FINANCIAL ACCOUNTING STANDARDS BOARD

MEMO		Memo No.	**2**
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Project	**Transition Resource Group for Credit Losses**
Project Stage	**Post-Issuance**
Issue(s)	**Scope of Purchased Financial Assets with Credit Deterioration Guidance for Beneficial Interests within Subtopic 325-40**

Memo Purpose

1. Stakeholders have informed the staff that for beneficial interests within the scope of Subtopic 325-40, Investments—Other—Beneficial Interests in Securitized Financial Assets (originally issued as EITF Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Transferor's Beneficial Interests in Securitized Financial Assets Obtained in a Transfer Accounted for as a Sale"), there are differing views about how an entity might determine a beneficial interest's "contractual cash flows." Determining "contractual cash flows" are necessary for determining whether the beneficial interest should be considered a purchased financial asset with credit deterioration (PCD asset) for estimating credit losses under the guidance in Accounting Standards Update No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*.

2. This memo summarizes the implementation questions and provides staff analyses of those issues. The staff will seek input from members of the Transition Resource Group for Credit Losses (TRG) on these implementation questions.

Questions for TRG members
1. Do the TRG members agree with the staff's views in this memo?

Background

What is a Beneficial Interest?

3. The Master Glossary of the *FASB Accounting Standards Codification*® defines the term *beneficial interests* as follows:

> 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:
>
> a. Senior and subordinated shares of interest, principal, or other cash inflows to be passed-through or paid-through
> b. Premiums due to guarantors
> c. Commercial paper obligations
> d. Residual interests, whether in the form of debt or equity.

4. Beneficial interests are often created through the securitization of a pool of fixed income financial assets. Securitization is a process in which the cash flows and related risks of a group of financial assets are transferred from one entity to another. Mechanically, this is accomplished by aggregating a pool of fixed income financial assets ("the collateral pool"), selling the collateral pool to a special-purpose entity (SPE) established for the sole purpose of securitizing the respective fixed income financial assets, and having this SPE issue new securities collateralized by the collateral pool. These new securities are beneficial interests.

5. Beneficial interests are commonly issued through either a "pass-through structure" or a "tranche structure." In a pass-through structure, one class of beneficial interest is issued by the SPE that passes to the beneficial interest holders all the cash flows and risks associated with the collateral pool. In a tranche structure, multiple classes of beneficial interests (or tranches) are issued by the SPE, which are distinguished by a hierarchy of subordination. These structures will have a predefined cash flow "waterfall" that specifies the order in which principal and interest cash flows will be distributed to each security issued by the SPE.

6. In a typical tranche structure, multiple tranches of securities are issued with defined principal amounts and interest rates and one tranche of securities are issued with the right to receive all cash flows generated by the collateral pool in excess of those that need to be distributed to the securities with the defined principal and interest rates. The tranche receiving excess cash flows is commonly referred to as the residual interest. The residual interest is also the first tranche to experience losses because of credit deterioration in the collateral pool. However, regardless of position within the structure, in all cases the receipt of cash flows each period is dependent upon the performance of the collateral pool that differentiates a beneficial interest from a corporate bond. For that reason, the

cash flows generated by the underlying collateral pool *and* SPEs' waterfall must be considered when determining cash flows related to a beneficial interest.

7. For example, the holder of a 10-year corporate bond with a bullet principal repayment at maturity knows the exact timing and amount of interest and principal cash flows each period, assuming the borrower does not default. However, in a beneficial interest in which the collateral pool is typically prepayable, the cash flows to be received on each beneficial interest are based upon the expected performance of the collateral pool. It is extremely uncommon in a securitization for the entire collateral pool to not experience some level of prepayments and/or defaults.

Accounting for Beneficial Interests

8. The issue raised by stakeholders **is only relevant to beneficial interests within the scope of Subtopic 325-40**. Subtopic 325-40 provides interest income and initial and subsequent measurement guidance for certain beneficial interests that are generally of low credit quality.[1] The discussion in the remainder of this memo will be in the context of these securities.

9. Interest income for beneficial interests subject to Subtopic 325-40 is initially based on the security's *expected cash flows*, which include expectations for all factors that may affect the amount or timing of cash flows, including prepayments and credit. After initial measurement, beneficial interest holders are required to continually update the expectation of cash flows to be collected and reflect that update as either an adjustment to accretable yield or as an other-than-temporary impairment (OTTI), if applicable.

10. The guidance in Update 2016-13 amended the subsequent measurement guidance for beneficial interests. Additionally, the amendments in Update 2016-13 require that certain beneficial interests apply the PCD methodology, which is described in detail in paragraphs 11–17 below.

Purchased Financial Assets with Credit Deterioration

11. The amendments in Update 2016-13 define PCD assets as those assets that, as of the date of acquisition, have experienced a more-than-insignificant deterioration in credit quality since origination.

12. An entity is required to "gross-up" the amortized cost basis of a PCD asset by the estimated amount of credit losses at the date of acquisition (the "PCD methodology"). The "gross-up" is recorded on an

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[1] Specifically, those beneficial interests that do NOT have both of the following characteristics:

(a) They are of high credit quality
(b) They cannot contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment.

asset-by-asset basis to establish the amount of accretable discount. Thus, the discount embedded in the purchase price attributable to credit losses at the date of acquisition is not accreted to interest income, and subsequent improvements in credit do not affect yield. Rather, subsequent improvement or deterioration in credit is recognized through earnings immediately through an adjustment to the allowance for credit losses. Consequently, under the amendments in Update 2016-13, subsequent measurement of credit losses on PCD assets is consistent with originated and non-PCD purchased assets.

13. The Board favored the PCD methodology for assets that, as of the date of acquisition, have experienced a more-than-insignificant deterioration in credit quality since origination because it enhances comparability between PCD assets and originated or non-PCD purchased assets and reduces artificially inflated yields by preventing accretion of credit related amounts into interest income.

Scope of the PCD Methodology for Beneficial Interests Subject to Subtopic 325-40 under Update 2016-13

14. Paragraph 325-40-30-1A of Update 2016-13 requires that an entity apply the PCD methodology to a beneficial interest within the scope of Subtopic 325-40 if it meets either of the following conditions:

    (a) There is a significant difference between **contractual cash flows** and expected cash flows at the date of recognition (Criterion A)

    (b) The beneficial interests meet the definition of purchased financial assets with credit deterioration (Criterion B).

15. Criterion B captures beneficial interests that, at the date of acquisition, have experienced a more-than-insignificant deterioration in credit quality. The Board included Criterion A with the intention of requiring the application of the PCD methodology for certain beneficial interests that have an expectation of credit losses embedded in the cash flows. Importantly, Criterion A was meant to capture beneficial interests that had expected credit losses embedded in the cash flows *at origination* because at origination not enough time has passed for the security to deteriorate in credit quality. In a tranche structure, Criterion A will capture, at a minimum, the residual tranche of a securitization.

16. Residual tranches are the first to absorb credit losses and, therefore, would contain expected credit losses at origination because there is typically an expectation that the ultimate loss amount on the collateral pool will exceed zero. Residual interests are acquired (either at origination or in the secondary market) with the expectation that credit losses, prepayments, and other factors will affect the amount and timing of cash flows; therefore, residual interests are recognized at fair value with the expectation of accreting to expected cash flows. The concept of a par or principal amount does not apply to residual interests. Therefore, the Board noted that these beneficial interests should apply

the PCD methodology at issuance because they did not want subsequent improvements in credit should to affect accretable yield.

17. Determining “contractual cash flows” affects whether an instrument is required to apply the PCD methodology and the subsequent determination of accretable yield. The remainder of this paper focuses on how “contractual cash flows” as used within Subtopic 325-40 should be defined.

Issue: How Should Contractual Cash Flows Be Determined When Assessing Whether a Beneficial Interest Meets Criterion A in Paragraph 325-40-30-1A?

18. To apply Criterion A, preparers would need to perform the following steps:

    (a) Determine expected cash flows

    (b) Determine contractual cash flows

    (c) Compare expected and contractual cash flows to determine whether there is a significant difference; if so, the PCD methodology applies.

19. There is generally no disagreement about how an entity would determine “expected cash flows.” Expected cash flows include assumptions for the holder’s expectations of prepayments, defaults, and any other event that may affect the timing and amount of cash flows to be received.

20. However, stakeholders have informed the staff that there are differing views about how an entity might determine “contractual cash flows” for a beneficial interest subject to Subtopic 325-40 because “contractual cash flows” are not defined within the amendments in Update 2016-13. Furthermore, determining “contractual cash flows” for beneficial interests may be complicated because they may not have predefined cash flows each period like a corporate bond. Stakeholder views differ on whether the determination of cash flows expected to be generated by the collateral pool should incorporate expectations of prepayments.

21. Determining how to compute “contractual cash flows” is important because it will affect whether a beneficial interest meets Criterion A and, therefore, whether it must apply the PCD methodology.

22. The stakeholders who raised this issue have put forth two viable views for determining the final amount of “contractual cash flows” for beneficial interests subject to Subtopic 325-40. Those views include either of the following:

    (a) Contractual cash flows are determined assuming zero credit losses and zero prepayments.

    (b) Contractual cash flows are determined assuming zero credit losses and expected prepayments.

View A: Contractual Cash Flows Are Determined Assuming Zero Credit Losses and Zero Prepayments

23. To apply this view, an entity would determine contractual cash flows by looking to the contractual terms of the security. In instances in which contractual payments of principal and interest are not specified by the security (for example, residual interests), an entity would consider the contractual terms of the underlying loans or assets. Thus, contractual cash flows would represent the stream of cash flows that the investor would receive if the underlying assets do not experience any credit defaults and do not receive any prepayments.

24. Proponents of this view argue that this interpretation of "contractual cash flows" is consistent with a literal interpretation of "contractual cash flows," in that prepayments are not *contractually required*; therefore, the determination of contractual cash flows should not make assumptions for *expected* prepayments.

25. However, opponents of this view point out that if prepayment expectations are not considered when estimating contractual cash flows, most—if not all—securities within the scope of Subtopic 325-40 would be considered PCD assets pursuant to Criterion A because a beneficial interest's expected cash flows and contractual cash flows, when defined in this manner, will typically exhibit significant differences because of prepayments.

26. Thus, prepayments alone may cause beneficial interests for which an entity does not have credit loss expectations to apply the PCD methodology. Opponents of this view note that this was not the Board's intention.

View B: Contractual Cash Flows Are Determined by Assuming Zero Credit Losses and Expected Prepayments

27. To apply this view, an entity would determine contractual cash flows by first looking to the contractual terms of the security. In instances in which contractual payments of principal and interest are not specified by the security (for example, residual interests), an entity would consider the contractual terms of the underlying loans or assets. Additionally, an entity also would consider expected prepayments of the underlying loans or assets for all tranches of beneficial interests. Thus, contractual cash flows would represent the stream of cash flows that the investor would receive if the underlying assets do not experience any credit defaults but prepay in accordance with the entity's expectations at acquisition.

28. Proponents of this interpretation note that this methodology isolates credit risk as the driver behind accounting for the beneficial interests as PCD assets. This result is consistent with the Board's underlying rationale for the PCD methodology, which is to prevent the accretion of a significant *credit discount*, or subsequent improvements in *credit*, into interest income. With this interpretation of "contractual cash flows", prepayment expectations alone could result in a beneficial interest within the scope of Subtopic 325-40 not being considered a PCD asset.

29. Proponents of this view acknowledge that this interpretation of "contractual cash flows" is generally inconsistent with a literal interpretation of "contractual cash flows" in that prepayments are not *contractually required*. However, they note that this interpretation of contractual cash flows is consistent with the current determination of the accretable yield on beneficial interests within the scope of Subtopic 325-40 because the accretable yield is based on expected cash flows. Therefore, considering prepayment estimates in determining "contractual cash flows" would be more consistent with the current interest income methodology within Subtopic 325-40.

Staff Analysis

30. It is the staff's understanding that Criterion A (see paragraph 14 above) was included to capture residual tranches because the Board did not want subsequent improvements in credit in such instruments to cause significant yield adjustments. The Board viewed residual tranches in a manner similar to purchased credit-impaired (PCI) assets subject to guidance in Subtopic 310-30, Receivables—Loans and Debt Securities Acquired with Deteriorated Credit Quality (originally issued as AICPA Statement of Position 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*), because both PCI assets and residual interests have the same yield outcomes. That is, the current accounting for both allows improvements in credit to be recognized through interest income. Therefore, the Board saw no difference between PCI assets and residual interests and wanted to address both in the same manner (that is, through the application of the PCD methodology under the amendments in Update 2016-13). However, it was not the Board's intention to apply a literal meaning of "contractual cash flows" within Criterion A; otherwise, all beneficial interests would be captured by Criterion A and there would be no need for Criterion B. Because the Board included Criterion B, in the staff 's view, Criterion A was not intended to capture all beneficial interests.

31. Therefore, in the staff's view, View B (see paragraph 27 above) is the appropriate application of determining contractual cash flows within Criterion A of paragraph 325-40-30-1A, and the staff agrees with the points described in paragraphs 28 and 29 above. The staff adds that this interpretation would likely result in *only* tranches that are expected to absorb significant credit losses from the collateral meeting Criterion A (without also meeting Criterion B given that Criterion A would capture beneficial interests at the origination of the instrument and not enough time would have passed for deterioration to occur), which is consistent with the Board's intention.

32. Furthermore, this view is consistent with how entities consider contractual cash flows under current guidance in Subtopic 310-30. Subtopic 310-30 uses the term *contractually required payments receivable*, which is defined under the Master Glossary of the Codification as follows:

> The total undiscounted amount of all uncollected contractual principal and contractual interest payments both past due and scheduled for the future, *adjusted for the timing of prepayments*, if considered, less any reduction by the investor. For an acquired asset-backed security with required contractual payments of principal and interest, the contractually required payments receivable is represented by the contractual terms of

> the security. However, when contractual payments of principal and interest are not specified by the security, it is necessary to consider the contractual terms of the underlying loans or assets. [Emphasis added.]

33. The term *contractually required payments receivable* under Subtopic 310-30 (which is being superseded by the amendments in Update 2016-13) serves the same purpose as the term *contractual cash flows* under Subtopic 325-40; that is, to determine the instruments that are expected to experience credit losses and to determine accretable yield. It is the staff's view that the Board intended for the term *contractual cash flows* within Subtopic 325-40 of the amendments in Update 2016-13 to have the same meaning as the term *contractually required payments receivable*.

34. Additionally, in applying this definition to beneficial interests, the staff notes that it would be appropriate to consider prepayments in determining *contractual cash flows* because the current interest income methodology for beneficial interests considers prepayments. That is, because prepayments are considered to determine interest income for beneficial interests under Subtopic 325-40, using those same assumptions to determine *contractual cash flows* for assessment under Criterion A would be appropriate.