Evaluating securitisation SPEs for consolidation under US GAAP and IFRS
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Evaluating the accounting implications of a securitisation often requires navigating different accounting rules, to assess potential consolidation of the securitisation special purpose entity (SPE) and derecognition of the financial assets transferred by the transferee (seller) to the SPE.

Analysing consolidation of the SPE is often complex and subject to a significant level of judgment. Careful evaluation of all facts and circumstances and a full understanding of the substance of the transaction, including power, risks and rewards, role of and fees paid to decision makers, and rights held by investors, are critical considerations. They directly impact the outcome of the analysis and whether the securitisation must be consolidated by the transferee or one of the investors.

This article analyses the latest developments affecting consolidation rules for securitisations, in relation to:

- Who must consolidate the SPE under Generally Accepted Accounting Principles in the US (US GAAP).
- The US Financial Accounting Standards Board (FASB) proposal to change its consolidation rules.

WHO MUST CONSOLIDATE THE SPE UNDER US GAAP

US GAAP consolidation rules for SPEs in securitisations are set out in ASC 810, Consolidation (see www.iasplus.com/en-us/standards/fasb/broad-transactions/asc810). In particular, the variable interest entity (VIE) subsections (formerly known as Statement of Financial Accounting Standards No. 167, Amendments to FASB Interpretation No. 46(R) (FAS 167)).

FASB’s changes to its consolidation guidance

A project to reform consolidation guidance began with joint deliberations between the FASB and the International Accounting Standards Board (IASB) in 2009. However, the FASB and IASB subsequently decided to continue their deliberations on the project separately.

- The IASB issued IFRS 10 in May 2011 (see below, Consolidation guidance under IFRS).
- The FASB issued ASU 2015-02 in February 2015.

FASB amendments to consolidation guidance. In February 2015, the FASB (www.fasb.org) issued ASU 2015-02 (FASB Accounting Standards Update No. 2015-02, Amendments to the Consolidation Analysis), which amends the consolidation requirements in ASC 810. The amendments could significantly change a reporting entity's consolidation conclusions. Specifically, the amended guidance will affect an entity's evaluation of whether:

- The fees it receives from managing a fund or asset-backed financing structure should result in the consolidation of the entity.
- Limited partnerships and similar entities should be consolidated.
- Variable interests held by the reporting entity’s related parties or de facto agents affect its consolidation conclusion.

In addition, it is expected that under the amended guidance, many limited partnerships will be VIEs and may be subject to the VIE disclosure requirements, regardless of whether they are consolidated.

Of these amendments, changes to how variable interests held by the reporting entity’s related parties and fees paid to a decision maker or service provider impact the consolidation analysis under ASC 810 are expected to have the greatest impact on the securitisation industry. Specifically, ASU 2015-02 could significantly change the consolidation conclusions related to collateralised financing entities (CFEs), including collateralised debt obligation entities (CDOs) and collateralised loan obligation entities (CLOs).

Accordingly, all reporting entities need to re-evaluate their previous consolidation conclusions in light of their involvement with:

- Current VIEs.
- Decision-maker or service-provider fee arrangements.
- Limited partnerships not previously considered VIEs.
- Entities previously subject to the deferral in ASU 2010-10.

For calendar-year public business entities, ASU 2015-02's guidance is effective January 1, 2016. For calendar-year entities other than public business entities, the ASU 2015-02's guidance is effective for annual periods beginning after 15 December 2016, and interim periods beginning after 15 December 2017 (that is, 1 January 2017 for calendar-year entities). Early adoption of ASU 2015-02 is permitted for all entities but the guidance must be applied as of the beginning of the annual period containing the adoption date.

VIEs

Not all SPEs are VIEs, but securitisation SPEs are generally 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 SPE.
- Often, the total equity investment at risk is not sufficient to permit the SPE to finance its activities without additional forms of credit enhancement or other financial support.
- If an SPE does not issue voting or similar interests or if the equity investment is insufficient, its activities are probably predetermined or decision-making ability is determined contractually.
Securitisation SPEs are generally VIEs, because they are:

- Typically insufficiently capitalised, with little or no true “equity” for accounting purposes.
- Rarely designed to have a voting equity class possessing power to direct the activities of the SPE.

Investments or other interests that absorb portions of a VIE’s expected losses or receive portions of its expected residual returns are called variable interests.

After the issuance of FASB 167 in 2009, the FASB deferred the amended consolidation model for certain investment funds. For these entities, it chose to retain the prior risk and rewards consolidation model, commonly known as FASB Interpretation No. 46R, Consolidation of Variable Interest Entities (FIN 46R). However, securitisation SPEs and asset-backed financing entities, such as CLOs, were specifically excluded from the scope of the deferral, and therefore apply a hybrid consolidation model. ASU 2015-02 eliminated the deferral under ASU 2009-17 (FASB Accounting Standards Update No. 2009-17, Improvements to Financial Reporting by Enterprises Involved With Variable Interest Entities (formerly Statement 167)) for investments in certain investment funds. Therefore, financial institutions, general partners, and investors in these investment funds and SPEs will need to perform a different consolidation evaluation.

Primary beneficiary

Controlling financial interest. ASC 810 requires identifying “the primary beneficiary”, which is the party that must consolidate the VIE. The primary beneficiary is the party that has a “controlling financial interest”, because it has both:

- The power to direct the activities of a VIE that most significantly impact the VIE’s economic performance.
- 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.

In a manner consistent with current guidance in US GAAP a reporting entity would be considered the primary beneficiary of a VIE when it has met the power and economics conditions, as described above. Further, as discussed below, ASU 2015-02 amended the evaluation of the economics condition to exclude a decision-maker or service provider fees if the fees are commensurate and “at market”.

Related parties. Under ASU 2009-17 (amendments to this guidance can be found in ASC 810 and ASU 2015-02) if there is a related-party relationship, each party in the related-party group must first determine whether it has the characteristics of a controlling financial interest (ASC 810-10-25-36A) in the VIE.

The term “related parties” includes those parties identified as related parties in ASC 850, and certain other parties described in ASC 810-10-25-43 that are considered de facto agents of the reporting entity.

ASU 2015-02 significantly amends how variable interests held by a reporting entity’s related parties or de facto agents affect its consolidation conclusion, but continues to retain the current requirement that each party in a related-party group must first determine whether it has the characteristics of a controlling financial interest (ASC 810-10-25-38A) in a VIE. The new consolidation guidance also retains the guidance prohibiting parties in a related-party group (including de facto agents) from concluding that they do not individually have these characteristics because they consider the power to be shared among them. If power is not shared and the related-party group as a whole has the characteristics of a controlling financial interest, the reporting entity must consider the factors in ASC 810-10-25-44 to determine which party in the group must consolidate the VIE (this analysis is commonly referred to as the “related-party tiebreaker test”).

If there is a single decision maker, the related-party tiebreaker test would be performed only by parties in the decision maker’s related-party group that are under common control and that together possess the characteristics of a controlling financial interest. In this situation, the purpose of the test would be to determine whether the decision maker or a related party under common control of the decision maker is required to consolidate the VIE. This is a significant change from the current consolidation requirements, under which an entity performs the related-party tiebreaker test even if the related parties (or de facto agents) are not under common control.

Finally, if neither the decision maker nor a related party under common control is required to consolidate a VIE, but the related-party group (including de facto agents) possesses the characteristics of a controlling financial interest, and substantially all of the VIE’s activities are conducted on behalf of a single entity in the related-party group, that single entity would be the primary beneficiary of the VIE.

These amendments are expected to have a significant impact on how a collateral manager considers interests held by its related parties or de facto agents when evaluating whether a decision making arrangement is a variable interest. When a collateral manager evaluates its economic exposure to a VIE (ASC 810-10-35-37(c)), it should consider its direct interests in the CFE together with its indirect interests held through its related parties (or de facto agents) on a proportionate basis unless the related party is under common control with the collateral manager. For example, if a collateral manager owns a 20% interest in a related party and that related party owns 40% of the residual tranche of the CFE being evaluated, the collateral manager’s interest would be considered equivalent to an 8% direct interest in the residual tranche of the CFE.

By contrast, if a collateral manager has an indirect interest in a CFE through a related party that is under common control (that is, the collateral manager holds a direct variable interest in the related party under common control), it must include the related party’s entire interest in its evaluation of its economic exposure rather than just its proportionate share. In addition, even if the collateral manager does not have an interest in the related party under common control, it would generally include the related party’s entire interest in its evaluation of its economic exposure. For example, if a collateral manager’s related party that is under common control owns 40% of the residual tranche of the CFE being evaluated, the collateral manager would generally include the entire 40% interest in the CFE’s residual tranche held by its related party when evaluating its economic exposure even though the collateral manager does not hold an interest in its related party.

If power is "shared". Parties in the related-party group (including de facto agents) cannot conclude that power is shared. Instead, they must identify one of the parties as the primary beneficiary of the VIE if power is considered "shared".

ASC 810 provides the following four criteria to consider in making this assessment:

- The existence of a principal-agency relationship between parties in the related-party group.
- The relationship and significance of the activities of the VIE to the various parties in the related-party group.
- A party’s exposure to the expected losses of the VIE.
- The design of the VIE.

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Are fees paid to decision makers variable interests?

Under current guidance in US GAAP, six criteria must be met before a reporting entity can conclude that a decision maker’s or service provider’s fee does not represent a variable interest:

- (a) The fees are compensation for services provided and are commensurate with the level of effort required to provide those services.
- (b) The fees are not subordinate to normal operating liabilities.
- (c) The service provider/decision maker has no other direct or indirect interests that expose it to more than an insignificant amount of variability.
- (d) The arrangement includes terms that are customary in nature.
- (e) The total amount of the anticipated fee is insignificant relative to the total anticipated economic performance.
- (f) The fee arrangement absorbs only an insignificant amount of variability relative to anticipated economic performance.

ASU 2015-02 eliminates the criteria related to the fee’s priority level (ASC 810-10-55-37(b)) and significance (ASC 810-10-55-37(e) and (f)). In addition, ASU 2015-02 amends 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 its decision-making arrangement represents a variable interest, on the basis of its relationship with the related party.

Under the ASU 2015-02, the evaluation of whether fees paid to a decision maker or service provider are a variable interest focuses on whether:

- The fees are compensation for services provided and are commensurate with the level of effort required to provide those services (commensurate) (ASC 810-10-55-37(a)).
- The decision maker or service provider has any other interests (direct, indirect interests through its related parties, or most interests held by its related parties under common control) in the entity that absorb more than an insignificant amount of the VIE’s variability (ASC 810-10-55-37(c)).
- The arrangement includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm’s length (at market) (ASC 810-10-55-37(d)).

As a result, it is expected that fewer fee arrangements will be considered variable interests.

Under ASU 2015-02, interests held by a decision maker’s or service provider’s related parties (or de facto agents) that are not under common control would only 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 entity through its related party on a proportionate basis. In contrast, interests held by a decision maker’s or service provider’s related parties (or de facto agents) that are under common control would generally be included in the evaluation of whether the decision maker’s or service provider’s fee arrangement represents a variable interest, regardless of whether the decision maker or service provider has an interest in the related party.

The determination of whether a reporting entity is required to consolidate a VIE under ASU 2015-02 focuses on whether the financial institution has both:

- The power to direct the activities that most significantly affect the economic performance of the VIE (power condition).
- A potentially significant interest in the VIE (economics condition).

Although ASU 2015-02 does not amend the existing threshold for evaluating whether a reporting entity meets the economics condition, under the new consolidation requirements, if the fees paid to a VIE’s decision maker are commensurate and at market, they should not be considered in the evaluation of the decision maker’s economic exposure to the VIE regardless of whether the reporting entity has other economic interests in the VIE. Under this new requirement, certain structures that were consolidated as a result of the significance of the fee arrangement would potentially need to be deconsolidated.

For example, a manager of a CLO or CDO entity that receives a junior or subordinated fee may no longer have a variable interest in the entity if the manager does not have any other interests in the entity and the remaining criteria in ASC 810-10-55-37 are not met. Historically, the criteria related to subordination of the fees often resulted in a conclusion that the CLO or CDO manager’s fee arrangement was a variable interest. This is because a collateral manager’s fees are typically structured with a portion at the top of the waterfall (senior fee), a portion at the bottom of the waterfall (subordinated fee), and an additional “contingent” management fee if the CFE performs well (incentive fee). Under US GAAP before ASU 2015-02, the collateral manager’s decision-making arrangement is often deemed to be a variable interest because it does not meet ASC 810-10-55-37(b) above, under which the fees received must not be subordinated. Further, if an incentive fee is present, the arrangement may not meet ASC 810-10-55-37(e) or (f).

In addition, excluding the fee arrangement from the evaluation of the economics condition increases the likelihood that CLOs or CDOs will be deconsolidated, particularly if a financial institution does not hold any other interests in the entity.

While fewer fee arrangements will be considered variable interests under ASU 2015-02, a reporting entity should carefully evaluate whether an arrangement exposes it to risk of loss. Under the ASU, if the fee arrangement includes compensation for assuming the risk of loss in the legal entity, the arrangement would automatically be a variable interest. For example, a fee arrangement that exposes the financial institution to the underlying credit of the financial assets transferred to a securitisation (the risk the trust was designed to pass on to its variable interest holders) would be considered a variable interest even if it meets all the criteria in ASC 810-10-55-37.

If a reporting entity determines that a fee paid to a decision maker or service provider is a variable interest, the interest will usually represent either:

- An obligation to absorb losses of the SPE.
- A right to receive benefits from the SPE that could be significant to the SPE.

Therefore, in many cases, the decision maker or service will often consolidate the SPE.

**CONSOLIDATION GUIDANCE UNDER IFRS**

IFRS (www.ifrs.org) no longer provides specific guidance for SPEs used in securitisations (this was previously included in Standing Interpretations Committee Interpretation - 12, Special Purpose Entities (SIC 12)).

IFRS 10, issued in 2011 and effective for annual periods beginning on or after 1 January 2013, provides the consolidation guidance under IFRS for all types of entities. This is a key distinction between
IFRS and existing US GAAP, which provides specific consolidation rules for variable interest entities partnerships and similar entities, and voting interest entities.

**Whether an investor controls the SPE**

The investor (which, in this article, includes the transferor), regardless of the nature of its involvement, must:

- Assess the investee entity (the SPE) for consolidation.
- Consolidate the SPE, if it determines that it has control over it.

**Three elements of control**: Investors have control over SPEs, if they have the following three elements of control (see box, investors and SPEs: three elements of control):

- **Power over the SPE**: whether the investor has the right to control the relevant activities of the SPE. Relevant activities are those that most significantly impact the SPE's returns.
- **Exposure to variable returns**: whether the investor is exposed, or has rights, to variable returns due to its involvement with the SPE. These returns can be positive or negative, and vary due to the SPE's performance.
- **The ability to use its power over the SPE to affect the amount of the investor's returns**.

IFRS 10 provides further guidance for determining whether the three elements of control exist over the SPE:

- The purpose and design of the SPE.
- The relevant activities of the SPE and how decisions about those activities are made.
- Whether the investor's rights give it the current ability to direct the relevant activities.
- Whether the investor is exposed, or has rights, to variable returns from its involvement with the SPE.
- Whether the investor has the ability to use its power over the SPE to affect the amount of the investor's returns.

An investor must consider all facts and circumstances in assessing whether it controls an SPE. In practice, determining who controls an SPE can be complex. Further:

- These elements of control do not depend on voting rights. Various SPEs are created for securitisations that have relevant activities controlled by means outside voting rights (see below, Decision making).
- Investors need to make this determination on a continuous basis. Investors may consolidate or deconsolidate an entity as circumstances change over time, or due to an event after the initial set-up of the SPE.
- Investors need to be aware of their relationships with other parties that may be involved with the SPE.

**Power over the SPE**: Power exists when the investor has existing rights that give it the current ability to direct the activities that significantly affect the SPE's returns ("relevant activities"):

- Rights to direct the relevant activities do not need to be exercised to provide an investor with power.
- If two or more investors have rights to direct different relevant activities, the investors must decide which of the relevant activities most significantly affect the returns of the SPE.
- Many securitisation entities are created so that many of their operations are pre-determined. Most rights, obligations and other activities are determined by the contractual arrangements governing the SPE. However, having pre-determined activities is not the same as having no relevant activities.

- Often, the relevant activities of an SPE are contingent on some change in circumstances. For example, many SPEs use asset servicers that engage in primarily administrative functions that are not relevant activities. However, if the underlying assets held by the SPE enter default or are otherwise under distress, a "special servicer" may take over responsibility for those assets, to maximise collection on the distressed assets. The activities of the special servicer and its decisions will usually be relevant activities for that SPE. The right to make those decisions exists, whether or not the event occurs.

**Decision making**: Most SPEs are expected to have some sort of decision making that relates to relevant activities of the SPE, even though to some extent the decision making is pre-determined by the contractual agreements. However, an SPE could be designed so that there are no decisions made relating to its relevant activities.

A careful assessment must be made when determining whether the investor's involvement in the design of the SPE is sufficient for the investor to have power over the SPE's relevant activities:

- Many parties are typically involved at that stage, and they must all agree to execute the transaction.
- Understanding the purpose and design of an SPE is the means by which an investor identifies the relevant activities, the rights from which power arises and who holds those rights. It can also assist in identifying investors that may have sought to secure control and whose position should be understood and analysed when assessing control.

Therefore, it is possible that control was established during this stage of the SPE's existence.

An SPE operating in a largely pre-determined 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 pre-determined parameters may need to be taken when that return fails to materialise. For example, for a portfolio of:

- High quality receivables, a decision on how to pursue recovery in the event of default.
- Debt securities, a decision to change the criteria for investment to permit investment in, say, AA securities, if the number of AAA-rated issuers diminishes.
- Equity investments, a decision to sell or hold an investment in the event of a significant, unexpected fall in value.
- Property interests, a course of action in the event of default by a blue-chip tenant or significant physical damage to a property.

Such decisions significantly affect the returns of the SPE, and are therefore relevant activities of the SPE. Consequently, the analysis of who has power over the SPE should include the ability to make those decisions.

**Whether a decision maker is principal or agent**

When an entity with decision-making rights (a decision maker) is considering whether it controls an SPE, it must determine whether it is a principal or agent.

Similarly, an investor must determine whether another entity with decision-making rights is acting as an agent for the investor.

A decision maker is an agent when it is primarily engaged to act on behalf and for the benefit of another party or parties (that is, the principal(s)). Such a decision maker does not control the SPE when it exercises its decision-making powers. However, a decision maker is not an agent simply because other parties can benefit from the decisions that it makes.

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Sometimes a principal’s power may be held and exercisable by an agent, but on behalf of the principal. An investor may delegate its decision-making authority to an agent on some specific issues, or on all relevant activities:

- When assessing whether it controls an investee, the investor should treat the decision-making rights delegated to its agent as held by the investor directly.
- When there is more than one principal, each principal should assess whether it has power over the investee.

**Whether rights are substantive.** For a right to be substantive, the holder must have the practical ability to exercise that right. Determining whether rights are substantive requires the exercise of judgment, taking into account all facts and circumstances. IFRS 10 sets out a number of factors that an investor should consider in assessing whether rights are substantive (the list is not exhaustive):

- Whether there are any barriers (economic or otherwise) that prevent the holder (or holders) from exercising the rights.
- When the exercise of rights requires the agreement of more than one party or, when the rights are held by more than one party, whether there is a mechanism for those parties to exercise their rights collectively.
- Whether the party or parties that hold the rights would benefit from the exercise of those rights.

In addition, for a right to be substantive, it must be exercisable when decisions about the direction of the relevant activities have to be made (that is, it is necessary to consider the timing of a removal right when assessing whether it is substantive).

**The overall relationship.** In all other circumstances, to determine whether it is an agent, the decision maker must consider the overall relationship between itself, the SPE, and other parties involved with the SPE. In particular, all the following factors should be considered:

- The scope of the decision maker’s decision-making authority over the SPE.
- The rights held by other parties.
- The remuneration to which the decision maker is entitled in accordance with the remuneration agreement(s).
- The decision maker’s exposure to variability of returns from other interests that it holds in the SPE.

All available facts and circumstances should be taken into account in making the assessment. Depending on the specific facts and circumstances, a particular factor may be a stronger indicator of an agency relationship than others.

**Remuneration.** Another key aspect is the remuneration received by the decision maker. The greater the magnitude and variability of its remuneration relative to the returns expected from the SPE, the more likely the decision maker is a principal. The decision maker should also consider whether:

- Its remuneration is commensurate with the services provided.
- The remuneration agreement includes only terms, conditions or amounts that are customarily present in arrangements for similar services and level of skills negotiated on an arm’s length basis.

A decision maker cannot be an agent unless the two conditions above are present. However, these two factors alone are not sufficient to conclude that the decision maker is an agent. The purpose of considering these two factors is to determine whether the remuneration for the decision maker is merely compensation for its services as an agent.

When a party holds a substantive right to remove the decision maker without cause, this is sufficient to conclude that the decision maker is an agent. When this is the case, it is not necessary to consider other factors (such as remuneration), so the conditions above need not be present.

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