures that must accompany fair value measurements. Before diving into the details, it is important to note one thing: ASC 820 does not prescribe when fair value is required; rather, it creates a uniform definition for determining fair value under US Generally Accepted Accounting Principles (GAAP)—using an “exit price” notion—when other areas of GAAP require fair value to be measured either for financial-statement or footnote-disclosure purposes. ASC 820 also makes clear that fair value is a market-based, not an entity-specific, measurement. ASC 820’s three-level fair value measurement hierarchy, described below, strives to bring increased transparency, consistency, and comparability to fair value estimates. Consistency and comparability are clearly desirable in financial reporting; however, ASC 820’s goals are squarely at odds with the wide range of valuation techniques used to value securitization interests. The friction between the numerous valuation practices and ASC 820’s desire for consistency and comparability is at the core of fair value controversies. However, no matter how complicated or detailed the technique or methodology, the end goal for accounting purposes remains

the same: to derive an estimate of the price at which assets may be sold or liabilities may be transferred in the market at the valuation date.

Do I need to measure the fair value of each position individually or can I use a portfolio approach?

Generally speaking, ASC 820 views an individual security as the appropriate unit of valuation for financial instruments. For example, the fair value of a large holding of a particular security would generally be determined as the product of the price per unit (e.g., per share or dollars of par value) times the quantity of units held. In fact, using “blockage” factors is specifically prohibited.

That said, ASC 820 does permit an entity to make an accounting policy choice to measure the fair value of a specific group of financial assets and financial liabilities on the basis of what would be received to exit a net-long or net-short position if all of the following conditions are met:

- The entity manages the group of assets and liabilities on the basis of its net exposure to either market risks (e.g., interest rate risk, currency risk, or other price risk) or credit risk.
- The entity provides information about the group on a net basis to management.

- All of the financial assets and liabilities are measured at fair value in the balance sheet (either by requirement or through election of the fair value option).

While the fair value measurement may be performed on a net basis, the presentation of those financial assets and financial liabilities would still be reported on a gross basis unless they meet the offsetting criteria in *ASC 210, Balance Sheet*. Therefore, even if an entity avails itself of the portfolio-based fair value practical expedient, it will have to use judgment to develop a reasonable and consistent methodology to attribute the portfolio fair value measurement to the individual financial assets and financial liabilities that constitute the group for presentation in the financial statements.

1, 2, 3 ... What level to be?

The three-level fair value hierarchy exists to communicate the reliability of the inputs used to estimate fair value and requires entities to prioritize the use of observable inputs. That is, when estimating fair value, entities are required to maximize the use of relevant observable inputs, using the following hierarchy:

Level 1: Quoted prices for the identical asset in an active market, without adjustment.

Level 2: Anything that is not Level 1, but that is directly or indirectly observable, including:



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- Quoted prices for similar assets or liabilities in active or inactive markets.
- Inputs other than quoted prices that are observable, such as yield curves, prepayment speeds, default rates, loss severities.
- Inputs derived principally from, or corroborated by, observable market data.

Level 3: Unobservable inputs that reflect the reporting entity's own assumptions about the assumptions market participants would use to estimate fair value.

One approach for estimating the fair value of beneficial interests issued in a securitization is a three-step present value technique that:

- Creates the best estimate of cash flows generated from the underlying assets.
- Applies the asset cash flows to the cash outflows per the transaction documents (i.e., the waterfall).
- Discounts the cash flows for the securities held at the yield a buyer will demand.

Is the market always right? What if it dries up?

An investor will look to the “markets” to obtain observable information to be utilized in the fair value estimation process. But before arriving at the inputs for the valuation technique above, investors must evaluate the market so that they can make the appropriate judgments about the information being conveyed through various pricing signals.

If an investor reaches a conclusion that there has been a significant decline in the volume or activity in a given market, further analysis of the transactions or quoted prices is needed, and an adjustment to the transactions or quoted prices, or a change in the valuation methodology employed, may be necessary to estimate fair value. Adjustments also may be necessary in other circumstances (e.g., if a price for a similar asset requires adjustment to make it more comparable to the asset being measured or when the price is stale).

To determine that a decrease in volume or level of activity has occurred, the investor needs to evaluate the following factors that are indicative of illiquid markets:

- There are few recent transactions.
- Price quotations are not based on current information.
- Price quotations vary substantially either over time or among market makers (e.g., some brokered markets).
- Indices that previously were highly correlated with the fair values of the asset or liability are demonstrably uncorrelated with recent indications of fair value for that asset or liability.
- There is a significant increase in implied liquidity risk premiums, yields, or performance indicators (such as delinquency rates or loss severities) for observed transactions or quoted prices when compared with the reporting entity's estimate of expected cash flows, considering all available market data about credit and other non-performance risk for the asset or liability.

- There is a wide bid-ask spread or significant increase in the bid-ask spread.
- There is a significant decline or absence of a market for new issuances (that is, a primary market) for the asset or liability or similar assets or liabilities.
- Little information is publicly available (e.g., a principal-to-principal market).

Together, an investor's observations of information in the market and judgments about the conditions of the market will drive the ultimate estimate of inputs into the present value technique described above.

What is the best estimate of cash flows? How do I know whether my model of the structure is correct? What yield should I use to discount the cash flows?

As is usually the case, the answer to these questions is, “it depends.” As a general rule, however, investors must answer these questions based on what a market participant would use and not based on their own view. Investors need not undertake exhaustive efforts to obtain information about market participant assumptions, but they need to incorporate information that is reasonably available without undue cost and effort.



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The continuing proliferation of detailed information on asset pools underlying securitizations results in an environment where the amount of information that might be considered in estimating the asset cash flows is often overwhelming. Consequently, there are sophisticated forecasting models that take into account a variety of factors—such as regional unemployment, home price appreciation or depreciation, the length of time a court will take to liquidate a property in bankruptcy, and the degree to which loan modification programs will take hold—all in an effort to arrive at a forecast of securitization collateral cash flows to be applied to the structure.

Further complicating the situation, some structures incorporate bespoke or custom features that are difficult to model and may be highly subjective. In certain cases, these features are major drivers of value, potentially rendering the first step of the process (asset cash flow estimation) incredibly difficult. For example, many of the “event of default” and subordination provisions in collateralized debt obligations challenge investors to conclude on interpretations of waterfalls described within transaction documents, often with very little or no precedent.

Once an investor has the appropriate inputs to make an estimate of the asset cash flows, and that those cash flows are applied to the structure through an accurate model, the investor needs to determine the appropriate rate of return that a market participant would demand should some or any of the beneficial interests be sold.

To that end, ASC 820 provides a useful example of one technique a market participant might utilize to arrive at a market rate of return for a mortgage-backed security. In this example, a market participant begins with an observable risk-free rate, and then makes adjustments by adding or subtracting basis points for product type, length of time outstanding, market conditions at inception versus the valuation date, credit risk, liquidity risk, and other factors. The result is an estimate of a market rate of return that incorporates and quantifies adjustments based on other observable and unobservable factors. The example also highlights one way to incorporate the difference between the cash nature of the asset and the synthetic nature of an index, as well as the difference between assets backing the security and those backing the index. Many of the adjustments are tied to concepts that highlight indicators for when a market has seen a decline in volume or activity.

Do I need to mark my book to indices?

The creation of indices to track prices for securities at different levels of the capital stack for different products issued in certain vintages provides ever-increasing flexibility to investors in terms of hedging capabilities, speculation, and price discovery. Unfortunately, the indices only directly translate to fair value for the exact same portfolio of securities; consequently, adjustments are required in order to determine the fair value of a single security. Ultimately, one needs to determine whether the adjustments that must be made to indices in order to arrive at a market rate of return result in a more reliable estimate than the return one would estimate using another less observable, but perhaps more relevant, input.

Can I book a gain or loss at inception? How do I calibrate my models?

To the extent sale accounting is achieved, gains or losses from a securitization will arise for the seller when the fair value of the proceeds from the transaction is greater or less than the carrying amount of the assets and/or liabilities transferred. If the seller receives a beneficial interest in the transferred assets, care must be exercised in the estimation of fair value for those interests.

The determination of fair value for securitization interests must adhere to the exit price notion called for in ASC 820, which recognizes the potential for the transaction price to



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be different from the exit price. Many in the securitization community interpret parts of ASC 820 to support an attack on the use of “mark to model” for received beneficial interests, or newly acquired investments, because the fair value established through the use of a model might result in higher estimates of exit price than would a negotiated transaction price.

In a speech in 2006, the Securities and Exchange Commission staff made it clear that models used to estimate fair value must be calibrated to reflect market conditions on the transaction date in a way that results in the exit price equaling transaction price, absent circumstances where the transaction price does not reflect fair value. Transaction price might not reflect fair value when the transaction is between related parties, when one or more of the parties is transacting under duress, or when the transaction price is established in a market that is not the principal or most advantageous market.

What if I need to change valuation methods? What other information about fair value estimates should I disclose?

Changes in valuation techniques or the application thereof could arise for many reasons. Techniques can be refined, or become less effective than alternatives, and markets could develop, consequently providing greater insight and stronger pricing signals, or they could diminish, leaving a dearth of pricing information.

When changes occur, diligent consideration of the significance of valuation inputs must be given in order to appropriately classify the estimate in the fair value hierarchy. In accounting parlance, the change in valuation technique or its application is typically accounted for as a change in accounting estimate under [ASC 250, Accounting Changes and Error Corrections](#). While ASC 250 has its own disclosure requirements, those criteria are not applicable because of existing fair value disclosures under ASC 820 that require disclosure of changes in valuation techniques. In any interim or annual period, reporting entities must discuss the valuation techniques used to measure fair value, as well as any changes in the techniques and inputs used for each major security type. Examples of major security types could include:

- Equity securities (segregated by industry type, company size, or investment objective)
- Debt securities issued by the US Treasury and other US government corporations and agencies
- Debt securities issued by US states or municipalities
- Debt securities issued by foreign governments
- Corporate debt securities
- Residential mortgage-backed securities
- Commercial mortgage-backed securities
- Collateralized loan obligations
- Other debt obligations

How do I measure the fair value of financial assets and financial liabilities of a collateralized financing entity I am required to consolidate?

The fair value of the financial assets of a collateralized financing entity may differ from the fair value of its financial liabilities even when the financial liabilities have recourse only to the financial assets. Because of diversity in practice, the FASB, with the consensus of the Emerging Issues Task Force, issued ASU 2014-13, *Measuring the Financial Assets and the Financial Liabilities of a Consolidated Collateralized Financing Entity*, (the “Update”) to eliminate that difference. Prior to this Update, there was no specific guidance in GAAP on how a reporting entity should account for that difference. The Update provides a measurement alternative such that the reporting entity should measure both the financial assets and financial liabilities of that consolidated financing entity in its consolidated financial statements using the more observable of the fair value of the financial assets and the fair value of the financial liabilities as follows:

- If the fair value of the financial assets of the collateralized financing entity is more observable, those financial assets should be measured at fair value, and the financial liabilities should be measured in consolidation as (1) the sum of the fair value of the financial assets and the carrying value of any nonfinancial assets held temporarily, less (2) the sum of the fair value of any beneficial interests retained by the reporting entity (other than those that represent compensation for services) and the reporting entity’s carrying value of any beneficial interests that represent compensation for services.



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The resulting amount should be allocated to the individual financial liabilities (other than the beneficial interests retained by the reporting entity) using a reasonable and consistent methodology.

- If the fair value of the financial liabilities of the collateralized financing entity is more observable, those financial liabilities should be measured at fair value, and the financial assets should be measured in consolidation as (1) the sum of the fair value of the financial liabilities (other than the beneficial interests retained by the reporting entity), the fair value of any beneficial interests retained by the reporting entity (other than those that represent compensation for services), and the reporting entity's carrying value of any beneficial interests that represent compensation for services, less (2) the carrying value of any nonfinancial assets held temporarily. The resulting amount should be allocated to the individual financial assets using a reasonable and consistent methodology.

This Update also clarifies that when this measurement alternative is elected, a reporting entity's consolidated net income (loss) should reflect the reporting entity's own economic interests in the collateralized financing entity, including (1) changes in the fair value of the beneficial interests retained by the reporting entity and (2) beneficial interests that represent compensation for services. Beneficial interests retained by the reporting entity that represent compensation for services (for

example, management fees or servicing fees) and nonfinancial assets that are held temporarily by a collateralized financing entity should be measured in accordance with other applicable topics.

When the measurement alternative is not elected for a consolidated collateralized financing entity, (1) the fair value of the financial assets and the fair value of the financial liabilities of the consolidated collateralized financing entity should be measured using the requirements of ASC 820 and (2) any differences in the fair value of the financial assets and the fair value of the financial liabilities of that consolidated collateralized financing entity should be reflected in earnings and attributed to the reporting entity in the consolidated statement of income (loss).

What are the disclosure requirements?

There are a number of disclosures required by entities that report financial assets at fair value on a recurring basis. Among others, these include:

- a. The fair value measurements at the reporting date
- b. The level within the fair value hierarchy in which the fair value measurements in their entirety fall, segregating fair value measurements using quoted prices in active markets for identical assets or liabilities (Level 1), significant other observable inputs (Level 2), and significant unobservable inputs (Level 3)

- c. For Level 2 and Level 3 fair value measurements, the valuation techniques and inputs used in determining fair value
- d. For fair value measurements categorized within Level 3, quantitative information about the significant unobservable inputs used in the fair value measurement
- e. For fair value measurements using significant unobservable inputs (Level 3), a reconciliation of the beginning and ending balances, separately presenting changes during the period attributable to the following:
 1. Total gains or losses for the period (realized and unrealized), segregating those gains or losses included in earnings (or changes in net assets), and a description of where those gains or losses included in earnings (or changes in net assets) are reported in the statement of income (or activities)
 2. Total gains or losses for the period recognized in other comprehensive income, and the line item(s) in other comprehensive income in which those gains or losses are recognized
 3. Purchases, sales, issuances, and settlements (each presented separately)
 4. Transfers in and/or out of Level 3 (e.g., transfers due to changes in the observability of significant inputs)
- f. For recurring fair value measurements categorized within Level 3, a narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs if a change in those inputs to a different amount might result in a significantly higher or lower fair value measurement



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- g. The amount of the total gains or losses for the period in subparagraph (e)(1) above included in earnings (or changes in net assets) that are attributable to the change in unrealized gains or losses relating to those assets and liabilities still held at the reporting date and a description of where those unrealized gains or losses are reported in the statement of income (or activities)
- h. If the reporting entity elects the measurement alternative for consolidated collateralized financing entities, for the less observable of the fair value of the financial assets and the fair value of the financial liabilities, it shall disclose that the amount was measured on the basis of the more observable of the fair value of the financial liabilities and the fair value of the financial assets for those financial assets and financial liabilities that are not incidental to the operations of the collateralized financing entity and have carrying values that approximate fair value (for example, cash, broker receivables, or broker payables).

How does international accounting compare?

For investors applying International Financial Reporting Standards (IFRS), *IFRS 13, Fair Value Measurement* governs fair value measurements and the related disclosure requirements. IFRS 13, which became effective on January 1, 2013, is substantially converged with GAAP. That is, a fair value measurement under IFRS should be essentially the same as a fair value measurement determined under GAAP. That said, some of the more notable remaining differences between IFRS 13 and ASC 820 are listed below:



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Subject	GAAP	IFRS
Practical expedient: net asset value	An entity may measure its investment in entities that do not have readily determinable fair values and meet the definition of an investment company under ASC 946 at net asset value as a practical expedient.	IFRS does not have this practical expedient.
Initial recognition: day-one gains and losses	GAAP does not prohibit the immediate (“day-one”) recognition of differences between initial fair value and transaction price, including differences that arise when unobservable inputs are used in the initial fair value measurement.	Under IAS 39 and IFRS 9, an entity is prohibited from immediately recognizing gains and losses related to unobservable inputs.
Disclosure: Offsetting fair value measurements disclosed in Level 3 roll-forward	ASC 820 permits entities to present derivative assets and liabilities on either a gross or a net basis in the reconciliation disclosure.	IFRS generally does not permit net presentation for derivatives.
Disclosure: sensitivity analysis	ASC 820 requires a narrative description of the sensitivity in recurring Level 3 measurements to changes in unobservable inputs if such changes would result in significantly different fair value measures. Quantitative sensitivity analysis is not required.	IFRS 13 requires quantitative information about significant changes in recurring Level 3 measurements resulting from changes in one or more unobservable input to reflect reasonably possible alternative assumptions, including the amount of the change in inputs, the amount of the change in the measurement, and how the effect was calculated.
Disclosure: exemptions available to nonpublic entities	Non-public entities are exempt from these disclosure requirements under ASC 820: <ul style="list-style-type: none"> • Narrative description of the sensitivity in recurring Level 3 measurements to changes in unobservable inputs. • Transfers between Level 1 and Level 2. • Disclosures required for fair value measurements disclosed, but not reported, in the statement of financial position. 	Non-public entities are not exempt from any of the disclosure requirements in IFRS 13.
Measurement alternative for consolidated collateralized financing entities.	GAAP provides a measurement alternative such that the reporting entity should measure both the financial assets and financial liabilities of that consolidated financing entity in its consolidated financial statements using the more observable of the fair value of the financial assets and the fair value of the financial liabilities.	IFRS does not contain any guidance specific to the measurement of consolidated collateralized financing entities.



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So where is the transparency?



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Disclosures, disclosures, and more disclosures ...

Having already discussed the many disclosures that are necessary for fair value measurements, one would think the gamut of disclosures required under both US Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS) has been covered. Not even close. There is agreement among those involved with accounting and financial reporting that investors and regulators will continue to demand greater transparency related to securitizations.

That said, [ASC 810](#) and [ASC 860](#) under GAAP and [IFRS 7](#), *Financial Instruments: Disclosures* and [IFRS 12](#), *Disclosure of Interests in Other Entities* require significant disclosures intended to provide financial statement users with (1) an understanding of the nature and extent of a transferor's continuing involvement with transferred financial assets, (2) how a transfer affects a transferor's financial statements, and (3) an entity's involvements with special purpose entities (SPEs). These requirements expand on the disclosures that may also be required under related guidance, such as financial instruments and fair value.

Rules of the disclosure road

A transferor of financial assets into a securitization should be attuned to the following objectives of the disclosure requirements under ASC 860 to provide information on:

- A transferor's continuing involvement with financial assets previously transferred.
- Any restrictions on assets included in the balance sheet of the reporting entity relating to transferred financial assets, including their carrying amounts.
- The reporting of servicing assets and servicing liabilities.
- For those transfers accounted for as either (1) sales where the transferor has continuing involvement or (2) secured borrowings, how the transfer impacts each of the transferor's financial statements.

There are increased disclosure requirements as a result of the need for enhanced qualitative information concerning any risk related to a transferor's exposure from transferred financial assets and any restrictions on the transferred assets.

Transferors are provided discretion when preparing the disclosures with respect to presenting information at an aggregated level; as always, the preparer should present information in the footnotes to maximize their usefulness. If aggregated reporting is presented, then the transferor should disclose how similar transfers are aggregated, and clearly distinguish between transfers accounted for as sales and those accounted for as secured borrowings.

When determining if aggregation is appropriate, information about the characteristics of the transfer should be considered including:

- The nature of any continuing involvement.
- The types of financial assets transferred.
- Any risks to which the transferor continues to be exposed after the transfer, and the change in the transferor's risk profile as a result of the transfer.
- Whether certain loan products increase the reporting entity's exposure to credit risk and thereby may result in a concentration of credit risk.

The transferor must find the right balance between obscuring critical information as a result of too much aggregation versus providing excessive detail that makes it difficult to understand the transferor's exposure.



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What if I have a secured borrowing?

If a transaction is accounted for as a secured borrowing, it could either result from the requirement to consolidate the securitization trust or a failure to relinquish effective control.

The objectives of the disclosures around secured borrowings are to provide the financial statement users with information on how the transfer of financial assets affects a transferor's financial position, financial performance, and cash flows.

Additionally, for secured borrowings resulting from the transferor consolidating the securitization trust, the following information should be disclosed:

- The significant judgments and assumptions made by a transferor in determining whether it must consolidate a variable interest entity (VIE) and/or disclose information about its involvement with a VIE.
- The nature of restrictions on a consolidated VIE's assets and on the settlement of its liabilities reported by the transferor in its balance sheet, including the carrying amounts of such assets and liabilities.
- The nature of, and changes in, the risks associated with the securitizer's involvement with the VIE.
- How a securitizer's involvement with the VIE affects the securitizer's financial position, financial performance, and cash flows.

The requirements also provide that depending on the facts and circumstances surrounding the VIE and the securitizer's interest in that entity, the information may also be aggregated by similar entities to the extent that separate reporting would not provide more useful information. Thus, a securitizer with multiple residential mortgage-backed securities transactions that need to be consolidated may aggregate the information to the degree that disaggregation does not improve the disclosure, such as term transactions of prime loans versus subprime loans and subprime loans of different vintage. Securitizers should consider both qualitative and quantitative information about the differing risk characteristics of the VIEs, as well as the significance of the VIE to the securitizer, in determining the appropriate level of aggregation.

Differentiation should be made between those VIEs which are consolidated and those that are not consolidated but the securitizer has a variable interest in the entity. Additionally, the disclosure requirements under ASC 810 can be provided within more than one footnote of the financial statements so long as there is appropriate cross referencing between the various footnotes.

Now, for the actual requirements

Whether a securitizer is the primary beneficiary, and thus must consolidate the VIE, or even if the securitizer just has a variable interest in a VIE, the following must be disclosed:

- The methodology for determining whether the securitizer is the primary beneficiary of the VIE, including significant judgments and assumptions made in reaching that conclusion.

- If the facts and circumstances have changed leading to a change in the previously reached consolidation conclusion, the securitizer is required to disclose the primary factors that caused the change and the consequent impact on the financial statements.
- If, during the period covered by the financial statements, the securitizer has provided any financial or other support to the VIE that was not contractually required, including through implicit arrangements, or if the securitizer intends to provide such support, the financial statements should disclose information regarding the type and amount of support provided and the primary reasons the support was provided.



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Additionally, the securitizer should provide qualitative and quantitative information about involvement with the VIE, including the nature, purpose, size, activities, and financing of the VIE.

If the securitizer is also the consolidator of a transaction, it should disclose:

- The gain or loss recognized upon initial consolidation of the vehicle.
- The carrying amounts and classifications of the VIE's assets and liabilities, including information regarding the relationships between those assets and liabilities. For example, if the assets may only be used to settle specific liabilities, that relationship should be disclosed.
- When the VIE's creditors or the beneficial interest holders do not have recourse to the general credit of the reporting entity.
- The terms of any explicit or implicit arrangements that could require the reporting entity to provide financial support to the SPE, including events or circumstances with the potential for the securitizer to incur a risk of loss.

What about those variable interest holders who are not the consolidator?

ASC 810 also requires specific disclosures for those reporting entities that hold a variable interest in a VIE, but are not the primary beneficiary. In these circumstances, the disclosures include the carrying amount and classification of the assets and liabilities within the balance sheet that relate to the entity's

variable interest in the VIE, and the maximum exposure to loss from involvement with the VIE. The reporting entity will also need to disclose qualitative information about how the reporting entity's maximum exposure to loss was determined and the significance sources of exposure to the VIE. If the maximum exposure to loss cannot be quantified, that too, must be disclosed.

Information with respect to the carrying amount of the assets and liabilities and the securitization party's exposure to loss should be presented in a tabular format. Both qualitative and quantitative information to provide a sufficient understanding of the differences between the two amounts should also be provided, including the terms of arrangements (both explicit and implicit) potentially requiring the variable interest holder to provide additional financial support. The reporting entity should also provide information about any support committed by third parties, including liquidity arrangements, guarantees, or other commitments.

Importantly, if the party to the transaction has not been identified as the primary beneficiary because of the existence of a shared power arrangement, the securitizer should disclose the significant factors that were considered and judgments that were made in determining that conclusion.

To the degree not disclosed already, for transfers of financial assets accounted for as secured borrowings, the securitizer should disclose the carrying amounts and classifications of both assets and liabilities recognized within the transferor's balance sheet for each period presented. Additionally, the securitizer

should include qualitative information regarding the relationship between those assets and liabilities, such as if assets are restricted to satisfying a specific obligation and the nature of the restrictions placed on those assets.

Amongst the many changes of ASU 2015-2 was an exception to applying the consolidation requirements to interests in entities that are money market funds or the equivalent. If this scope exception is applied, a reporting entity is required to disclose explicit arrangements to provide financial support to those entities.

Is separate presentation required for consolidated VIEs?

The guidance requires that entities consolidating a VIE separately present on the face of the balance sheet the (a) assets of that VIE which can only be used to settle its own obligations and (b) liabilities of that VIE for which the creditors or beneficial interest holders of the VIE do not have recourse to the general credit of the primary beneficiary. This requirement has generated much discussion and debate, primarily because of the lack of guidance on how to apply this requirement to the balance sheet and that there is no similar requirement for presentation within the income statement and statement of cash flows.

One of the common misconceptions about the separate presentation requirement is whether collapsing all of the VIE's assets into a single line item and all of the VIE's liabilities into a single line item is permitted. It is not permitted. Rather, this information should be presented on a line-by-line basis, so that a VIE's assets should not be combined as a single asset line item and its liabilities should not be combined as a single liability line



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item, unless permitted by other applicable GAAP. Accordingly, the assets of the securitization trust (which may include, for example, cash, loan receivables, and real estate owned property) should not be combined on the face of the balance sheet as a single line item unless they are the same category of asset.

Because ASC 810 does not provide specific guidance on application of the separate presentation requirement, there are various presentation alternatives available. One alternative would be for an enterprise to present receivables as one line item and parenthetically disclose the amount of receivables that are in a VIE and that meet the separate presentation criteria. A second alternative would be for an enterprise to present



Consolidated Balance Sheet	
in € m.	
Assets:	
Cash and due from banks	
Interest-earning deposits with banks	
Central bank funds sold and securities purchased under resale agreements	
Securities borrowed	
Financial assets at fair value through profit or loss	
of which € 158 billion and € 87 billion were pledged to creditors and can be sold or repledged at December 31, 2007 and December 31, 2006, respectively	
Financial assets available for sale	
of which € 17 billion and € 23 billion were pledged to creditors and can be sold or repledged at December 31, 2007 and 2006, respectively	

²² For example, 810-20-45-1 addresses a similar question related to the consolidation of limited partnerships by stating: An entity [that consolidates a limited partnership] has financial statement and disclosure alternatives that may provide additional useful information. For example, an entity may highlight the effects of consolidating a limited partnership by providing consolidating financial statements or separately classifying the assets and liabilities of the limited partnership(s) on the face of the balance sheet.

receivables in two separate line items (one line item for those that are in a VIE and meet the separate presentation criteria, and another line item for all other receivables). There may be other acceptable alternatives.²² Fortunately, the separate presentation requirement does not need to be applied on a VIE-by-VIE basis.

Also, as mentioned above, ASC 810 is silent with regard to presentation requirements on the income statement and the statement of cash flows. An entity is permitted to present the activities of consolidated VIEs separately in both statements through an accounting policy election applied consistently to all consolidated VIEs. Some entities may choose to do this to help distinguish the income statement and cash flow implications of its legacy consolidated operations from those associated with the initial application of ASC 810.

I have sale accounting. What do I need to disclose?

For securitizations that achieve sale accounting and the transferor has some form of continuing involvement with those transferred assets, ASC 860 requires specific disclosures for each income statement period presented in the financial statements. The transferor should disclose:

- Information about the characteristics of the transfer, including the nature of the continuing involvement
- The type and initial fair value of the assets obtained and any liabilities incurred as part of the transfer
- The gain or loss recognized resulting from the sale

For those initial fair value measurements, the transferor also should disclose the level at which the measurements fall within the fair value hierarchy, the key inputs and assumptions used in the measurement, and the valuation techniques utilized. For the key considerations in determining the fair value of the interests, see [Chapter 9](#).

Also, the footnote disclosure needs to contain information about the cash flows between the transferor and transferee. ASC 860 requires disclosure of proceeds from new transfers, proceeds from collections reinvested in revolving facilities, purchases of previously transferred assets, servicing fees, servicing advances, and cash flows received from a transferor's beneficial interests in the transferred assets.

For each balance sheet presented in the financial statements, the following disclosures are required regardless of when the transfer occurred:

- Transferors should provide qualitative and quantitative information regarding their continuing involvement. The purpose of this requirement is to provide users of financial statements with information necessary to assess the reason for the continuing involvement and the exposure to risks the transferor retains.
- Transferors should also disclose the extent of any changes in their risk profile as a result of the transaction, including consideration of credit risk, interest rate risk, and other risks. Information to be disclosed as a result include:



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- The total outstanding principal amount, the amounts derecognized, and any amounts that continue to be recognized in the balance sheet.
- Information on any arrangements that could require the transferor to potentially provide financial support to the transferee or its beneficial interest holders and whether any financial support has been provided in the periods presented, including the type and the amount of support and the primary reasons for providing the support.
- Information about any third-party-provided liquidity arrangements, guarantees, or other commitments related to the transferred financial assets.
- Securitizers should disclose its accounting policies for subsequent measurements of the assets or liabilities related to the continuing involvement, as well as the key inputs and assumptions used in measuring the fair value of those assets or liabilities, including quantitative information about discount rates, expected prepayment speeds, and anticipated credit losses.
- Transferors should conduct a sensitivity analysis or stress test, usually presented in tabular format and displaying the hypothetical effect on the fair value of the transferor's interests in the transaction of two or more unfavorable variations from the expected levels for each key assumption. To this table, a description of the objectives, methodology, and limitations of the sensitivity analysis or stress test should also be disclosed.
- Finally, the securitizer should disclose information on the quality of the transferred financial assets, along with

information on the same asset classes that are managed by the securitizer. This information should be categorized as pertaining to those assets derecognized and those that continue to be recognized within the balance sheet, and should include, but is not limited to, delinquencies and credit losses, net of recoveries.

What are the disclosure requirements with respect to servicing assets and liabilities?

For recognized servicing assets and servicing liabilities, securitizers should disclose:

- The basis for determining the classes of servicing assets and servicing liabilities.
- A description of the inherent risks associated with servicing assets and servicing liabilities, and a description of any instruments used to mitigate the income statement impact of changes in fair value changes of servicing assets and servicing liabilities.
- The amount of contractually specified servicing fees, late fees, and ancillary fees earned, including where each of those amounts is recorded, for each income statement period presented.
- Quantitative and qualitative information regarding the assumptions used to estimate fair value, such as discount rates, anticipated credit losses, and prepayment speeds.

For those servicing assets and servicing liabilities subsequently measured at fair value, ASC 860 also requires a disclosure of where the changes in fair value are reported in the income

statement for each period presented and a rollforward of the activity for each class of servicing assets and servicing liabilities, including, the beginning balance, additions from (1) purchases of servicing assets or assumptions of servicing obligations and (2) recognition of servicing obligations that result from transfers of financial assets, disposals, changes in fair value, and the ending balance.

Similarly, for servicing assets and servicing liabilities carried at amortized cost, ASC 860 requires (1) disclosure of the changes in the carrying amount of the servicing assets and servicing liabilities, (2) where such changes are reported in the income statement, and (3) a rollforward of the activity for each class of servicing assets and servicing liabilities. These disclosures should include (1) the beginning balance, (2) additions from purchases of servicing assets or assumptions of servicing obligations, and (3) additions from recognition of servicing obligations that result from transfers of financial assets, disposals, amortization, application of any valuation allowance to adjust the carrying value of servicing assets, any other-than-temporary impairments, any other changes that affect the balance and a description of those changes, and the ending balance. Additionally, for each class of servicing assets and servicing liabilities carried at amortized cost, securitizers should disclose the fair value of those recorded servicing assets and servicing liabilities at the beginning and end of the period. Finally, the risk characteristics considered in the measurement of any impairment of servicing assets and a rollforward by class for any recognized impairment of servicing assets carried at amortized cost should also be disclosed.



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What about segment reporting?

Footnote reporting of operating segments in [ASC 280](#), *Segment Reporting* is driven by the boss. The identification of operating segments depends on how the company reports operating results to the CEO, chief operating officer, or whatever person or group makes resource allocation decisions for the company as its “chief operating decision-maker.” A primary purpose of segment disclosures is to show readers how a company is managed, so different companies will likely have different segments, even if they are in similar businesses.



Depending on how previously unconsolidated VIEs are reported internally for management purposes, they could either represent one or more separate segments or they could become part of an existing segment or two. One could even imagine the now-consolidated VIEs reducing the number of reportable segments. An example might be a mortgage banker whose management reporting follows its external financial reporting. If it no longer reports gain on sale and service fee income to the chief operating decision-maker, it might no longer have separate reportable segments for origination and servicing. It might conclude that it now only has a single mortgage lending segment.

It is hard to imagine that a consolidated VIE would not be an operating segment or part of one because even VIEs would have the segment characteristics of:

- Business activities generating revenues and expenses, reported as
- Discrete financial information, subject to
- Regular review to assess performance and allocate resources.

A segment should be reported if it meets one of the 10 percent significance thresholds (combined internal and external revenues, absolute value of segment profit or loss, and combined segment assets). Segments representing at least 75 percent of external revenue should be shown. Segments with similar economic characteristics, such as gross margin, products, services customers, production, distribution, and regulatory

environment can be combined for reporting. Segment reporting is required in both annual and interim financial statements for public companies.

Any other disclosures to consider?

In addition to the disclosures discussed above, there are likely incremental disclosures that should also be considered. These additional requirements may include, but are not limited to, those related to fair value measurements, derivatives, or disclosures required for the allowance for loan losses (for those loans within consolidated securitization structures measured on an amortized cost basis). Reporting entities will need to consider all the potential additional disclosures that may be required from the consolidation of the securitization structures where they are determined to be the primary beneficiary.

Illustrative disclosure²³—sale accounting securitizations with continuing involvement²⁴

The Bank securitizes a variety of loans, including residential mortgage, commercial real estate, credit card, and automobile loans through sponsored SPEs. In a securitization, the Bank transfers assets to an SPE, which then converts those assets into cash through the issuance of debt and equity instruments, certificates, commercial paper, and other notes of indebtedness. The Bank’s continuing involvement with securitizations for which sale accounting is achieved typically is in the form of servicing the loans held by the SPEs or through holding a residual interest in the SPE. These transactions are structured without recourse, so the Bank’s exposure is limited to standard representations and warranties as seller of the loans and responsibilities as servicer of the SPE’s assets.

²³ This disclosure example is for illustrative purposes only and does not necessarily detail all information that may be required depending on specific facts and circumstances.

²⁴ Some disclosure information has been provided on an aggregated basis rather than detailing out by product type, which may be more appropriate depending on the specific circumstances.



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The following table details the total principal outstanding as well as historical loss and delinquency amounts for the managed portfolio for 20X3 and 20X2 (\$in millions) [for simplicity, disclosures for 20X2 are not included below]:

	Total principal amount of loans	Delinquent principal over 60 days	Average balance (optional)	Credit losses (net of recoveries)
Type of loan	At December 31, 20X3		Year ended December 31, 20X3	
Auto	\$120	\$6.3	\$132	\$4.6
Residential mortgage	982	46.8	970	35.6
Commercial mortgage	744	38.1	720	26.2
Credit card balances	74	5.0	79	6.0
Total loans managed	\$1,920	\$96.2	\$1,901	\$72.4
Comprised of:				
Loans held in portfolio	\$452	\$22.6		
Loans held for sale or securitization	119	1.2		
Loans securitized	1,349	72.4		
Total loans managed	\$1,920	\$96.2		

The below table provides information about the Bank's maximum exposure to loss from continuing involvement with the sponsored SPEs.

Maximum exposure to loss in significant unconsolidated VIEs					
	Funded exposures			Unfunded exposures	
	Total involvement with SPE assets	Debt investments	Equity investments	Funding commitments	Guarantees and derivatives
Auto	\$96	\$-	\$18.6	\$-	\$-
Residential mortgage	741	30.0	18.8	-	-
Commercial mortgage	438	25.0	11.5	-	-
Credit card balances	74	-	14.2	-	-
Total	\$1,349	\$55.0	\$63.1	\$-	\$-

The Bank recorded net gains from securitizations of \$53 million, \$78 million, and \$67 million during 20X3, 20X2, and 20X1, respectively. Net gains reflect the (1) gain (loss) from new securitizations, (2) the reversal of the allowance for loan losses associated with receivables sold, and (3) the net gains on replenishing the SPE assets offset by any other-than-temporary impairments. The Bank continues to perform servicing for some of these securitizations and recognized servicing assets of \$12 million, \$49 million, and \$32 million in 20X3, 20X2, and 20X1, respectively.

The following table summarizes selected cash flow information related to securitizations for the years 20X3, 20X2, and 20X1:

(in millions)	20X3	20X2	20X1
Proceeds from new securitizations	\$118.4	\$326.8	\$23.2
Proceeds from collections reinvested in revolving receivables	\$90.1	\$165.8	\$124.5
Contractual servicing fees received	\$11.8	\$12.2	\$12.0
Cash flows received on retained interests and other net cash flows	\$6.2	\$16.3	\$14.2



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The Bank carries retained interests in the Bank's sponsored securitization SPEs as trading securities carried at fair value with changes in fair value recognized in earnings. The key economic assumptions used in measuring the fair value of the Bank's retained interests resulting from securitizations completed during 20X3 and 20X2 (weighted based on principal amounts securitized) were as follows [for simplicity, disclosures for 20X2 are not included below]:

	Auto loans	Credit card loans	Residential mortgage	Commercial mortgage
Prepayment speed (annual rate)	1.00%	15.00%	10.00%	8.00%
Weighted-average life (in years)	1.80	0.50	7.80	6.50
Expected credit losses	1.10%-2.40%	6.10%	1.25%	1.30%
Residual cash flow discount rates	13.3%	12.2%	11.6%	10.1%
Interest rates on adjustable loans and bonds	Forward Eurodollar yield curve plus contractual spread over LIBOR ranging from 30 to 80 basis points			

At December 31, 20X3, key economic assumptions and the sensitivity of the current fair value of residual cash flows to immediate 10 percent and 20 percent adverse changes in those assumptions are as follows (\$in millions):

	Auto loans	Credit card loans	Residential mortgage	Commercial mortgage
Balance sheet carrying value of retained interests-fair value	\$18.60	\$14.24	\$48.76	\$36.45
Weighted-average life (in years)	1.7	0.4	6.5	6.1
Prepayment speed assumption (annual rate)	1.3%	15.0%	11.5%	9.3%
Impact on fair value of 10% adverse change	\$0.3	\$0.6	\$6.3	\$4.6
Impact on fair value of 20% adverse change	\$0.7	\$1.2	\$12.8	\$9.0
Expected credit losses (annual rate)	3.0%	6.1%	0.9%	1.8%
Impact on fair value of 10% adverse change	\$2.2	\$3.3	\$1.1	\$1.2
Impact on fair value of 20% adverse change	\$4.4	\$6.5	\$2.2	\$3.0
Residual cash flows discount rate (annual)	14.0%	14.0%	12.0%	12.0%
Impact on fair value of 10% adverse change	\$1.0	\$0.1	\$1.6	\$1.2
Impact on fair value of 20% adverse change	\$1.8	\$0.1	\$2.9	\$2.5
Interest rates on variable and adjustable loans and bonds	Forward eurodollar yield curve plus contract spread			
Impact on fair value of 10% adverse change	\$0.8	\$1.2	\$1.4	\$2.5
Impact on fair value of 20% adverse change	\$1.5	\$2.4	\$2.7	\$4.8

These sensitivities are hypothetical and should be used with caution. As the figures indicate, changes in fair value based on a 10 percent variation in assumptions generally cannot be extrapolated because the relationship of the change in assumption to the change in fair value may not be linear. Also, in this table, the effect of a variation in a particular assumption on the fair value of the retained interest is calculated without changing any other assumption; in reality, changes in one factor may result in changes in another (e.g., increases in market interest rates may result in lower prepayments and increased credit losses), which might magnify or counteract the sensitivities.



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These sensitivities are hypothetical and should be used with caution. As the figures indicate, changes in fair value based on a 10 percent variation in assumptions generally cannot be extrapolated because the relationship of the change in assumption to the change in fair value may not be linear. Also, in this table, the effect of a variation in a particular assumption on the fair value of the retained interest is calculated without changing any other assumption; in reality, changes in one factor may result in changes in another (e.g., increases in market interest rates may result in lower prepayments and increased credit losses), which might magnify or counteract the sensitivities.

Illustrative disclosure²⁵—involvements with securitization SPEs

The Bank has various types of involvements with SPEs that hold financial assets and raise capital by issuing debt to third-party investors, which is supported by the cash flows of those financial assets. Several of these SPEs are considered VIEs under GAAP.

The Bank is required to consolidate any VIEs in which the Bank is deemed to be the primary beneficiary through having (1) power over the significant activities of the entity and (2) an obligation to absorb losses or the right to receive benefits from the VIE, which are potentially significant to the VIE.

The Bank is typically considered to have the power over the significant activities of those VIEs in which we act as the servicer or special servicer to the financial assets held in the VIE. The Bank's servicing fees are typically not considered variable interests in the securitization SPEs, however, when the Bank retains a residual interest in the SPE, either in the form of a debt note or equity interest, the Bank will often have an obligation to absorb losses or the right to receive benefits that would potentially be significant to the SPE. In those instances, the Bank would be identified as the primary beneficiary of the

securitization SPE and required to consolidate the SPE within the Bank's consolidation financial statements.

The Bank is not required, and does not currently intend, to provide any additional financial support to the sponsored securitization SPEs. Investors and creditors only have recourse to the assets held by the SPE.

The following table below summarizes the Bank's involvements with VIEs for the years ended December 31, 20X3 and 20X2 [for simplicity, disclosures for 20X2 are not included below]:

(\$in millions)	Consolidated		Unconsolidated		
	Carrying amount of assets	Carrying amount of liabilities	Principal amount of assets	Carrying amount of liabilities	Maximum exposure to loss
Variable interest entities—December 31, 20X3					
Automobile securitizations	\$88	\$80	\$-	\$-	\$-
Residential mortgage securitizations	645	607	328	328	6*
Commercial mortgage securitizations	432	396	212	212	4*
Credit card revolving securitizations	172	138	-	-	-
Total variable interest entities	\$1,337	\$1,221	\$540	\$540	\$10

²⁵This disclosure example is for illustrative purposes only and does not necessarily detail all information that may be required depending on specific facts and circumstances.



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Does IFRS have specific disclosure requirements?

Similar to GAAP, the disclosure requirements for securitization related transactions under IFRS hit across multiple standards and have undergone enhancement as a result of the financial downturn. Historically, IFRS 7 has included all the disclosure requirements for exposures to financial instruments. In 2010, the IASB issued amendments to IFRS 7 to increase the disclosure requirements for transactions involving transfers of financial assets. These amendments were intended to provide greater transparency around risk exposures of transactions where a financial asset is transferred but the transferor retains some level of continuing exposure in the asset. The amendments also require disclosure where transfers of financial assets are not evenly distributed throughout the period (e.g., where transfers occur near the end of a reporting period).

In 2011, the IASB issued IFRS 12, which requires extensive disclosures relating to an entity's interests in subsidiaries, joint arrangements, associates, and unconsolidated structured entities. An entity is required to disclose information that helps users of its financial statements evaluate the nature of and risks associated with its interests in other entities and the effects of those interests on its financial statements.

For consolidated subsidiaries, an entity that is a parent should disclose information regarding:

- The composition of the group
- Non-controlling interests (including summarized financial information about each subsidiary with material non-controlling interests)

- Significant restrictions on the parent's ability to access or use the assets and settle the liabilities of its subsidiaries
- The nature of, and changes in, the risks associated with interests in consolidated structured entities
- The effects of changes in its ownership interest that did or did not result in a loss of control during the reporting period

IFRS 12 requires extensive disclosures to help users understand the nature and extent of an entity's interests in unconsolidated structured entities and the risks associated with those interests. IFRS 12 defines a structured entity as "an entity that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity." Examples of structured entities include securitization vehicles, asset-backed financings, and certain investment funds. The required disclosures include (among others):

- The nature, purpose, size and activities of the structured entity
- How the structured entity is financed
- The carrying amounts of assets and liabilities relating to interests in unconsolidated structured entities and how they compare to the maximum exposure to loss from those interests
- Any support provided to an unconsolidated structured entity when there is no contractual obligation to do so (including the reasons for providing such support)



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How will taxes impact my transaction?



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Chapter 11: How will taxes impact my transaction?

Tax Rules versus GAAP

The current US income tax rules (Tax Rules)²⁶ for securitization transactions can be quite different from applicable US Generally Accepted Accounting Principles (GAAP). Understanding the tax implications of each class of ownership allows issuers and investors to properly assess the after-tax return, clearly vital to all involved. When considering taxes, it is essential to understand the *timing*, *character* and *source* of taxable income or loss that may result from the transaction.

- **Timing:** Determination of the proper tax reporting period requires application of the correct tax accounting methodology, such as cash vs. accrual method, or the application of mark-to-market principles
- **Character:** Categorization of income as ordinary vs. capital, determination of any special tax rates, limitations, or other rules that may apply
- **Source:** Jurisdictional and related issues, such as where income should be subject to tax, taxation of non-US investors, ability to utilize foreign tax credits, and state and local apportionment

²⁶ Unless otherwise noted all tax related references are to the income tax rules contained in the Internal Revenue Code of 1986, as amended, and regulations thereunder as of December 31, 2015.

²⁷ The status of certain enumerated foreign entities as corporations is provided in Treasury Regulation Section 301.7701-2(b)(8).

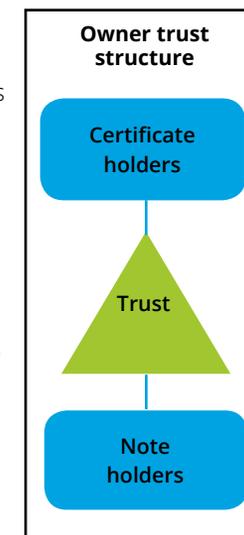
Of course, a key tax consideration for most issuers is whether their transaction is considered a sale or financing under the Tax Rules. The term “sale” includes a sale, exchange, or other transaction that results in a realization of gain or loss for US income tax purposes. It may also be possible to structure a transaction to meet the requirements for GAAP sale accounting while receiving financing treatment for tax—commonly referred to as a debt-for-tax structure. This can allow sponsors to optimize results by reporting a gain on sale in their financial statements without incurring a current tax liability.

Taxation of a securitization structure is determined by the entity type/jurisdiction chosen and accounting methods utilized.

What is the tax impact of choosing an entity type?

From a tax perspective, the type of entity used in a securitization transaction can be an important consideration. For an issuing entity that is not otherwise a corporation²⁷ and does not qualify as an investment trust, such as an owner trust, a limited liability company or partnership, the so-called check-the-box rules provide added flexibility in determining the tax treatment of the entity. Absent an election by the taxpayer to the contrary, these rules provide that a domestic entity is considered a partnership if it has two or more members, or is disregarded as an entity separate from its owner if it has a single owner.

A foreign entity is treated as a partnership if it has two or more members and at least one member does not have limited liability; an association (taxable as a corporation) if all members have limited liability; or a disregarded entity (DRE) if it has a single owner that does not have limited liability. The determination of whether an interest constitutes debt or equity for US income tax purposes is a key consideration in applying the check-the-box rules.



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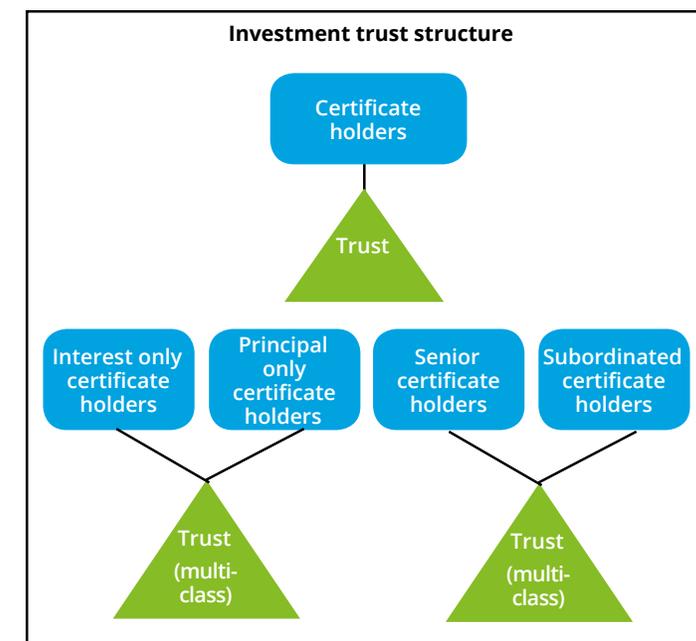
Select US Tax considerations for securitization transactions

Consideration	Investment trust	Other entities	Corporations	REMICs
Asset class limitations	No	No	No	Yes
Debt or equity analysis required	N/A	Yes	Yes	No
Time tranching allowed	N/A	Yes ^a	Yes ^a	Yes
Restricted ownership/transfer: ^b				
Debt	N/A	No	No	No
Equity	No	No	No	Yes
Gain or loss recognition:				
Transfer of assets to entity	No	No ^c	No ^c	No
Transfer of interests	Yes	Yes ^d	Yes ^d	Yes
Entity level taxation	No	No ^a	Yes ^c	No
Equity holder treatment:				
Owner of assets	Yes	No ^e	No	No
Issuer of debt	Yes	No ^e	No	No
Taxable income determination	Holder level	Entity level ^e	Entity level	Entity level
Floor on taxable income	N/A	N/A	N/A	Yes

^a Subject to the Taxable Mortgage Pool rules.
^b Tax withholding rules should be considered.
^c Special rules may apply.
^d In the case of an equity interest.
^e Except in the case of a disregarded entity.

Investment trust structures

The use of an investment trust (sometimes called a grantor trust) can accomplish several objectives—including no entity-level taxation and exemption from withholding tax. Under the Tax Rules, an investment trust is meant to include a trust that is not a business trust and has either a single class of ownership interests representing an undivided interest or multiple classes that are incidental to facilitating direct investment in the assets of such trust. Such classes could include creation of an interest-only class or a senior subordinate structure, where principal and interest generally are paid pro rata, but losses are allocated to just one of the classes.



Chapter 11: How will taxes impact my transaction?

In addition, there must be no power under the trust agreement to vary the investment of the certificate holders. An example of such a “power to vary” generally would include reinvestment of amounts collected on the trust assets (i.e., principal, interest, sales proceeds, etc.)—so a revolving structure would not qualify.

Other pass-through structures

If an entity does not qualify as an investment trust, pass-through treatment may still be achieved for tax purposes by utilizing a DRE for entities with only one equity owner or a partnership for entities with two or more equity owners. Owners of DREs are treated as if the entity did not exist—they are considered the tax owner of all of the assets and the tax issuer of any debt. When

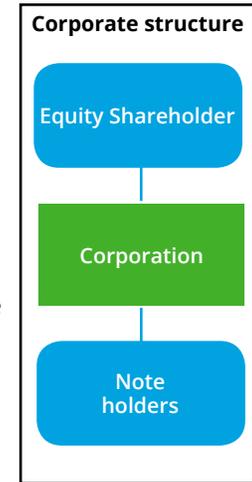
assets are first transferred to a special purpose entity—even if the transfer might otherwise qualify as a sale under the Tax Rules—the transfer may not result in a current federal income-tax liability and the assets may obtain carryover basis for tax purposes under rules applicable to an entity classified as a DRE or a partnership.

Owners of interests in a partnership are also taxed on their share of all items of income and deduction. However, determination of each partner’s share is based on a complex set of rules intended to recognize the economic arrangements between the parties. Accordingly, partnership structures may be useful when the parties have interests that are not strictly pro rata in nature. For example, the “carried interest” arrangements common in private equity partnerships are possible because of the partnership allocation rules.

Corporate structures

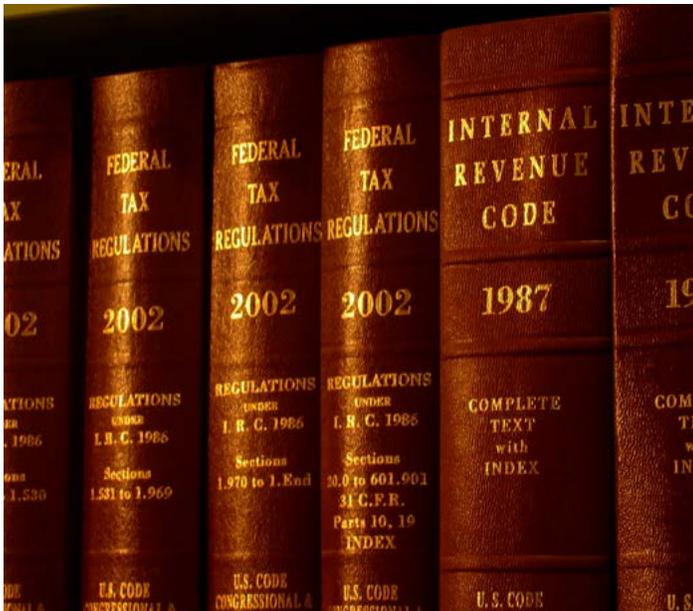
The imposition of entity-level tax on US corporations is one of several tax and non-tax considerations resulting in the infrequent use of these entities for securitization transactions. Foreign corporations (or similarly treated entities) that do not engage in a US trade or business are frequently the issuer in securitization transactions such as collateralized loan obligations (CLOs). These non-US entities are typically characterized as passive foreign investment companies (PFICs) for US tax purposes and all income typically is considered to be from passive activities (interest, dividends, etc.). Non-US entities may also be Controlled Foreign Corporations (CFCs). As a result, US investors that hold interests in a PFIC or CFC that are not

characterized as debt for US income-tax purposes generally are subject to special rules. In the case of a PFIC, an investor can choose to include currently their pro rata share of the PFIC’s net income (but not losses) in taxable income by making a qualified electing fund (QEF) election on IRS Form 8621. If the QEF election is not made, the investor may be subject to certain interest charges. A US investor that owns 10 percent or more of the total combined voting power of all classes of stock entitled to vote of an entity that is characterized as a CFC is required to currently include its pro rata share of the CFC’s net income (but not losses) in taxable income.



Real Estate Mortgage Investment Conduit structures

A specific set of statutory Tax Rules provide for a specialized vehicle that can be used as the issuing entity in the securitization of mortgage loans. This vehicle is called a real estate mortgage investment conduit (REMIC). While a number of requirements and special rules apply, the REMIC structure provides tax certainty regarding the treatment of debt and equity classes. A REMIC generally is not subject to an entity-level income tax because its income is taxable to the owners of the interests in the REMIC. However, REMICs are subject to a 100 percent tax on their net income from certain “prohibited transactions.” REMICs have significant flexibility in structuring cash flows, unhampered



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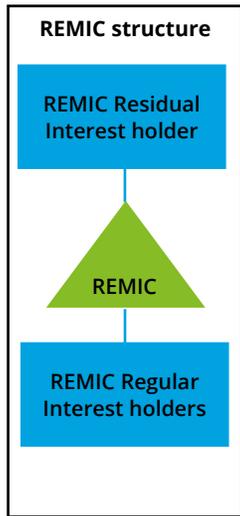
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by the need to consider if a class should be treated as debt or equity for tax purposes.

Debt issued by a REMIC, termed a “regular” interest for tax purposes, is subject to the Tax Rules applicable to all debt investments, discussed below. A REMIC is a pass-through entity for tax purposes, and therefore the holder of the tax equity interest, known as the “residual” interest and often designated as an “R” bond, is subject to tax on the net taxable income of the REMIC.

A REMIC generally is required to have a US person as the holder of its tax equity interest. While this interest represents the tax equity, the tax equity interest frequently does not have an economic interest in the cash flows. Accordingly, it is commonly referred to in the marketplace as a noneconomic residual interest, or “NERD.” Ownership of this class may result in negative tax consequences to the holder of this interest, including recognition of phantom income and application of the excess inclusion rules outlined below. These interests are often considered to have negative economic value equal to the net present value of the tax impact of ownership. Due to the negative tax consequences associated with ownership of the NERD, it is common for sponsors of REMICs to pay an inducement fee to the original purchaser of this interest.

In exchange for the greater flexibility and certainty, REMICs are subject to fairly stringent initial and ongoing qualification requirements. In addition, the REMIC sponsor is required to recognize gain or loss upon the sale, exchange, or other taxable disposition of the REMIC’s regular and residual interests. Lastly, the taxable income reportable by a REMIC residual interest holder may also be considered “excess inclusion” income. Excess inclusion income effectively cannot be offset by losses from other business operations, net operating losses, or even losses from other REMICs. Excess inclusion income is determined quarterly, and equals the excess of REMIC taxable income over an assumed investment return at 120 percent of the applicable federal rate. In the case of a NERD, the amount of excess inclusion income generally equals the taxable income of the REMIC.

Important rule. Absent a REMIC election, when time-tranching is desired (i.e., a multiclass issuance with different maturities) in a mortgage securitization, the issuing entity may be characterized as a taxable mortgage pool (TMP) and become subject to an entity-level tax and additional special rules. The Tax Rules treat a TMP as a separate corporation that is subject to entity-level taxation and not includible in a consolidated tax return. Although special exemptions apply for real estate investment trusts (REIT) and certain other entities, a TMP generally refers to any entity (other than a REMIC) that meets the following conditions:

01. Substantially all of its assets are debt obligations.
02. More than 50 percent of those debt obligations are real estate mortgages.
03. The entity is the obligor under debt obligations with two or more maturities.

04. Payments on the debt obligations under which the entity is obligor bear a relationship to payments on the debt obligations that the entity holds as assets.

How does the concept of ‘consolidation’ apply for tax purposes?

Similar to the accounting concept, consolidation may result in one or more legal entities or business operations joining together in the filing of a single report that consolidates their tax results and generally serves to eliminate the effect of intercompany transactions. Common examples include the

A REMIC is any entity that has:

01. A valid REMIC election,
02. Only regular interests or residual interests,
03. Only one class of residual interests (and all distributions, if any, with respect to such interests are pro rata),
04. As of the close of the third month beginning after its startup day and at all times thereafter, substantially all of its assets consist of qualified mortgages and permitted investments,
05. A calendar taxable year, and
06. Reasonable arrangements designed to ensure:
 - a. Its residual interests are not held by “disqualified organizations”, and
 - b. Information necessary for imposition of tax on any transfer to a disqualified organization will be made available



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filing of a consolidated federal income-tax return or state tax filings that are made on a unitary or “combined” basis. Tax consolidation is generally a form-driven question based on ownership, legal entity form, and any check-the-box elections made, and does not have the nuance of the GAAP rules. For example, foreign corporations are not consolidated for tax purposes, and may be classified as a DRE, a partnership, or a corporation.

The key takeaway here is that GAAP and the Tax Rules do not always apply the concept of consolidation in a similar fashion. Also important, the answer for federal income-tax purposes may not be the same for state tax purposes.

When is a securitization vehicle subject to entity-level taxation?

Because any imposition of tax on the issuer will reduce the amount of funds otherwise available to pay investors, thereby increasing the overall cost of borrowing for the transferor, a primary objective is the selection of a vehicle that will not be subject to an entity-level tax. In the absence of a REMIC election, the commonly preferred characterization would be either a partnership or a DRE, because neither is subject to a separate entity-level income tax. The check-the-box regulations contained in [Treas. Reg. §301.7701-3](#) have made structuring to achieve either characterization a reasonably simple process for transferors. For REMICs, the tax answer is simple, regardless of the entity’s legal form: a REMIC essentially is treated as a pass-through vehicle and is generally not subject to an entity-level income tax. Foreign corporations will not generally be subject to tax (other than certain withholding taxes) if they do not

engage in a US trade or business. In order to minimize the risk of US taxation, foreign entities often follow certain self-imposed trading and operational restrictions determined through consultation with their tax advisors.

When is a securitization treated as a sale for tax?

Generally, the income tax results of a transaction are decided based upon its substance, rather than its form, and, importantly, a “sale” is not always required for gain or loss recognition to occur. For example, certain assumptions of liabilities by the transferee made in connection with the transfer of assets may result in gain recognition.

Typically, the determination of whether a transaction is properly characterized as a sale for tax purposes, rather than a mere pledge of the assets as security for a financing, requires an analysis of the specific facts and circumstances of the transaction. The result will depend upon the answer to several questions, including:

- Who possesses the benefits and burdens of owning the transferred assets?
- Who exercises control over the assets?
- What is the form of the transaction?

The determination of whether a transaction is considered a sale or a financing for tax purposes is often directly linked to the tax characterization of the interest(s) that is/are being transferred. Consequently, the “debt or equity” question can be an important consideration for both securitizers and investors.

Sale or financing?

Benefits and burdens of ownership

- Who bears the risk of loss?
- Who has the opportunity for gain?
- Who possesses the power to dispose of the assets?
- Does the agreement provide for a fixed price?
- Are the payment terms of the receivables and the certificates significantly different?

Servicing arrangement

- Who controls servicing of the assets?
- Who is obligated to collect receivables?
- Who bears the cost of collection?
- Is the transferee held harmless for acts of collection agent?

Form of transaction

- Are borrowers notified of change in receivable ownership?
- Who is liable for property, excise, sales or similar taxes?
- Does the transferor have the right to inspect the books and records of transferee?
- Is the transferee a shell subsidiary?



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If the transaction is characterized as the transfer of an ownership or equity interest in the assets, for tax purposes, the securitizer typically recognizes gain or loss to the extent of such transfer. Alternatively, if the transaction is characterized as a borrowing for tax purposes, the securitizer typically recognizes no gain or loss for US income tax purposes. The investor is similarly interested in the characterization, because it can be an important consideration when determining their tax reporting and withholding tax requirements.

How is tax gain or loss determined?

Once a transaction has been determined to result in a tax sale, the amount of gain or loss recognized generally is determined by comparing the net value received to the allocated tax basis of the interests sold—but special rules can apply to limit or disallow the deductibility of losses where related parties participate. Tax basis typically differs from GAAP carrying value for various reasons that can stem from differences in accounting methodology. For example, the allowance for loan losses, while reducing carrying value, typically would not reduce tax basis. Differences can also result from the use of lower of cost or fair value accounting for GAAP and mark-to-market (applicable to dealers in securities, including loan originator/sellers and certain traders) or non-mark-to-market for tax. Another common example is the recognition of a servicing asset for GAAP that is not recorded as an asset for tax purposes.

Special rules for REMICs

Additional rules apply to the sponsor of a REMIC. A REMIC sponsor is defined as any person who directly or indirectly transfers qualified mortgages and related assets to a REMIC in exchange for its regular and residual interests. The Tax Rules provide that no gain or loss is recognized as a result of the initial transfer of assets to a REMIC, with the sponsor's tax basis in the assets transferred to the REMIC simply being allocated among the regular and residual interests issued by the REMIC in proportion to their fair market value. Gain or loss is recognized upon the subsequent sale of the REMIC interests (including the sale of the REMIC regular interests). The amount of such gain or loss would equal the difference between the sponsor's net proceeds (i.e., proceeds received less selling expenses) and the allocated tax basis of the REMIC interest sold.

Generally, gain or loss attributable to REMIC interests that are retained by the sponsor is deferred and recognized over time. The amount of such unrecognized gain or loss is equal to the difference between the fair market value of the retained REMIC interest at the start-up date of the REMIC and its allocated tax basis.

What determines whether an interest is debt or equity?

Once the securitization has been completed, the securitizer and investors must begin to report their ongoing taxable income from the related interests that they have either acquired or retained. The tax accounting will depend to some degree on whether the interest held constitutes debt or equity for tax purposes. The tax characterization of an interest ultimately depends upon the nature and degree of participation that the investor has in the activities/success of the issuing entity or the assets underlying the transaction. For example, interests issued by the securitization trust that represent a passive investment to its holder, based on a limited risk of loss, stable return, and a fixed maturity would be more consistent with debt issued in a lending arrangement than an equity interest.



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Debt or equity?

The factors determining whether a security will be considered debt or equity for US federal income tax purposes include:

01. Whether there is an unconditional promise on the part of the issuer to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future;
02. Whether holders possess the right to enforce the payment of principal and interest;
03. Whether the rights of the holders of the instrument are subordinate to rights of general creditors;
04. Whether the instruments give the holders the right to participate in the management of the issuer;
05. Whether the issuer is thinly capitalized;
06. Whether there is identity between holders of the instruments and stockholders of the issuer;
07. The label placed upon the instrument by the parties; and
08. Whether the instrument is intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial accounting purposes.

Alternatively, if the interest is more closely tied to the overall performance and success of the issuing entity (or underlying assets), it suggests that the interest is more akin to an equity investment.

Invariably, the tax characterization of the interest will fall somewhere along the continuum between pure debt and pure equity due to the blending of the risks, rewards, and related contingencies negotiated by the parties.

Subject to much debate over the years, the Tax Rules for analyzing whether an interest represents debt or equity are the product of a variety of income tax rulings and court decisions.

How is periodic income for debt instruments determined?

The Tax Rules provide special rules for interest, discount, and premium, and distinguish between debt instruments acquired at the issue date and those purchased in the secondary market. While discount or premium that results from an investor's purchase of a debt instrument in the secondary market (i.e., after the issue date) does not affect the issuer's taxable income calculation, it must be considered in determining the ongoing income of the investor. Typically investors must account for each of the following items separately, based upon the applicable Tax Rules. However, the Tax Rules provide an election that allows for all interest, discount, and premium of a debt instrument to be accounted for in aggregate.

Special rules for amortization of discount or premium are prescribed for debt instruments where principal can be accelerated due to prepayments on the underlying collateral (Prepayable debt instruments, or PDI securities) or for contingent payment debt instruments (CPDI securities). The mere possibility of impairment due to insolvency, default, or similar circumstances does not cause a debt instrument to provide for contingent payments. Common examples of PDI securities include: REMIC regular interests, other mortgage-backed securities and asset-backed securities, and mortgage and consumer loan pools. Examples of CPDI securities include: debt instruments that provide for a payment based upon the gross receipts of the issuer or that pay based upon the fluctuations in the price of a publicly traded stock. Because PDI securities are the more common type of debt instrument encountered in securitization transactions, discussion is limited to the Tax Rules that generally apply to them. Similarly, for ease of illustration, there will be no discussion of the effects of the mark-to-market method of tax accounting that generally can apply in the case of dealers in securities and electing traders in securities.

Interest

For tax purposes, interest falls into two general categories: qualified stated interest (QSI) and non-qualified stated interest (non-QSI). Generally, QSI includes all interest that is unconditionally payable at least annually, i.e., typical coupon interest from loans that may not be paid in kind. QSI is considered to be interest income for tax purposes. While normal



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tax accounting methods generally apply to its recognition, QSI earned with respect to a REMIC regular interest must be recognized using the accrual method, regardless of the general tax accounting method of the holder. All payments other than QSI and principal are non-QSI payments, and typically are accounted for as part of original issue discount (OID).

Original Issue Discount

Subject to certain *de minimis* rules, a debt instrument with an issue price that is less than its stated redemption price (SRP) at maturity is generally considered to have OID. The SRP of a debt instrument equals the sum of all payments expected to be made with respect to the debt instrument other than QSI (i.e., the sum of principal and non-QSI payments).

OID accrues and is recognized currently based upon the debt instrument's yield to maturity (the tax yield). There are two methods that can apply for purposes of determining the amount to be accrued. The standard method *IRC 1272(a)(3)* applies to debt instruments that are not CPDI and not otherwise subject to the prepayment adjustment catch-up (PAC) method *IRC 1272(a)(6)*. Note: The PAC methodology was used to amortize discount and premium in the simplified tax example below.

The methods differ both in their determination of tax yield and in the amount of OID that must be recognized each period. Under the PAC method, the determination of tax yield allows for the use of a prepayment assumption (the tax prepayment assumption) while the standard method does not. **Regardless of the method employed, the Tax Rules do not allow a loss**

assumption to be used when determining the tax yield. See further discussion of tax loss below.

In addition, the legislative history to the PAC method clarifies that a negative OID accrual is not permitted. Instead, the amount of OID is treated as zero for the period, and the computation of OID for the next period would be made as though that period and the preceding period were a single period (i.e., OID would not be accrued until the cumulative result produces a positive amount).

Premium

There are two types of premium under the Tax Rules: market premium and acquisition premium. Market premium occurs when a debt instrument is acquired at a price that is greater than its SRP. If the debt instrument was issued with OID, only the market premium is accounted for by the holder, because the holder is not required to account for the OID. While holders are not required to amortize market premium for taxable debt instruments, they may elect to amortize it based upon the debt instrument's yield to maturity (e.g., its tax yield). In the case of debt instruments that are subject to the PAC method, the legislative history suggests that holders may apply rules for amortizing premium similar to those provided for the accrual of market discount (discussed below).

Debt instruments subject to the PAC method

- Any regular interest in a REMIC or qualified mortgage held by a REMIC,
- Any other debt instrument if payments under such debt instrument may be accelerated by reason of prepayments of other obligations securing such debt instrument (or, to the extent provided in regulations, by reason of other events), or
- Any pool of debt instruments the yield on which may be affected by reason of prepayments (or to the extent provided in regulations, by reason of other events).

Note: The above referenced regulations have not yet been issued.

Acquisition premium occurs when a debt instrument is purchased at a premium to its adjusted issue price (AIP), but at a price that is less than its SRP. The AIP is the issue price of the debt instrument increased for previous accruals of OID and decreased for payments of principal and non-QSI. In this case, the holder must continue to account for OID from the debt instrument. The amortization of acquisition premium is mandatory, and the amount amortized each period equals the product of the OID accrual for the period and the fixed ratio of acquisition premium to the OID remaining at the holder's date of acquisition.



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Market discount

A debt instrument has market discount when it is acquired subsequent to its date of issuance for a price that is less than its SRP (or, in the case of a debt instrument issued with OID, for a price less than its AIP). Market discount is very important to many investors, as these rules serve to recharacterize all or part of the holders' gain to ordinary income that is not eligible for the beneficial capital gains rates. In short, the Tax Rules require that any gain upon sale is ordinary income to the extent of market discount accrued prior to the sale date. Additionally, any payments on the instrument are recognized as ordinary income to the extent of market discount accrued prior to the payment date. Alternatively, holders may elect to recognize market discount as it accrues, which may be beneficial to holders seeking to increase taxable income or decrease differences between GAAP and tax.

The default calculation of market discount is ratable amortization over the period between the purchase date and maturity date, based upon the number of days held during the period. Alternatively, the holder can elect to accrue market discount based upon a constant interest rate determined in a manner similar to the standard method used for calculating the tax yield. It should be noted that the constant yield method would generally result in a more beneficial calculation for taxpayers seeking to limit market discount amortization.

For debt instruments that provide for two or more principal payments, a special rule applies that requires market discount to be accrued based upon a method provided in regulations. Although these regulations have not yet been issued at publication date of this book, the legislative history for the rule provides that a holder may not use the ratable method for these instruments. The history provides that a holder may accrue market discount based upon either a constant interest method or an applicable ratio method, the market discount accrual ratio (MDAR). The MDAR that applies will vary depending upon whether the debt instrument was issued with OID. The stated interest ratio method applies to debt instruments issued without OID, and the OID ratio method applies to debt instruments issued with OID.

The amount of a holder's deductible net direct interest expense may be limited where market discount has accrued, but has not been recognized.



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Tax accounting methods

Constant interest methods

- IRC 1272(a)(3)—The standard method $[a \times b - c]$
The amount of OID accrued generally equals the product of (a) the debt instrument's AIP at the beginning of the period, and (b) the tax yield of the debt instrument, less (c) the amount of QSI for the period.
- IRC 1272(a)(6)—The PAC method $[a + b - c]$
The amount of OID accrued generally equals the sum of (a) the present value of cash flows remaining at the end of the period (based upon the tax prepayment assumption) and (b) any principal and non-QSI payments during the period less (c) the debt instrument's AIP at the beginning of the period.

The Market Discount Accrual Ratio method $[a \times b]$

The amount of market discount accrual equals the product of (a) the MDAR for the period and (b) the amount of market discount remaining (i.e., not previously accrued) at the beginning of the accrual period. Use tax prepayment assumption for instruments that would have been subject to the PAC method if issued with OID. The MDAR that applies will vary depending upon whether the debt instrument was issued with OID. The stated interest ratio method applies to debt instruments issued without OID, and the OID ratio method applies to debt instruments issued with OID.

Market Discount Accrual Ratios $[a/b]$

- Stated interest ratio equals (a) the Interest (other than OID) for the accrual period divided by (b) the sum of such Interest and the interest (other than OID) remaining at the end of the period, using the tax prepayment assumption for instruments that would have been subject to the PAC method if issued with OID.
- OID Ratio equals (a) the OID for the accrual period divided by (b) the total OID remaining at the beginning of the period using the tax prepayment assumption for instruments that would have been subject to the PAC method if issued with OID.

Acquisition Premium $[a \times b]$

The amount of amortization equals the product of (a) the OID accrual for the period and (b) the fixed ratio of Acquisition Premium to the OID remaining at the holder's date of acquisition.



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An investor example:

Assume Much Pursued Investment Fund (MPIF) purchased \$100,000 par of REMIC regular interest Class O for a price of 65 on the first day of the January accrual period. The Class O has OID and no QSI, and has made no principal or interest payments since Investor's purchase. At the end of the quarter, MPIF contacted the REMIC and obtained a statement containing the following information for the calendar quarter:

Period	QSI	OID	Beginning AIP	MDAR
Jan-16	0	2,000	80,000	0.10000
Feb-16	0	5,000	82,000	0.27778
Mar-16	0	3,200	87,000	0.24615

Based upon this information, MPIF determined that its taxable income for the calendar quarter was as follows:

Period	Mkt Disc	MDAR	MD Accrued
Jan-16	15,000	0.10000	1,500
Feb-16	13,500	0.27778	3,750
Mar-16	9,750	0.24615	2,400

However, because no principal payments have been made during the accrual periods, if MPIF has not otherwise elected to currently recognize market discount, the total amount of income to be reported by MPIF for the first calendar quarter would be \$10,200 – the amount of OID.

Note: The issuer provided information shown is based upon Investor's specific facts for ease of illustration only; actual information provided by the Issuer is typically on a "per unit of original face amount" or similar basis.

How are mortgage servicing rights (MSRs) treated for tax purposes?

Mortgage servicing rights (MSRs) are assets that can represent two different types of instruments for tax purposes. "Normal" servicing is the right to reasonable compensation for the services to be performed. "Excess" servicing is the right to receive any amounts greater than the normal amount. There is no specific guidance available with respect to the numeric amounts that should be considered normal vs. excess, though an election is available under which a safe harbor may be utilized for one- to four-unit residential loans.

Amounts paid by a servicer for normal servicing are amortized for tax purposes over either nine or 15 years, depending on the circumstance. Amounts paid for excess servicing are treated as paid for an interest-only (IO) strip off of the mortgage itself. Accordingly, income from excess MSRs must be recognized as OID income related to an IO strip, and requires calculations on the PAC method. Additionally, because excess MSRs are considered to be IO interests in the mortgages, they are qualified assets for REITs.

What is the tax accounting that applies to interests that are classified as equity for tax purposes?

For owners of investment trusts and similarly DREs, the determination of taxable income or loss is made at the investor level. For other entities, the determination of taxable income or loss is made at the entity level. In each case, the rules described above for determining the ongoing income (and expense) from debt instruments continue to apply.

Why is taxable income to the interest holders sometimes more than the cash they received?

Taxable income greater than cash distributions to equity holders is sometimes referred to as "phantom" income. Phantom income can result from differences that exist between the weighted average yield on the debt instruments held by the issuing entity and the weighted average yield on the debt instruments issued by the entity. For example, in a traditional sequential pay structure, if the yield curve is upward sloping on the date of the securitization, the issued debt will have different yields. Specifically, the shorter-term issued debt will have lower yields than the longer-term issued debt. In contrast, the yield on the assets held by the issuing entity will be a fixed, medium-term yield. The weighted average yield (and, therefore, interest/OID expense) on the issued debt will increase over time as the lower yielding classes are retired. This effect creates net taxable income in early periods (phantom income) and net deductions in later periods (phantom deductions).

Phantom income can also result from structural features that result in the utilization of cash for purposes other than distribution to the equity holders. For example, in CLO structures, it is common for cash from sales of assets to be reinvested in additional assets during the reinvestment period. Any net gain, market discount, or OID associated with these positions therefore results in phantom income to the equity investors during this period.



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Finally, phantom income can result from straightforward differences between tax accounting methods and cash distributions. For example, accruals of OID will result in taxable income without receipt of corresponding cash amounts. Additionally, taxable items must be reported on an accrual method, while securitization entities make distributions only on specific payment dates.

Example: CLO equity

Investor owns 40 percent of the preference shares of RCLO, Ltd. (RCLO), a Cayman CLO that is in its reinvestment period. Investor has been informed that RCLO is not a controlled foreign corporation. Investor receives a PFIC Annual Information Statement informing him that the earnings and profits (E&P) of RCLO are \$4,125,000. Investor received cash distributions of only \$1,000,000 from RCLO during the taxable year. Upon inquiry, Investor learns from the collateral manager and RCLO's tax advisor that the E&P of RCLO is calculated as follows:

Interest income	\$12,500,000
OID	250,000
Market discount	587,500
Gains on sale of loans	787,500
Interest expense	(8,750,000)
Mgmt/admin expenses	<u>(1,250,000)</u>
E&P	<u>\$4,125,000</u>

If Investor makes or has made a QEF election with respect to RCLO, they will report \$1,650,000 of taxable income (40 percent of \$4,125,000) with respect to their ownership in RCLO. Its tax basis in RCLO will be increased by this amount, and decreased by the cash distributions that it received during the taxable year.

When are losses taken into account for tax purposes?

Generally speaking, the effect of less-than-desirable credit performance may only be taken into account for tax purposes once it can be demonstrated that an actual credit event has occurred. Moreover, the Tax Rules do not permit the use of a loss assumption when projecting the cash flows to be used in determining the tax yield of a debt instrument. Consequently, while a reserve established based upon the general expectation that credit losses will occur in future is not deductible for tax purposes, the specific write-off of a debt instrument due to a credit loss may result in a properly deductible tax expense (see below).

Non-accrual of interest

The Tax Rules require that interest income continues to be accrued to the point it is no longer collectible. In those circumstances where interest has been properly accrued and is subsequently determined to be uncollectible, the holder may not reverse the accrual, but may record a bad debt expense or loss deduction (see below). If, however, it can be demonstrated that the interest income is "uncollectible" at the date it otherwise would be accrued, then the accrual of interest is not required. For this purpose, interest would be considered "uncollectible" where, based upon the surrounding facts and circumstances, no reasonable expectation exists at the time of accrual that the interest will be collected.

Bad debt expense

Typically, a holder is entitled to a deduction for bad debt expense when there is clear evidence that a debt instrument it owns has become wholly or partially worthless. In the case of a deduction for partial worthlessness, the holder must be able to demonstrate that the debt instrument was "charged-off" on the holder's books and records during the same tax year as the deduction is taken. Special rules can apply to require the recognition of gain or loss upon foreclosure of a loan to the extent that the fair market value of property acquired in foreclosure differs from the holder's tax basis in the loan. In addition, a modification to the terms of a debt instrument that is considered to be "significant" under the Tax Rules can result in the recognition of taxable gain or loss.

The ability to deduct bad debt expense does not apply to certain debt instruments considered a "security" for this purpose, such as debt issued by a corporation in registered form. Also, noncorporate holders are entitled to a deduction only if the debt instrument was created or acquired in connection with the holder's trade or business. The inability to meet this requirement would cause such a loss to be available only at the time of complete worthlessness, and to be characterized as a short-term capital loss.



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Worthless securities

In the case of a security that is a capital asset in the hands of the investor and becomes worthless during the taxable year (i.e., if the investor does not otherwise qualify for a bad debt expense), the loss is treated as resulting from the sale or exchange of a capital asset on the last day of the same taxable year. The term “security” includes a share of stock in a corporation; a right to subscribe for, or to receive, a share of stock in a corporation; or a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form.



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The changed regulatory capital landscape

The last several years have yielded a new banking regulatory landscape as supervisory agencies globally have focused on strengthening the financial system. Large financial institutions (especially those deemed “too big to fail”) have seen significant changes in regulatory requirements due to an increased focus on the systemic risk posed by globally interconnected firms. Banks both in the United States and abroad have been focused on implementing and fine-tuning regulatory compliance solutions to meet the new wave of regulations, which continues to evolve.

US regulators passed new risk-based capital regulations (commonly referred to as **Basel III**), introduced new methodologies for charging deposit insurance premiums,

overhauled derivatives regulation, curtailed banking activities considered proprietary trading, and created new rules intended to limit banks' relationships with hedge funds and private equity funds. Rules have also been finalized requiring securitizers to retain “skin in the game” by retaining a portion of their securitizations.

All these regulations, directly and indirectly, affect the securitization market, changing the responsibilities of securitizers and impacting investors' yield demands. In trying to determine whether a securitization is economical for a bank, it is necessary to review US Basel III capital and related regulations and their impact on a bank's appetite for issuing or investing in structured finance securities.

Basel III restructured the current regulatory capital rules (Basel I and Basel II) into a harmonized, comprehensive framework that is applicable to all banks:²⁸

- Replacing the Basel I risk-weighting standards with the new Standardized Approach.²⁹
- Updating the Basel II risk-weighting standards with the new Advanced Approaches.³⁰

- Introducing a new methodology to calculate the amount of regulatory capital (i.e., the numerator in the capital ratio), and the applicable minimum capital thresholds and buffers common to both Basel III Standardized and Advanced Approaches.
- Revising the market risk rule.³¹
- Adding new leverage and liquidity requirements.

Basel III had a very aggressive implementation timeline. Banks that must comply with the Advanced Approaches—so-called Advanced Approach banks—must do so beginning in January 2014; all other banks must comply with the Standardized Approach beginning in January 2015. However, in both cases, the transition period from Basel II to Basel III extends through the end of 2018.

Before proceeding further, some explanations are in order to provide context on the basic construct of the Basel regulations, which is as follows:

$$\frac{\text{Regulatory capital}}{\text{Risk weighted assets}} \geq \text{Minimum capital ratios}$$

²⁸ Bank generally includes depository institutions (DI), bank holding companies (BHC), savings and loan holding companies (SLHC) (except those that are substantially engaged in insurance or commercial activities), and also non-bank financial companies (covered non-bank) designated by the Financial Stability Oversight Council (FSOC).

²⁹ Basel III Standardized Approach banks include all banks, except BHC < \$500 million, that are not Advanced Approach banks.

³⁰ Basel III Advanced Approach banks are BHC or SLHC, and their consolidated DIs, with >\$250 billion in total assets or \$10 billion in foreign exposure (excluding insurance subsidiaries), covered non-banks, and opt-in banks.

³¹ Basel III Market Risk banks include those with significant trading activity (i.e. trading portfolio > \$1 billion, or 10 percent of total assets).



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Regulatory capital

- Basel III strengthens the quality and quantity of regulatory capital by introducing the Common Equity Tier 1 (CET1) category, making the eligibility criteria stricter for Tier 1 and Tier 2 capital, and eliminating a Tier 3 category.

Risk-weighted assets (RWA)

- Under Basel I and under the Basel III Standardized Approach, RWA for credit risk is generally derived by applying fixed risk-weight (RW) factors, based on borrower/exposure characteristics; also fixed credit conversion factors (CCF) are applied to off-balance sheet exposures to obtain the exposure amount.
- Under Basel II and the Basel III Advanced Approaches, banks use internal models to calculate RWA for credit risk for the majority of wholesale and retail exposures, while requiring fixed RW factors for other types of exposures (e.g., equity and unsettled trades). Banks also use internal estimates for CCF factors for most types of off-balance-sheet exposures.
- Additionally, Market Risk banks have to calculate RWA for market risk for their eligible trading book assets, and Advanced Approach banks have to calculate RWA for operational risk.

Minimum required capital ratios³²

- Under Basel I and Basel II, regulatory capital ratios were 4 percent for Tier 1 capital and 8 percent for total capital. Basel III introduces the new CET1 threshold of 4.5 percent, increases the current Tier 1 threshold to 6 percent, and keeps the total capital ratio at 8 percent.
- Under Basel III, as per Section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (commonly known as the Collins Amendment) the Standardized Approach acts as a capital floor for the Advanced Approaches, which means that Advanced Approach banks need to calculate capital under both the Standardized and Advanced Approaches.
- Basel III additionally defines various capital buffers (e.g. conservation buffer, countercyclical buffer, etc.) over and above the minimum ratios and increases the capital ratios required as per prompt corrective action regulations.
- Systemically Important Financial Institutions (SIFIs) have to maintain additional capital buffers. In addition, US regulators have proposed new rules that will require large banks to maintain sufficient long-term debt and capital to meet a new “total loss-absorbing capacity,” or TLAC, requirement.

The following is a summary of the evolution of regulatory capital treatment for securitization across the Basel I, II, and III standards. The Basel III framework and definitions are covered in more detail later in the chapter.

Basel I. When Basel I was implemented in 1988, it did not have any securitization specific provisions, but as the market grew, US regulators incorporated securitization specific [rules](#)³³ in 2001.

- For issuers, securitized assets were generally treated as off-balance sheet, and attracted no minimum capital requirements.
- For the credit risk calculation in the banking book, securitization exposures retained or invested in, attracted 20 percent to 200 percent RWs based on external ratings (or internal ratings under certain conditions) or a Gross-up Approach.
- Basel I also included a low-level exposure rule, which limited capital requirements to the maximum contractual exposure. Exposures subject to the low-level recourse rule, and residual interests ineligible for the Ratings Based Approach (RBA), attracted approximately 1250 percent RW.
- Credit-enhancing interest-only strips (CEIO) in excess of 25 percent of Tier 1 capital were deducted from Tier 1 capital.
- For the market risk calculation of positions in the trading book, if applicable, securitizations were generally treated like debt instruments.

³² Regulatory capital ratios are defined as a percentage of RWA. Given minimum capital requirement of 8 percent of RWA, 100 percent RWA is equivalent to 8 percent capital (i.e., 1250 percent RWA is broadly equivalent to capital deduction or 100 percent capital).

³³ Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Capital Treatment of Recourse, Direct Credit Substitutes and Residual Interests in Asset Securitizations; Final Rules, Nov 29, 2001.



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Basel II. Basel II came into effect in 2007 in the US, and aimed for greater risk sensitivity and alignment of capital requirements with the underlying risk of an exposure.

- It introduced a broader definition of securitization exposures and a new hierarchy of approaches comprising: RBA, internal assessment approach (IAA), supervisory formula approach (SFA), and deduction.
- Certain positions (e.g., CEIO strips, residual interests, etc.) continued to be deducted from capital. These changes resulted in risk-weight estimates ranging from 7 percent to 1250 percent.
- Also, certain changes to US Generally Accepted Accounting Principles (GAAP), in particular, Statement of Financial Accounting Standards (FAS) 166 and FAS 167, disallowed off-balance sheet treatment for certain securitized assets.
- These changes all focused on the banking book; the market risk rules did not change.

Basel III. As it relates to securitization, Basel III introduces a number of key changes. These include:

- Retaining the Basel II definition of securitization, with certain incremental changes.
- Revising the hierarchy of approaches by removing references to external ratings (i.e., the RBA and the IAA), retaining SFA for Advanced Approach banks, and introduces a new methodology called simplified SFA (SSFA). It also raises the Basel II risk-weighting floor from 7 percent to 20 percent for the most senior securitization positions; increases the risk-based capital requirements for most other classes in a securitization; and introduces rigorous due diligence requirements for all securitization exposures.
- Changing the exposure calculation methodology.
- Prescribing more punitive treatment for re-securitizations.
- Changing the market risk rules to extend the banking book credit risk treatment (i.e., SSFA and SFA) for calculation of the specific risk component for securitization positions.
- Defining treatment of securitization exposures for leverage and liquidity ratios.

Basel III impacts securitization transactions in multiple ways

Overall, Basel III increases the regulatory capital for most securitization exposures, and introduces new due-diligence requirements a bank must perform if it wishes to invest in securitizations.

Definition of securitization exposures

The broad regulatory definition of traditional securitizations,³⁴ introduced in Basel II and retained in Basel III with some modifications, is based on a set of criteria, including:

01. All or a portion of the credit risk of one or more underlying exposures is transferred to one or more third parties other than through the use of credit derivatives or guarantees.
02. The credit risk associated with the underlying exposures has been separated into at least two tranches reflecting different levels of seniority.
03. Performance of the securitization exposures depends upon the performance of the underlying exposures.
04. All or substantially all of the underlying exposures are financial exposures.
05. The underlying exposures are not owned by an operating company.
06. Regulators may determine that a transaction in which the underlying exposures are owned by an investment firm that exercises substantially unfettered control over the size and composition of its assets, liabilities, and off-balance sheet exposures is not a traditional securitization based on the transaction's leverage, risk profile, or economic substance.

³⁴Synthetic securitizations definition is largely similar, except that tranching of credit risk occurs through the use of credit derivatives and/or guarantees instead of through the sale of assets. It also has specific operational criteria.



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This broad regulatory definition also excludes structures where the underlying assets are held by a small business investment company, a firm investment which qualifies as a community development investment, an investment fund, a collective investment fund, an employee benefit fund, a company registered with the Securities and Exchange Commission under the Investment Company Act of 1940, or foreign equivalents thereof.

The boundary between what is and what is not a securitization exposure for regulatory capital purposes can be challenging to determine in some circumstances (a determination that must

be done based on economic substance, rather than strict legal form). Similarly, supervisors retain the power to expand the scope of the securitization definition to include any transaction if it is supported by the economics of the transaction.

This determination is further complicated by the fact that the broad regulatory definition may deviate from generally employed industry conventions. The primary regulatory determinant of securitization exposures is tranching of credit risk exposure arising out of a pool of underlying assets (i.e., non pro rata or non pass-through). For example, the regulatory definition excludes certain securitization-type structures involving non-financial assets (e.g., physical real estate or commodities) or recourse (e.g., covered bonds). It also includes exposures to non-operating companies (e.g., hedge funds) that are commonly not viewed in the industry as securitizations. Exposures to non-operating companies has been a source of major industry feedback, and regulators have issued additional [guidance](#)³⁵ that

Adding to the misalignment, securitization exposures may be reported under loans (e.g., loans to special purpose entities [SPEs] and servicer cash advances), debt securities (e.g., tranches of asset-backed securities, residential mortgage-backed securities, and commercial mortgage-backed securities), equity (e.g., investments in hedge funds), other assets (e.g., CEIOs, and accrued interest and fees), trading assets (e.g., derivatives with SPEs), and off-balance sheet items (e.g., synthetic securitizations and liquidity facilities).

provides clarity on how regulatory approval may be granted to exposures to investment firms that exercises substantially unfettered control over the size and composition of its assets, liabilities, and off-balance sheet exposures.

Operational criteria for originated securitizations

In addition to the securitization definition requirements, Basel III continues to require originating banks to satisfy the following four additional operational criteria to apply securitization treatment:

01. The exposures are not reported on the bank's consolidated balance sheet under GAAP.
02. The bank has transferred to one or more third parties credit risk associated with the underlying exposures.
03. Any clean-up calls relating to the securitization are eligible clean-up calls defined under Basel III.
04. The securitization does not (a) include one or more underlying exposures in which the borrower is permitted to vary the drawn amount within an agreed limit under a line of credit, and (b) contain an early amortization provision.

Failure to meet these four operational criteria will require a bank to hold regulatory capital on all the underlying assets of the originated transaction as if they had not been securitized.³⁶



³⁵ Federal Reserve Basel Coordination Committee (BCC) Bulletin 13-2: Excluding Exposures to Investment Firms from the Definition of "Traditional Securitization."

³⁶ The criteria shown are for traditional securitizations, this differs for synthetic transactions.



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Criterion 4 is new under Basel III and is applicable to many securitizations of revolving credit facilities (e.g., credit card receivables) containing provisions that require the securitization be wound down and investors repaid if the excess spread falls below a certain threshold. An early amortization event can increase a bank's capital needs if new draws on the revolving credit facilities need to be financed by the bank using on-balance sheet sources of funding.

Thus, given the consolidation rules under Accounting Standards Codification (ASC) 810, the operational criteria, and other factors like implicit support, many securitization structures are being consolidated. The fact that a bank may have to hold more capital for a securitization than for the underlying loan pool means consolidation may lead to a more capital efficient outcome in some cases.

All of the above complexities, along with misalignments between industry terminology and regulatory definitions of securitizations, make proper asset classification quite challenging in the regulatory capital calculation process.

Hierarchy of methodologies for securitization risk-based capital

Securitization exposures are subject to a hierarchy of approaches for determining regulatory capital. As noted, the hierarchy of approaches has changed under Basel III, including the elimination of the RBA available under Basel I and Basel II, as required by [Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act](#), and the introduction of SSFA. Under the Advanced Approaches, Basel III also retains the SFA that was available under Basel II, and for the Standardized Approach (for non-Market Risk banks), retains the Gross-up Approach defined under Basel I.

SFA

Basel III retains the SFA available under Basel II with certain modifications. It is only available to Advanced Approach banks and must be applied unless data is not available, in which case SSFA may be applied. However, supervisors expect banks to use the SFA rather than the SSFA in all instances where data to calculate the SFA is available.

SFA capital is based on the capital estimate of the underlying pool of assets as if held directly on the balance sheet, adjusted for the degree of subordination (i.e., loss absorbance by junior tranches) of a given tranche.

The SFA requires the calculation of seven pool- and tranche-level parameters:

Tranche-level parameters	
L	Credit enhancement level of the securitization exposure within the tranche structure
T	Thickness of the securitization exposure within the tranche structure
TP	Tranche percentage of the securitization exposure the bank owns
Pool-level parameters	
UE	Amount of the underlying exposures within the pool
Kirb	Capital requirement of the underlying pool based on the Advanced Approaches • This requires transaction data of the underlying pool of loans, and also development of risk models to generate the risk parameters, i.e., probability of default and loss given default.
EWALGD	Exposure weighted average loss given default of the underlying pool
N	Effective number of exposures in the underlying pool

Based on the above inputs, SFA uses a supervisory prescribed formula to calculate the capital requirement. It results in 1250 percent RW for portions of the tranche with subordination level below the Kirb threshold (similar to the Low Level Exposure Rule under Basel I), and applies progressively lesser capital to more senior tranches above the Kirb threshold, subject to a 20 percent RW floor. The SFA formula is unchanged from Basel II, except to reflect that Basel II required deduction for exposures below the Kirb threshold, and the RW floor was 7 percent.



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Interestingly, SFA, as it requires the Kirb calculation of the underlying pool of assets, is not eligible for transactions with any non-internal-ratings-based underlying assets (i.e., not a wholesale, retail, equity, or securitization exposure as defined under Basel III). While under Basel II such transactions required deduction, they will now be eligible for SSFA instead.

The implementation of SFA includes several hurdles associated with obtaining the transaction data for underlying pools, and developing risk models. Supervisors have issued [guidance](#)³⁷ to provide flexibility in the Kirb calculation to circumvent data and modeling challenges.

SSFA

The SSFA is newly introduced in Basel III, and is available under both the Standardized and Advanced Approaches. Under Advanced Approaches, SSFA is allowed only if SFA is not possible, while under Standardized Approaches, SSFA is the primary option, especially for Market Risk banks. Additionally, as per the Collins Amendment, Advanced Approach banks, if applying SFA for any transaction, will still need to calculate capital based on SSFA for that transaction for Standardized Approach capital floor calculation.

As the name indicates, SSFA uses a similar approach to SFA, and is also based on the capital estimate of the underlying pool of assets as if held directly on the balance sheet, adjusted for the degree of subordination (i.e., loss absorbance by junior tranches) of a given tranche. It requires five pool- and tranche-level parameters:

Tranche-level parameters	
A	Attachment point of securitization exposure within the tranche structure
D	Detachment point of securitization exposure within the tranche structure
Pool-level parameters	
K_G	Weighted average total capital requirement of the underlying pool based on the Standardized Approach
W	Ratio of delinquent exposures in the underlying pool
P	Supervisory calibration parameter (0.5 for securitizations and 1.5 for re-securitizations)

Similar to SFA, SSFA also results in 1250 percent RW for portions of the tranche with a subordination level below the K_G threshold, and applies progressively lesser capital to more senior tranches above the K_G threshold, subject to the RW floor of 20 percent.

Gross-up approach:

Non-Market Risk Standardized Approach banks also have the option of using the Gross-up Approach, instead of the SSFA, as long as it is applied across all securitization exposures. The Gross-up Approach, similar to Basel I, is also based on the subordination of the tranche and the RW applicable to the underlying pool of assets. It requires four inputs:

- Exposure amount.
- Pro rata share (similar to tranche percentage in SFA).
- Enhanced Amount: par value of all other senior tranches.
- Average RW of the underlying pool of assets, as per the Basel III Standardized Approach (similar to K_G).

The final RWA is calculated by applying the average RW to the sum of the exposure amount plus pro rata share times the enhanced amount, subject to a RW floor of 20 percent.

1250 percent RW: Securitization exposures to which none of these approaches can be applied must be assigned a 1250 percent RW (i.e., 100 percent capital charge).



³⁷ Federal Reserve BCC Bulletin 13-7: Implementing the Supervisory Formula Approach for Securitization Exposures & Federal Reserve BCC Bulletin 15-1: Supervisory Guidance for Implementation of the Simplified Supervisory Formula Approach for Securitization Exposures under the Advanced Approaches Risk-Based Capital Rule.



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Exceptions and alternatives for specific exposure types:

Gain-on-sale. This refers to an increase in equity capital resulting from a traditional securitization, other than an increase in equity capital resulting from the bank's receipt of cash in connection with the securitization or reporting of a mortgage servicing asset (MSA).

While Basel III retains the Basel I and Basel II approach of deduction for any after tax gain-on-sales, the deduction is applied to CET1 instead of Tier 1, and also amends the definition to exclude MSA.

CEIO. This is an on-balance sheet asset that in form or in substance: (1) represents a contractual right to receive some or all of the interest and no more than a minimal amount of principal due on the underlying exposures of a securitization, and (2) exposes the holder of the CEIO to credit risk directly or indirectly associated with the underlying exposures that exceeds a pro rata share of the holder's claim on the underlying exposures, whether through subordination provisions or other credit-enhancement techniques.

Under Basel III, any portion of a CEIO that does not constitute a gain-on-sale attracts a 1250 percent RW. Basel II required 50 percent Tier 1 and 50 percent Tier 2 deduction for CEIOs, whereas under Basel I only amounts in excess of 25 percent of Tier 1 are deducted from Tier 1.

Senior purchased credit derivatives and non-credit derivatives with securitization SPE counterparties. Counterparty credit risk for such exposures is calculated using the securitization framework, as per the applicable hierarchy. However, an alternative option of 100 percent RW is also available. The 50 percent RW cap for derivatives under Basel I is no longer available.

Transactions failing due diligence requirements. Basel III imposes a new requirement around due diligence for all securitization transactions, which banks need to satisfy prior to acquiring and on an on-going basis (no less frequently than quarterly). It requires a bank to demonstrate a comprehensive understanding of the features of the securitization that would materially affect the performance of the exposure (e.g., triggers, enhancements, and pool performance). The analysis is required to be commensurate with the complexity of the exposure and the materiality of the exposure in relation to capital.

Failure to comply with initial and on-going due diligence requirements for any securitization exposures requires a 1250 percent RW to be assigned to such exposures.

Certain asset-backed commercial paper (ABCP) exposures. This provides the option of applying the RW based on the highest RW applicable to any of the individual underlying exposures for eligible ABCP liquidity facilities and eligible second-loss position or better exposures to an ABCP.

Implicit support. In case a bank provides implicit support (i.e., support in excess of its contractual obligations), it must hold capital on the entire pool of underlying assets and is also subject to additional disclosure requirements.

Interest-only mortgage-backed securities (IO MBS). Like Basel I and Basel II, Basel III retains the 100 percent RW floor for IO MBS strips.

Trust-preferred security collateralized debt obligations (TruPS CDOs). TruPS CDOs are synthetic exposures to the capital of unconsolidated financial institutions and are subject to deduction from capital (i.e., significant and non-significant financial institution threshold deduction tests). Any amounts of TruPS CDOs that are not deducted are subject to the securitization treatment (unless treated as a covered fund under Section 619 of the Dodd-Frank Act, known informally as the Volcker Rule).



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Credit risk mitigation for securitization exposures

Credit risk mitigation (CRM) methodology provides a capital benefit by recognizing certain collateral or guarantees/credit derivatives supporting securitization exposures. CRM is recognized for financial collateral, as per the “collateral haircut” approach.³⁸ For eligible guarantees and eligible credit derivatives obtained from an eligible guarantor, CRM is recognized as per the borrower substitution approach rules.

The definition of eligible guarantor is updated in Basel III to exclude insurance companies predominantly engaged in providing credit protection (i.e., monoline bond insurers), borrowers with positive correlation (i.e., wrong-way risk) with the guaranteed exposures, and entities without investment grade unsecured long-term debt.

Securitization exposure amount calculation

For the RWA calculations, securitization exposure amount is calculated based on the on-balance sheet and off-balance sheet amounts.

For on-balance sheet assets, a securitization exposure amount is determined as per GAAP (see [Chapter 8](#)). An accumulated other comprehensive income (AOCI) adjustment is no longer required under Basel III, the exposure amount calculation of all available-

³⁸ Under the collateral haircut approach, exposure amount is determined based on the value of the exposure, less the value of any financial collateral, plus adjustments based on collateral type and any currency mismatch.

³⁹ Under the CEM approach, exposure amount is the sum of a contract's mark-to-market value plus a potential future exposure (PFE) amount. The PFE amount is calculated based on notional principal amount and a conversion factor determined based on the type of derivative contract and remaining maturity.

for-sale (AFS) debt securities, including securitization exposures, is based on the fair value. However, Basel III retains the AOCI opt-out option for Standardized Approach banks. If exercised, such banks will continue to follow the Basel I and Basel II approach of calculating exposure amount based on book value for their AFS debt securities portfolio.

Exposure amounts for counterparty credit risk exposures with securitization SPE counterparties

are calculated using the same approach as for other wholesale counterparties, i.e., primarily using the Current Exposure Methodology (CEM)³⁹ approach for derivatives. For sold credit derivatives, exposure amount is the full notional amount of protection provided, and for credit protection provided through an n^{th} -to-default credit derivative, exposure amount is the largest notional amount of all the underlying exposures.

For other **off-balance sheet commitment amounts**, exposure amount is generally set at the full notional amount.

- For an off balance sheet exposure to an ABCP program, such as an eligible ABCP liquidity facility, the notional amount may be reduced to the maximum potential amount that could be required to fund given the ABCP program's current underlying assets (calculated without regard to the current credit quality of those assets).
- Exposure amount for eligible ABCP liquidity facilities for which SSFA does not apply is calculated by applying a credit conversion factor (CCF) of 50 percent to the notional amount, but the full notional amount (i.e., a CCF of 100 percent) is applicable for such facilities where SSFA is applied.

- For overlapping or duplicative facilities, duplicative capital is not required for the overlapping position. The applicable risk-based capital treatment that is applied is the one that results in the highest risk-based capital requirement.
- For facilities to all other customer SPEs, a reduction is not available and the full notional amount is used to calculate exposure amount.

Eligible **servicer cash advance facilities** are required to hold risk-based capital against any funded advances, but not any future potential cash advances under the facility. Ineligible servicer cash advance facilities must hold risk-based capital against both any funded advances and the amount of all potential future cash advance payments that it may be contractually required to provide during the subsequent 12-month period.



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Subject to certain conditions, for **small business obligations sold with recourse**, exposure amount is calculated only for the contractual exposure.

Definition and treatment of re-securitizations

Re-securitization refers to a securitization which has more than one underlying exposure and in which one or more of the underlying exposures is a securitization exposure. Basel III modifies the definition from Basel II to exclude re-tranching of a single securitization exposure (i.e., a re-securitization of a real estate mortgage investment conduit).

The RWA calculation for re-securitizations is subject to the same hierarchy of approaches (i.e., SFA and SSFA) and requires a look-through approach to the ultimate underlying pool supporting the underlying securitization position.

Re-securitization exposures generally attract higher capital under both SFA and SSFA. For example, SFA requires the EWALGD input be set to 100 percent and SSFA requires the parameter p input be set to 1.5 for all re-securitizations. Additionally, re-securitizations are ineligible as financial collateral.

Treatment of securitizations exposures under the market risk framework

As noted earlier, the market risk framework applies only to the Market Risk banks (banks with trading assets in excess of \$1 billion, or 10 percent of total assets). The market risk framework related changes in Basel III (sometimes referred to as Basel 2.5) have been effective since January 1, 2013.

Under Basel I, and also left unchanged in Basel II, market risk RWA rules required calculation of a general risk component (based on internally developed value at risk model) and a specific risk add-on (based on either internal models or supervisory add-on factors). Generally, securitization exposures in the trading book, subject to market risk rules, required lower capital than similar exposures in the banking book, which were subject to credit risk rules.

However, Basel III introduces multiple changes aimed at overall increase of market risk capital in the trading book, with a focus on securitizations. In particular, Basel III imposes due diligence requirements, and also, outside of the correlation trading portfolio, increases the specific risk add-on to be equal to the banking book credit RWA charges, i.e., as per SSFA and SFA, as applicable. Also, Basel III strengthens the eligibility criteria for market risk covered treatment, such that certain trading book portfolios are no longer eligible for market risk treatment.⁴⁰ For market risk covered correlation trading portfolio positions, an internally modeled approach is allowed, but with strict

qualification criteria. Thus, securitization exposures in the trading book now receive an equal number of governance requirements, and in most cases, higher capital than similar exposures in the banking book.

The Basel Committee on Banking Supervision (BCBS) published a revised international standard for market risk in January 2016. The boundary between trading book and banking book has now been revised to make it more difficult for banks to arbitrage their capital requirements. Also, the internal models approach has been modified to better capture “tail risks” and market illiquidity risks, improve the model approval process, and place limits on capital reduction that can be achieved through hedging and portfolio diversification. The standardized approach for market risk has also been revised to make it more risk-sensitive.

The US regulators have yet to publish a proposal for implementing the corresponding changes in the US rules. BCBS expects the new framework to go into effect on January 1, 2019.

BCBS revisions to securitization framework

Since the publication of the Basel III international capital framework, the BCBS has been in the process of revising various aspects of the rules, including those related to the Standardized Approach for Credit Risk, Counterparty Credit Risk, Market Risk (as mentioned in the previous section), and the Securitization Framework. Certain significant enhancements to the Basel Securitization Framework have been finalized internationally by

⁴⁰ Basel 2.5 and Basel III market risk framework revisions restrict the applicability of market risk treatment to exposures with 'trading intent' regardless of trading or banking book classification from an accounting perspective.



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the BCBS with an effective date of January 1, 2018. Overall, the changes to the international framework make it more aligned with the existing US rules. However, there will continue to be certain divergences in capital charges for similar securitization exposures across jurisdictions (such as between the United States and European Union).

The revised set of calculation approaches and hierarchy per the new BCBS securitization framework is discussed below:

Internal Ratings Based Approach (SEC- IRBA):

This is at the top of the hierarchy and is analogous to the existing SFA approach, but with certain modifications. In addition to the input parameters required by SFA (Kirb, A, D, EWALGD, etc.), the new methodology also requires effective maturity (Mt), defined as either the cash flow weighted average maturity or 80 percent of the remaining contractual maturity.

Based on the above inputs, a supervisory prescribed formula is used to calculate the RWA with a RW floor of 15 percent. The SEC-IRBA approach can be applied only if the bank is able to calculate Kirb for least 95 percent of the underlying assets.

External Ratings Based Approach (SEC- ERBA):

The revised international framework retains the external rating approaches (RBA, inferred RBA, and IAA). However, to better align with jurisdictional differences, especially given that it is disallowed in the United States under Basel III rules, the SEC-ERBA approach is required only in jurisdictions that allow external ratings.

Standardized Approach (SEC- SA):

In general, this is analogous to the US Basel III SSFA approach, but with a RW floor of 15 percent. If the delinquency status is unknown for no more than 5 percent of the underlying pool, an adjustment factor applies, beyond which the exposure will attract 1,250 percent RW.

Securitization exposures within the Basel III leverage ratios

There is already a leverage ratio requirement as part of Basel I, which has also been retained under Basel III, defined as the ratio of Tier 1 capital to total on-balance sheet assets.⁴¹ Additionally, the Basel III Advanced Approach also includes a supplementary leverage ratio requirement, which is similar to the leverage ratio but also includes a measure for off-balance sheet assets.

Both leverage ratios require total on-balance sheet assets to be measured as per GAAP, or any other accounting framework no less stringent than GAAP. Accordingly, all exposures that are consolidated as per ASC 810 are included. For off-balance sheet commitments, 10 percent of the notional amount is used only for unconditionally cancellable commitments; otherwise, the full notional amount is used as the off-balance sheet measure. For derivatives, the CEM approach, as defined in the Basel III capital requirements, is used to calculate the exposure amount.

Securitization exposures within the Basel III liquidity ratios

Basel III also introduced measures to strengthen the liquidity profile of the banking sector. Liquidity ratio requirements comprise two ratios: the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR). The LCR promotes the short-term resilience of a bank's liquidity profile, and the NSFR requires banks to maintain a stable funding profile in relation to their activities over a longer period.

The US LCR rule requires covered banks to maintain minimum amounts of High Quality Liquid Assets (HQLA) to withstand cash outflows over a 30-day horizon. The LCR final rule mandates a minimum LCR ratio of 90 percent by January 2016 and 100 percent by January 2017 for financial institutions with more than \$50 billion in assets. However, the smaller banks covered by the rule that are not "Basel Advanced Approach" banks will be subject to a less-stringent "modified LCR" rule.

⁴¹ Less assets deducted from Tier 1 Capital.



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$$\text{Liquidity Coverage Ratio (LCR): } \frac{\text{Stock of high quality liquid assets (HOLA)}}{\text{Net cash outflows over a 30-day stress period}} \geq 100\%$$

Assets that qualify for HQLA treatment (and can be included in the numerator of the LCR ratio) include government securities, investment-grade corporate bonds, and agency MBS. There are minor differences in definition of HQLA between the international standards finalized by the BCBS and the US regulations (e.g., private label securitizations do not qualify in the US as HQLAs). HQLAs are further classified as level 1, 2A and 2B based on the relative asset quality and haircuts, and limitations are defined for how much of these assets can be included in the numerator. As a result, Fannie Mae and Freddie Mac securities that qualify for HQLA level 2A and, GNMA securities that qualify for HQLA level 1 are preferable to private label securitization holdings from an LCR ratio perspective.

The denominator of the LCR ratio is computed based on net cash outflow amounts prescribed by regulators over a 30-day stress period. Specifically related to securitizations, the following outflow rates are defined:

- Undrawn amounts of liquidity facilities or credit enhancement facilities to SPEs that issue or have issued commercial paper or securities are assigned a 100 percent outflow rate.

- Similarly, for undrawn amounts of facilities extended to SPEs that are consolidated subsidiaries of certain customers or counterparties are assigned outflow rates ranging from 10 percent to 100 percent based on the type of facility and the type of counterparty consolidating the SPE.
- Also if a bank is a sponsor of a structured transaction where the issuing entity is not consolidated on the bank's balance sheet, then the outflow amount required is the greater of (i) the total maturing obligations of the issuing entity and all commitments made to purchase assets within the next 30 days; or (ii) the maximum funding the bank may be required to provide the issuing entity within the next 30 days.
- And a 100 percent outflow rate is assigned to undrawn amounts related to other facilities to SPEs not outlined above.

The NSFR measures liquidity risk over a longer time period, which extends to one year.

$$\text{Net Stable Funding Ratio (NSFR): } \frac{\text{Available amount of stable funding (ASF)}}{\text{Required amount of stable funding (RSF)}} \geq 100\%$$



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Per the international framework finalized by the BCBS, a 50 percent RSF factor has been assigned to RMBS securities with a credit rating of at least AA. Assets with greater RSF factor tend to reduce the NSFR ratio and are likely to be less desirable from a liquidity perspective. The NSFR rules are not yet finalized in the United States

Other regulatory considerations impacting securitizations

Apart from the regulations discussed above, which directly affect capital, there are a variety of regulations that have an impact on the overall securitization industry, while indirectly affecting risk management and capital requirements. Two specifically highlighted below are the impacts around Risk Retention and the Volcker Rule:

Risk Retention Rules

Risk retention rules finalized by the US regulators generally require the sponsors⁴² of ABS to retain at least 5 percent credit interest in these transactions. These rules are intended to align the interest of the sponsors to the interest of the investors by ensuring that the sponsors maintain "skin in the game" and curb the "originate to distribute" model (whereby loans are originated with the sole purpose of offloading them into securitization pools, thus reducing incentive to maintain high underwriting and credit standards). On the other hand, the rule also permits an exemption from risk retention when the securitization pool contains particular types of underlying assets and is subject to conditions that enable prudent underwriting standards.

The rule prescribes the following standard options to retain credit risk:

Eligible horizontal interest retention

Under this option, the sponsor must retain at least 5 percent of economic interest in the credit risk of the first to default or first loss tranche of the securitization pool. The tranche has to have the most subordinate claim to any principal and interest payments and absorbs losses resulting from any shortfalls before any other interests in the pool. The 5 percent interest is measured using the GAAP fair value measurement framework, and additional disclosures are required related to the fair value calculation method employed.

Eligible vertical interest retention

Under this option, the sponsor must retain at least 5 percent of economic interest in the credit risk across all the tranches of the securitization pool. The rule requires the sponsor to hold a proportional interest in each tranche of the pool to make up the 5 percent. However, unlike the horizontal risk retention option, fair value measurement is not mandatory.

Hybrid interest retention

The rule also allows the sponsor to meet the requirements by retaining a combination of the horizontal and vertical interests, provided that the combination adds up to 5 percent. However, the rule does not specify separate minimums for either the horizontal or vertical interest that a sponsor should hold when opting for the hybrid interest retention.

Eligible horizontal cash reserve account

The sponsor may also meet the risk retention requirement by establishing an eligible horizontal cash reserve account in an amount equal to the 5 percent of the securitized assets. The account has to be held by a trustee, and may only be composed of cash and cash equivalents. The use of these funds is severely restricted by rule, but they can be used to absorb losses, similar to an eligible horizontal tranche.

Outside the standard retention options defined above, the sponsor can also employ alternative ways to satisfy the risk retention requirements specific to certain assets class categories (provided certain conditions are met).

The rule specifies a number of exemptions related to different categories of qualifying underlying assets, which would not require sponsors to retain the 5 percent. For example, the rule specifies that the sponsor may not retain any risk in securitization pools that are solely composed of qualified residential mortgages, as defined by Consumer Finance Protection Bureau (CFPB) under the Truth in Lending Act. In case of a blended pool of qualifying residential mortgages and other assets, the risk retention requirements can be prorated and reduced to 2.5 percent of the total securitization pool.

⁴² Risk retention is required by either the sponsor or the depositor (if the depositor is not the sponsor).



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Additionally, GNMA transactions are also fully exempt from risk retention requirements since such transactions are federally insured or guaranteed. Similarly, Fannie Mae and Freddie Mac transactions can also satisfy risk retention requirements by guaranteeing interest and principal payments on the investor interests, as long as they continue to operate under conservatorship.

Note: ABS collateralized by residential mortgages were required to be compliant with the risk retention rules beginning December 24, 2015, and all other ABS are required to be compliant by December 24, 2016.

The Volcker Rule

The [Volcker Rule](#) restrictions generally exempt securitization activities, but classify some securitization vehicles (collateralized debt obligations and collateralized loan obligations that are not solely composed of loans) as “covered funds,” which are then subject to strict de minimis limits and punitive capital treatment (i.e., deduction from Tier 1 capital). Grandfathering exemptions are allowed for TruPS CDOs issued before May 19, 2010 by BHCs less than \$15 billion in size, or by mutual holding companies that were acquired by a bank on or prior to December 10, 2013.

Regulatory capital considerations will continue exert pressure

Given the current environment of regulatory overhang, banks have to deal with the impact of higher regulatory capital, leverage, and liquidity charges for securitizations, and increased implementation and compliance challenges. Ultimately, certain assets may migrate to the non-bank sector that is not subject to capital regulations.

The pace of regulatory reform continues to force banks to evolve their overall strategy and operating model to ensure long-term sustainability while meeting regulatory expectations. In general, regulatory capital remains an area in which banks, and other market participants, will have to continue to navigate carefully.



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Coming changes

The inherent challenge with this type of publication is trying to make it as current and relevant as possible. The Financial Accounting Standards Board (FASB) and International Accounting Standard Board (IASB) have had, and continue to have, very full agendas. In this chapter, we will discuss the projects both boards are working on that may impact securitization accounting and the most up-to-date thinking⁴³ related to each project.

Financial instruments—classification and measurement (GAAP and IFRS)

This project began as a joint project between the FASB and IASB and while both boards originally hoped to converge their guidance on financial instruments under US Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS), respectively, that objective was not achieved. After performing stakeholder outreach and a cost-benefit analysis, the FASB ultimately decided to make only limited changes to existing GAAP.

On January 5, 2016, the FASB completed this project with the issuance of Accounting Standards Update (ASU) 2016-01, *Financial Instruments—Overall (Subtopic 825-20): Recognition and*

⁴³ For updated information and developments that may occur after the date of this publication, please feel free to contact any of the professionals identified in [Appendix: Contacts](#).

Measurement of Financial Assets and Financial Liabilities. ASU 2016-01 is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years for public business entities. This standard provides a framework for how to classify and measure financial assets and financial liabilities. From a securitization perspective, this standard is relevant both for investors in securitization structures as well as entities that are required to consolidate securitization entities.

While ASU 2016-01 does not significantly change GAAP, a summary of some of the more significant changes are provided below:

- Entities are required to carry all investments in equity securities at fair value through net income. However, this requirement does not apply to investments that qualify for the equity method of accounting or to those that result in consolidation of the investee or for which the entity has elected the practicability exception to fair value measurement.
- For investments in equity securities without a readily determinable fair value that do not qualify for the net asset value practical expedient in ASC 820-10-35-59, an entity is

permitted to elect a practicability exception to fair value measurement, under which the investment will be measured at cost, less impairment, plus or minus observable price changes (in orderly transactions) of an identical or similar investment of the same issuer.

- ASU 2016-01 eliminates the requirement in GAAP to assess whether an impairment of such an investment is other than temporary. Rather, as of each reporting period, an entity will qualitatively consider indicators (from ASC 321-10-35-3, which was added by the ASU) to determine whether the investment is impaired. If the entity determines that the equity security is impaired on the basis of the qualitative assessment, it will recognize an impairment loss equal to the amount by which the security's carrying amount exceeds its fair value. By contrast, the current guidance in ASC 320-10-35-30 requires an entity to perform a two-step assessment under which it first determines whether an equity security is impaired and then evaluates whether any impairment is other than temporary.
- Changes in fair value attributable to instrument-specific credit risk of financial liabilities for which the fair value option is elected will be recognized separately in other comprehensive income. This amount is to be measured as the difference

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between the total change in fair value and the amount resulting from a change in a base market rate (e.g., a risk-free interest rate). This is a significant change from current GAAP, which requires the instrument's entire change in fair value to be recognized through earnings. Alternatively, an entity may also use another method that it believes results in a faithful measurement of the fair value change attributable to instrument-specific credit risk. Entities are required to apply the method consistently to each financial liability from period to period.

The IASB issued the final version of **IFRS 9, *Financial Instruments*** in July 2014, which introduced a new impairment model to IFRS and modified the standard's existing classification and measurement guidance. IFRS 9, as amended, is effective for annual periods beginning on or after January 1, 2018. Meanwhile, the FASB issued ASU 2016-01, *Financial Instruments—Overall (Subtopic 825-20): Recognition and Measurement of Financial Assets and Financial Liabilities* on January 5, 2016.

Under IFRS 9 financial assets are classified on the basis of their contractual cash flow characteristics and the business model in which they are managed. Unless financial assets qualify for the fair value option and the entity elects to apply that option, such assets are measured at amortized cost if (1) the contractual cash flows are solely payments of principal and interest on the principal amount outstanding (SPPI) and (2) the objective of the business model in which the assets are managed is to hold assets to collect contractual cash flows.

Contractual Cash Characteristics Assessment

When a debt instrument contains a prepayment feature, the asset meets the cash flow characteristics criterion if the prepayment amount substantially represents unpaid amounts of principal and interest on the principal outstanding (which may include additional compensation for the early termination of the contract). When the financial asset is acquired or originated at a premium or discount to the contractual par amount and the fair value of the prepayment feature at initial recognition is insignificant, the asset meets the contractual cash flow characteristics test if the prepayment amount substantially represents the contractual par amount and accrued (but unpaid) contractual interest (which may include reasonable additional compensation).

Under IFRS 9 there are three distinct business models under which assets can be held and managed:

- **Hold-to-collect.** Assets are held to collect contractual cash flows. Financial assets that meet the SPPI criterion and that are held in a hold-to-collect business model are accounted for at amortized cost.
- **Hold-and-sell.** Assets are held to maximize value, either by collecting contractual cash flows or through selling in the marketplace. In other words, the entity has not determined whether it expects to hold or sell the assets. Financial assets that meet the SPPI criterion and that are held in a hold-and-sell business model are accounted for at fair value through other comprehensive income or, optionally, at fair value through net income (FV-NI).

- **Neither of the above.** Financial assets held in neither a hold-to-collect nor a hold-and-sell business model are accounted for at FV-NI.
- This business model assessment is performed at the level at which an entity manages its activities and risks. Therefore, an entity may have more than one business model depending on how the entity manages its various portfolios. This is quite a bit different than the current model, where investors have a choice (subject to certain restrictions) in classification for securities—held to maturity, available-for-sale or trading.



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The IFRS 9 model includes specific criteria that need to be met for a beneficial interest in a securitization structure to meet the SPPI test. Those criteria are:

- The contractual cash flows of the beneficial interests give rise to cash flows that are solely payments of principal and interest.
- The underlying pool of financial instruments contains one or more instruments that have contractual cash flows that are solely payments of principal and interest. The pool may also include instruments that either (1) reduce cash flow variability or (2) align the cash flows of the tranches of beneficial interests with the cash flows of the pool of underlying instruments.
- The exposure to credit risk inherent in the tranche of beneficial interest is equal to or lower than the exposure to credit risk of the underlying pool of financial instruments.

Derecognition

Under IFRS 9, the recognition and derecognition guidance states that the determination of whether a transferred financial asset should be derecognized is primarily based on an assessment of the extent to which the entity has retained the asset's risks and rewards of ownership. This derecognition model for financial assets under IFRS is fundamentally different from that under GAAP due to that fact that the GAAP model is primarily based on an assessment of whether the transferor surrenders control of a financial asset.

Financial instruments—impairment of financial assets (GAAP and IFRS)

Like the classification and measurement project, the impairment project was originally a joint project between the FASB and IASB. It has been ongoing for several years and has seen the level of agreement between the two Boards progress from very different models, to significantly similar models, and now, to something that is perhaps somewhere in between. This project is a result of the financial downturn and the concern that the incurred loss model in both GAAP and IFRS did not recognize losses on financial assets soon enough (a practice often referred to as “too little, too late”).

The FASB is currently finalizing amendments to its guidance on the impairment of financial instruments. The proposed amendments would introduce a new impairment mode based on expected losses rather than incurred losses.

The FASB's proposed ASU, Financial Instruments—Credit Losses (Subtopic 825-15), would bring about the following changes to overcome the perceived shortcomings of current GAAP:

- **Expected loss approach over life of loan.** Change the accounting requirement from an incurred loss approach using a “loss emergence period” concept to an expected loss approach using “life of loan” loss forecast horizon to provide financial statement users with more decision-useful information about expected credit losses. Under this approach, the expected credit loss is an estimate of contractual cash flows an entity does not expect to collect for the remaining life of an instrument. Said differently, under

the current expected credit loss (CECL) impairment model, the net asset will be measured to reflect the amount of contractual cash flows that an entity expects to collect.

- **Elimination of the “probable” threshold.** Existing allowance for loan and lease losses models delay recognition of credit losses until the loss is considered probable. This recognition threshold is perceived to have interfered with the timely recognition of credit losses and overstated assets during the global economic downturn.
- **Forward-looking approach.** When credit losses are measured under current GAAP, an entity generally only considers past events and current conditions in measuring the incurred loss. The CECL model requires an entity's estimate of credit losses to be based on relevant information about past events, including historical loss experience with similar assets, current conditions, and reasonable and supportable forecasts that affect the expected collectability of the financial assets' remaining contractual cash flows. Although the CECL model will require contemplation of future conditions, an entity would not be required to forecast conditions over the contractual life of the asset. Rather, for the period beyond the period for which the entity can make reasonable and supportable forecasts, the entity would revert to an unadjusted historical credit loss experience.
- **Reduced complexity.** The FASB's CECL model replaces or amends five different impairment models for instruments that are within the scope of the proposed amendments and would result in a more consistent measurement approach that simplifies the estimation process. In addition, the CECL



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model will not be prescriptive and will permit use of variety of methods to estimate expected credit losses. Due to the fact that a lot of beneficial interests in securitizations are either securities or subject to the gross-up approach, investors should not expect to see a single approach for all credit instruments.

Other major components of the new model include considerations around unit of account, reasonable and supportable forecasting to estimate expected losses over the life of the loan, and the evaluation of the possibility of occurrence of loss at the time of origination itself. A final standard is tentatively expected to be released in Q2 2016. The FASB plans to provide a long transition timeline (i.e., January 1, 2019, for calendar-year public business entities that are Securities and Exchange Commission filers and January 1, 2020, for calendar-year public business entities that are not public).

IFRS 9 uses a dual-measurement approach for expected credit losses. For financial assets other than purchased or originated credit-impaired financial assets, the standard requires entities to measure expected credit losses by recognizing a loss allowance at an amount equal to either of the following:

- The 12-month expected credit losses (i.e., the expected credit losses that result from default events on the financial instrument that are possible within 12 months after the reporting date). This measurement is required if the credit risk is low as of the reporting date or the credit risk has not increased significantly since initial recognition.

- Full lifetime expected credit losses (i.e., the expected credit losses that result from all possible default events over the life of the financial instrument). Unless the credit risk is low as of the reporting date, this measurement is required if the credit risk has increased significantly since initial recognition. It is also required for contract assets and trade receivables that do not contain a significant financing component in accordance with IFRS 15.

Both the impairment model in IFRS 9 and the FASB's tentative impairment model are based on expected credit losses. However, the FASB's tentative approach would require entities to recognize current expected credit losses for all assets, not just those for which there has been a significant increase in credit risk since initial recognition.



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Appendix: Contacts

For more information on how Deloitte can help your company in its efforts to address its securitization accounting issues, please contact any of the individuals listed below.

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