Statutory Issue Paper No. 86

Securitization

STATUS
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Current Authoritative Guidance for Securitization: SSAP No. 103R
This issue paper may not be directly related to the current authoritative statement.

Original SSAP from Issue Paper: SSAP No. 33

Type of Issue:
Common Area

SUMMARY OF ISSUE

FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities *FASB Statement No. 77, Reporting by Transferors for Transfers of Receivables with Recourse,* *FASB Technical Bulletin 85-2, Accounting for Collateralized Mortgage Obligations (CMOs)*

Sales of Future Revenues

DISCUSSION

At its June 5, 1989 meeting (89–2), the working group reached conclusions on the following two issues relating to REMIC's:

1. If an insurer holds a junior, how should it report its holdings, as a bond or equity or some other form of security?

   It was the consensus of the working group that the holding of a junior should be reported as a bond.

2. If a junior is a bond, how should it be valued?

   The consensus of the working group was that it should be valued in accordance with procedures established by the NAIC Securities Valuation Office. (However, this conclusion was modified by the group during its March 26, 1990 meeting. See Number 3. below.)

   A third issue was also discussed at the June 5, 1989 meeting (EI 89–2) and at subsequent meetings of the working group. At the December 4, 1989 meeting (EI 89–4) the working group reviewed a paper (Attachment B) in the form of an issue summary prepared by Ransom Jones of Goldman, Sachs. Mr. Jones and Katherine Mason agreed to illustrate a transaction for the March 1990 meeting (Attachment C). Mr. Clark also provided an illustration (Attachment D) of the transaction which had been the impetus for his original issue summary.

   Following a discussion of the material provided, the working group reached the following conclusions on accounting for these transactions:

1. How should the allocated basis of each of the layers or tranches be determined?

   The consensus of the working group was that fair market value should be used in determining the allocated basis for each tranche.

2. Should the exchange of mortgages and the issuing of securities be considered a sale and should a gain or loss be recognized?

   The group agreed that the transaction should be considered a sale. It further agreed that any gain or loss arising from the sale of the senior tranche should be recognized. The working group concluded loss, if any, should be recognized immediately. A gain on the sale should be deferred and amortized over the life of the juniors and residuals but in no event faster than the risk retained by the insurer is eliminated.

3. At what value should the juniors and/or residuals be carried by the insurer?

   It was the consensus of the working group that juniors and residuals should initially be carried at their allocated book value. They should be amortized as cash is received and should be periodically assessed as to realizability and valued downward.

Accounting for Financing Secured by Mortgage Loans

This issue was previously discussed under the caption "Secured Borrowing" during the

Specifically, an insurer (the "transferor") transfe

3. How should an insurance company account for borrowings under this type of arrangement?

   The borrowing transaction would result in an increase in cash or cash equivalents, and a like increase in the liability, borrowed money.

   A disclosure should be made in the Notes to the Financial Statement as required for "Borrowed Money".

   Because of the interest of and certain concerns raised by industry observers at the meeting, the chairman agreed to expose the foregoing preliminary conclusions through these minutes. Final adoption of conclusions by the working group will be made at the June 1992 meeting.

   In addition, proposed Accounting Manual language was developed by the working group. The proposed language (for exposure) is attached as Attachment E.

Generally Accepted Accounting Principles

FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities

Accounting for Transfers and Servicing of Financial Assets

9. A transfer of financial assets (or all or a portion of a financial asset) in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:

   a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership (paragraphs 23 and 24).
   b. Either (1) each transferee obtains the right—free of conditions that constrain it from taking advantage of that right (paragraph 25)—to pledge or exchange the transferred assets or (2) the transferee is a qualifying special-purpose entity (paragraph 26) and the holders of beneficial interests in that entity have the right—free of conditions that constrain them from taking advantage of that right (paragraph 25)—to pledge or exchange those interests.
   c. The transferor does not maintain effective control over the transferred assets through (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (paragraphs 27-29) or (2) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable (paragraph 30).

10. Upon completion of any transfer of financial assets, the transferor shall:

    a. Continue to carry in its statement of financial position any retained interest in the transferred assets, including, if applicable, servicing assets (paragraphs 35-41), beneficial interests in assets transferred to a qualifying special-purpose entity in a securitization (paragraphs 47-58), and retained undivided interests (paragraph 33)
    b. Allocate the previous carrying amount between the assets sold, if any, and the retained interests, if any, based on their relative fair values at the date of transfer (paragraphs 31-34).

11. Upon completion[3] of a transfer of assets that satisfies the conditions to be accounted for as a sale (paragraph 9), the transferor (seller) shall:

    a. Derecognize all assets sold
    b. Recognize all assets obtained and liabilities incurred in consideration as proceeds of the sale, including cash, put or call options held or written (for

example, guarantee or recourse obligations), forward commitments (for example, commitments to deliver additional receivables during the revolving periods of some securitizations), swaps (for example, provisions that convert interest rates from fixed to variable), and servicing liabilities, if applicable (paragraphs 31, 32, and 35-41)

c. Initially measure at fair value assets obtained and liabilities incurred in a sale (paragraphs 42-44) or, if it is not practicable to estimate the fair value of an asset or a liability, apply alternative measures (paragraphs 45 and 46)

d. Recognize in earnings any gain or loss on the sale.

The transferee shall recognize all assets obtained and any liabilities incurred and initially measure them at fair value (in aggregate, presumptively the price paid).

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[3] Although a transfer of securities may not be considered to have reached completion until the settlement date, this Statement does not modify other generally accepted accounting principles,

Secured Borrowings and Collateral

15. A debtor may grant a security interest in certain assets to a lender (the secured party) to serve as collateral for its obligation under a borrowing, with or without recourse to other assets of the debtor. An obligor under other kinds of current or potential obligations, for example, interest rate swaps, also may grant a security interest in certain assets to a secured party. If collateral is transferred to the secured party, the custodial arrangement is commonly referred to as a pledge. Secured parties sometimes are permitted to sell or repledge (or otherwise transfer) collateral held under a pledge. The same relationships occur, under different names, in transfers documented as sales that are accounted for as secured borrowings (paragraph 12). The accounting for collateral by the debtor (or obligor) and the secured party depends on whether the secured party has taken control over the collateral and on the rights and obligations that result from the collateral arrangement:

a. If (1) the secured party is permitted by contract or custom to sell or repledge the collateral and (2) the debtor does not have the right and ability to redeem the collateral on short notice, for example, by substituting other collateral or terminating the contract, then
   - (i) The debtor shall reclassify that asset and report that asset in its statement of financial position separately (for example, as securities receivable from broker) from other assets not so encumbered.
   - (ii) The secured party shall recognize that collateral as its asset, initially measure it at fair value, and also recognize its obligation to return it.

b. If the secured party sells or repledges collateral on terms that do not give it the right and ability to repurchase or redeem the collateral from the transferee on short notice and thus may impair the debtor's right to redeem it, the secured party shall recognize the proceeds from the sale or the asset repledged and its obligation to return the asset to the extent that it has not already recognized them. The sale or repledging of the asset is a transfer subject to the provisions of this Statement.

c. If the debtor defaults under the terms of the secured contract and is no longer entitled to redeem the collateral, it shall derecognize the collateral, and the secured party shall recognize the collateral as its asset to the extent it has not already recognized it and initially measure it at fair value.

d. Otherwise, the debtor shall continue to carry the collateral as its asset, and the secured party shall not recognize the pledged asset.

Extinguishments of Liabilities

16. A debtor shall derecognize a liability if and only if it has been extinguished. A liability has been extinguished if either of the following conditions is met:

   a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes delivery of cash, other financial assets, goods, or services or reacquisition by the debtor of its outstanding debt securities whether the securities are canceled or held as so-called treasury bonds.

   b. The debtor is legally released[5] from being the primary obligor under the liability, either judicially or by the creditor.

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[5] If nonrecourse debt (such as certain mortgage loans) is assumed by a third party in conjunction with the sale of an asset that serves as sole collateral for that debt, the sale and related assumption effectively accomplish a legal release of the seller-debtor for purposes of applying this Statement.

Disclosures

17. An entity shall disclose the following:

   a. If the entity has entered into repurchase agreements or securities lending transactions, its policy for requiring collateral or other security

   b. If debt was considered to be extinguished by in-substance defeasance under the provisions of FASB Statement No. 76, Extinguishment of Debt, prior to the effective date of this Statement, a general description of the transaction and the amount of debt that is considered extinguished at the end of the period so long as that debt remains outstanding

c. If assets are set aside after the effective date of this Statement solely for satisfying scheduled payments of a specific obligation, a description of the nature of restrictions placed on those assets

d. If it is not practicable to estimate the fair value of certain assets obtained or liabilities incurred in transfers of financial assets during the period, a description of those items and the reasons why it is not practicable to estimate their fair value

e. For all servicing assets and servicing liabilities:

   (1) The amounts of servicing assets or liabilities recognized and amortized during the period

   (2) The fair value of recognized servicing assets and liabilities for which it is practicable to estimate that value and the method and significant assumptions used to estimate the fair value

   (3) The risk characteristics of the underlying financial assets used to stratify recognized servicing assets for purposes of measuring impairment in accordance with paragraph 37

   (4) The activity in any valuation allowance for impairment of recognized servicing assets—including beginning and ending balances, aggregate additions charged and reductions credited to operations, and aggregate direct write-downs charged against the allowances—for each period for which results of operations are presented.

sale to the transferor's competitor would not constrain the transferee if it were able to sell the transferred assets to a number of other parties; however, it would be a constraint if that competitor were the only potential willing buyer.

Qualifying Special-Purpose Entity

26. A qualifying special-purpose entity[7] must meet both of the following conditions:
   a. It is a trust, corporation, or other legal vehicle whose activities are permanently limited by the legal documents establishing the special-purpose entity to:
      (1) Holding title to transferred financial assets
      (2) Issuing beneficial interests (If some of the beneficial interests are in the form of debt securities or equity securities, the transfer of assets is a securitization.)
      (3) Collecting cash proceeds from assets held, reinvesting proceeds in financial instruments pending distribution to holders of beneficial interests, and otherwise servicing the assets held
      (4) Distributing proceeds to the holders of its beneficial interests.
   b. It has standing at law distinct from the transferor. Having standing at law depends in part on the nature of the special-purpose entity. For example, generally, under U.S. law, if a transferor of assets to a special-purpose trust holds all of the beneficial interests, it can unilaterally dissolve the trust and thereby reassume control over the individual assets held in the trust, and the transferor "can effectively assign his interest and his creditors can reach it."[8] In that circumstance, the trust has no standing at law, is not distinct, and thus is not a qualifying special-purpose entity.

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[7] The description of a special-purpose entity is restrictive. The accounting for transfers of financial assets to special-purpose entities should not be extended to any entity that does not satisfy all of the conditions articulated in this paragraph.

[8] *Scott's Abridgment of the Law on Trusts,* §156 (Little, Brown and Company, 1960), 296.

Agreements That Maintain Effective Control over Transferred Assets

27. An agreement that both entitles and obligates the transferor to repurchase or redeem transferred assets from the transferee maintains the transferor's effective control over those assets, and the transfer is therefore to be accounted for as a secured borrowing, if and only if all of the following conditions are met:
   a. The assets to be repurchased or redeemed are the same or substantially the same as those transferred (paragraph 28).
   b. The transferor is able to repurchase or redeem them on substantially the agreed terms, even in the event of default by the transferee (paragraph 29).
   c. The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price.
   d. The agreement is entered into concurrently with the transfer.

28. To be substantially the same,[9] the asset that was transferred and the asset that is to be repurchased or redeemed need to have all of the following characteristics:

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[9] In this Statement, the term substantially the same is used consistently with the usage of that term in the AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position.

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a. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same)
b. Identical form and type so as to provide the same risks and rights
c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities have similar remaining weighted-average maturities that result in approximately the same market yield)
d. Identical contractual interest rates
e. Similar assets as collateral
f. The same aggregate unpaid principal amount or principal amounts within accepted "good delivery" standards for the type of security involved.

29. To be able to repurchase or redeem assets on substantially the agreed terms, even in the event of default by the transferee, a transferor must at all times during the contract term have obtained cash or other collateral sufficient to fund substantially all of the cost of purchasing

36. An entity that undertakes a contract to service financial assets shall recognize either a servicing asset or a servicing liability, unless the transferor securitizes the assets, retains all of the resulting securities, and classifies them as debt securities held-to-maturity in accordance with Statement 115, in which case the servicing asset or liability may be reported together with the asset being serviced. Each sale or securitization with servicing retained or separate purchase or assumption of servicing results in a servicing contract. A servicer of financial assets commonly receives the benefits of servicing—revenues from contractually specified servicing fees, late charges, and other ancillary sources, including “float,” all of which it is entitled to receive only if it performs the servicing—and incurs the costs of servicing the assets. Each servicing contract results in a servicing asset or servicing liability. Typically, the benefits of servicing are expected to be more than adequate compensation to 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 the servicer for performing the servicing, the contract results in a servicing liability.

37. A servicer that recognizes a servicing asset or servicing liability shall account for the contract to service financial assets separately from those assets, as follows:

a. Report servicing assets separately from servicing liabilities in the statement of financial position (paragraph 13).
b. Initially measure servicing assets retained in a sale or securitization of the assets being serviced at their allocated previous carrying amount based on relative fair values, if practicable, at the date of the sale or securitization (paragraphs 10, 33, 34, and 42-46).
c. Initially measure servicing assets purchased or servicing liabilities assumed at fair value (paragraph 13).
d. Initially measure servicing liabilities undertaken in a sale or securitization at fair value, if practicable (paragraphs 11.b., 11.c., and 42-46).
e. Account separately for rights to future interest income from the serviced assets that exceeds contractually specified servicing fees. Those rights are not servicing assets; they are financial assets, effectively interest-only strips to be accounted for in accordance with paragraph 14 of this Statement.
f. Subsequently measure servicing assets by amortizing the amount recognized in proportion to and over the period of estimated net servicing income—the excess of servicing revenues over servicing costs (paragraph 13).
g. Subsequently evaluate and measure impairment of servicing assets as follows:
    (1) Stratify servicing assets based on one or more of the predominant risk characteristics of the underlying financial assets. Those characteristics may include financial asset type,[10] size, interest rate, date of origination, term, and geographic location.

[10] For example, for mortgage loans, financial asset type refers to the various conventional or government guaranteed or insured mortgage loans and adjustable-rate or fixed-rate mortgage loans.

    (2) Recognize impairment through a valuation allowance for an individual stratum. The amount of impairment recognized shall be the amount by which the carrying amount of servicing assets for a stratum exceeds their fair value. The fair value of servicing assets that have not been recognized shall not be used in the evaluation of impairment.
    (3) Adjust the valuation allowance to reflect changes in the measurement of impairment subsequent to the initial measurement of impairment. Fair value in excess of the carrying amount of servicing assets for that stratum, however, shall not be recognized. This Statement does not address when an entity should record a direct write-down of recognized servicing assets (paragraph 13).

Securitizations

47. Financial assets such as mortgage loans, automobile loans, trade receivables, credit card receivables, and other revolving charge accounts are assets commonly transferred in securitizations. Securitizations of mortgage loans may include pools of single-family residential mortgages or other types of real estate mortgage loans, for example, multifamily residential mortgages and commercial property mortgages. Securitizations of loans secured by chattel mortgages on automotive vehicles as well as other equipment (including direct financing or sales-type leases) also are common. Both financial and nonfinancial assets can be securitized; life