

The Deloitte logo is positioned in the top left corner. The background of the entire page is a modern office interior with two blue armchairs and a small table with a plant, set against a large window overlooking a city skyline at sunset. Overlaid on this scene are several abstract graphic elements: a grid of small blue dots on the left, a series of larger blue and green circles and lines forming a path across the center, and a vertical column of green circles on the right.

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## Chapter 5

How about some examples?

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**Private label residential mortgage-backed securities (RMBS)—the traditional two-stepper**

"Private label" (i.e., nongovernmental-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 SPE. The depositor, which traditionally has been consolidated with the 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 the originator is the servicer? What happens if the originator holds the bottom classes or if the originator holds the bottom classes and is the servicer?**

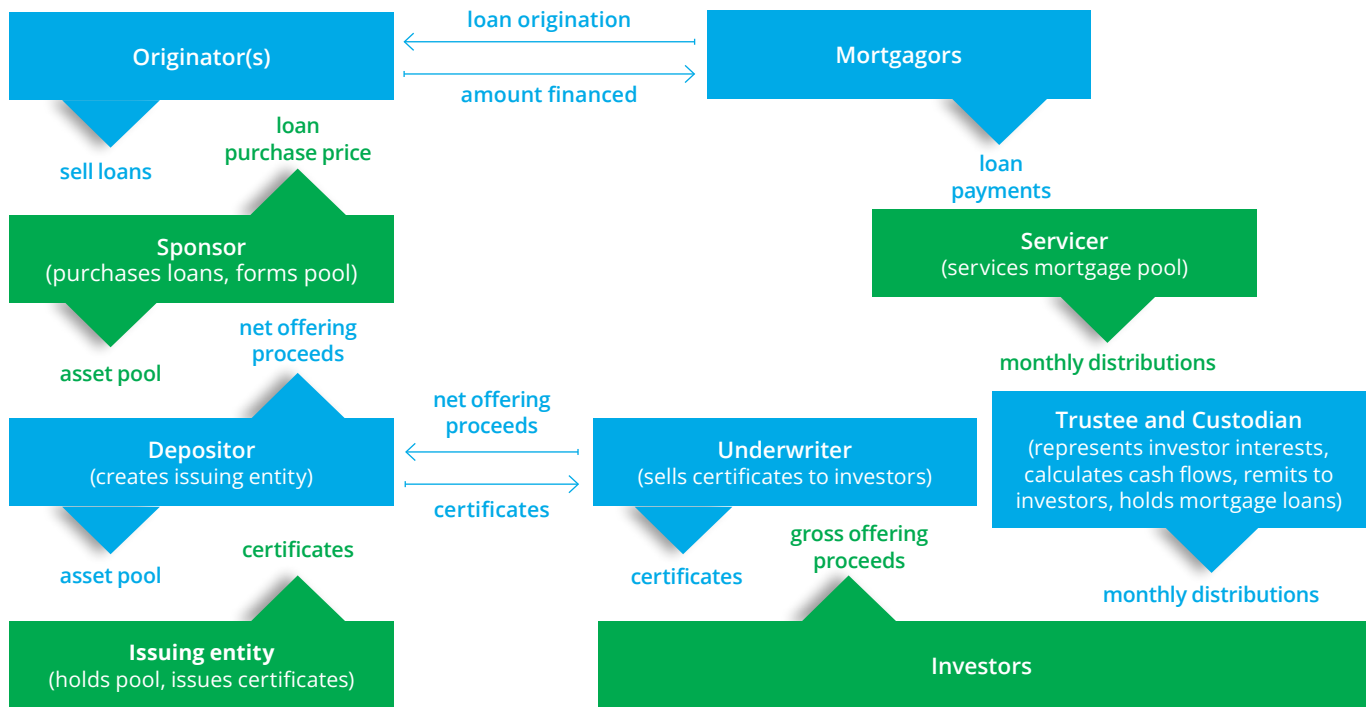
**US GAAP analysis**

In most securitizations, the 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 has 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 sponsor retains the servicing function, for which it receives a fee. A 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 sponsor holds the equity tranche or the servicing fees paid to the sponsor are not commensurate and at market.<sup>1</sup> On the other hand, the fees would not be a variable interest if the sponsor: (1) receives fees commensurate with the level of effort required to provide services, (2) the 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.



<sup>1</sup> 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.

With respect to activities that would most significantly impact the economic performance of the issuer, in practice many believe that the default-management function has the most significant impact on the economic activities of the trust. In 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 sponsor retains the servicing function and holds other variable interests that absorb more than an insignificant amount of the expected losses or receive more than an insignificant amount of the expected residual returns, the servicing arrangement would be identified as a variable interest. 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).<sup>2</sup> 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.

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 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) the fee arrangement is a variable interest. This serves as a safeguard to ensure that if the fee 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.

<sup>2</sup> 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).



**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.

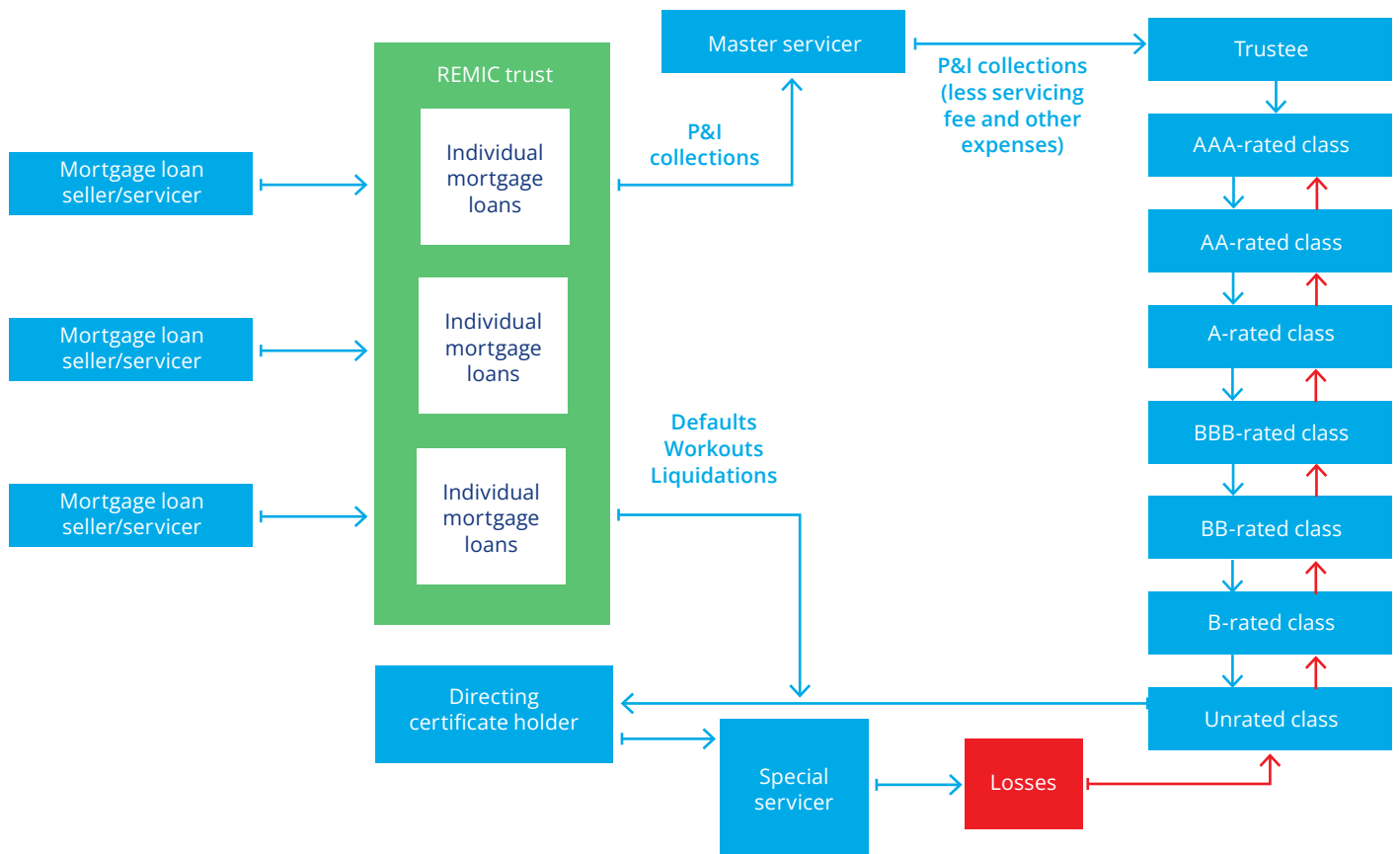
As noted above, in a private label RMBS, default management is typically the activity that most significantly impacts the economics of the trust. And the servicer, which is generally the sponsor, is typically the one responsible for default management. So, the servicer meets the first criterion, but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

Under IFRS 10, servicing fees are considered exposure to variable returns. When assessing the ability to utilize power to influence returns, it includes an assessment as to whether the servicer 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 the third criterion. 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.

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

Like their RMBS cousins, CMBS 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 (REMIC) trust. However, given the complexities of working out troubled commercial mortgages and managing the underlying properties, CMBS transactions also typically include a special servicer should the obligor default.



Typically, CMBS 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/master servicer.

When a loan is assigned to the special servicer, a range of responses are available. Absent any external constraints, the possible special servicer responses fall into the following general categories: (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).

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 also may, but does not always, 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 generally represent a variable interest.

In this example, since the special servicer is both holding a subordinate position in the transaction and managing defaulting assets, the special servicer (and absent any kick-out rights held by a single noteholder), may be the primary beneficiary. Under IFRS 10, the special servicer would also have power and the combination of the fee, and the significant subordinated interest would likely lead to the conclusion that the special servicer is a principal in the transaction and likewise consolidate.

Many CMBS transactions also have the concept of a controlling classholder, and this controlling classholder may have the discretion to remove the special servicer. The special servicer may or may not hold the controlling class of bonds. In many instances, the controlling class is junior in the capital structure, such that losses over time erode that interest and the next most senior class of notes becomes

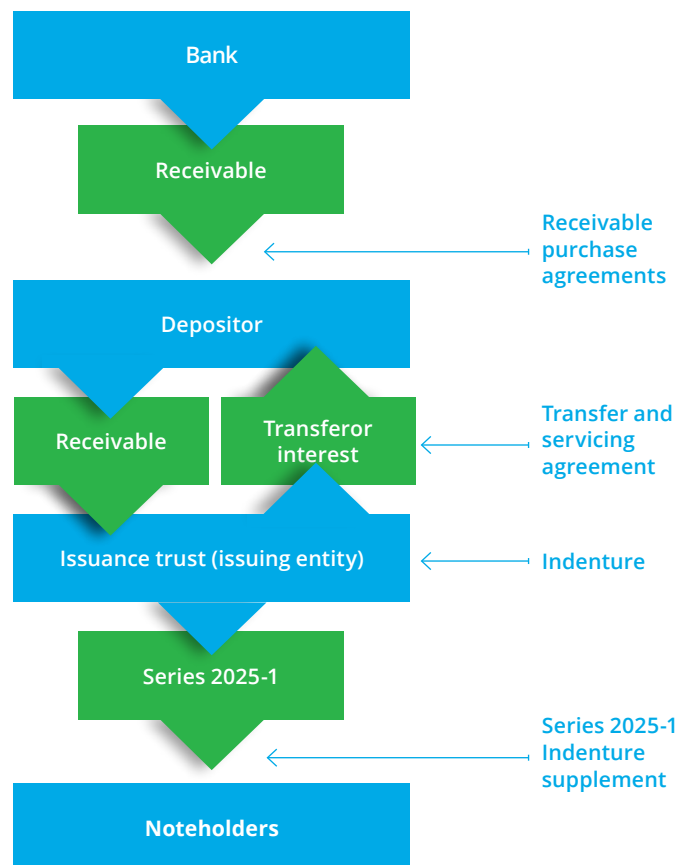
the controlling class. In these cases, the continual assessment of the primary beneficiary required by both GAAP and IFRS may result in the identification of a new party becoming the primary beneficiary, assuming the next, more senior class of notes, was held by a single party or effectively controlled by a single party.

In the event that a special servicer did not hold any of the bonds and its fees meet certain criteria, the special servicer may not have a variable interest in the VIE, and it could not be the VIE's primary beneficiary, and it may be considered to be an agent of other variable interest holders.

**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 SPE 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 a 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.

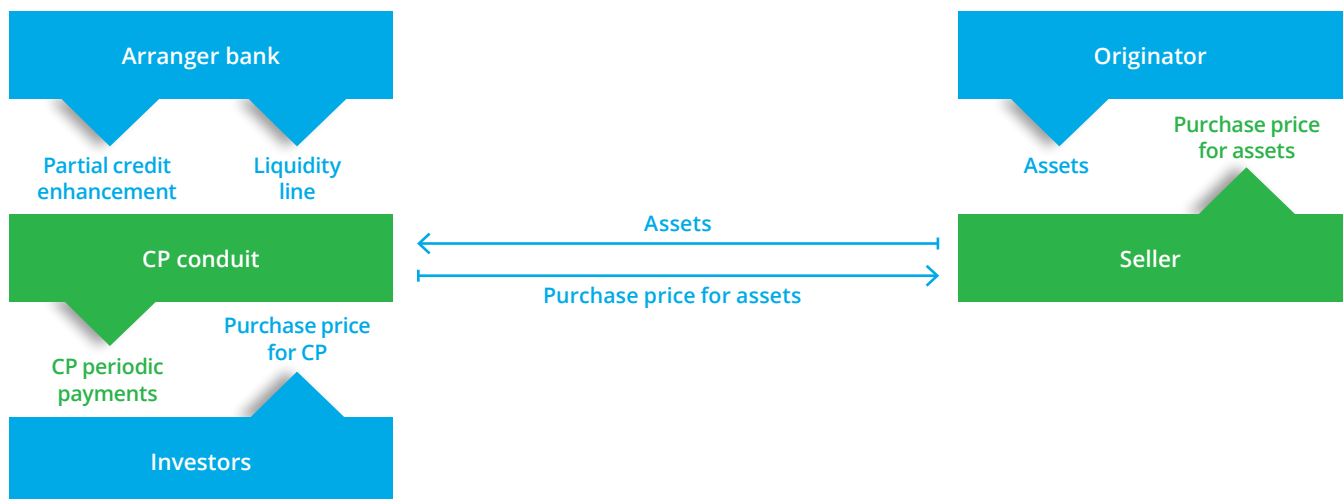
Currently, because most credit card securitizers retain servicing as well as the account relationship with the customers, and have variable interests in the master trust through its seller's interest, interests in cash collateral accounts, IO strip, and servicing fee, the credit card bank would be identified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

### Asset-backed CP 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. However, 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 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.

### Asset-backed CP conduits



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;

CP conduits, typically arranged/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.

### **What is the originator's accounting analysis for revolvers?**

A typical originator of trade or other receivables in a revolving securitization (the "Originator" in the above diagram) will first transfer the financial assets to a bankruptcy-remote SPE (the "seller" in the above diagram).

Those 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 that the 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 seller**

Because of the overcollateralization required by the CP conduit, the seller 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 seller would be consolidated by the originator 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 seller's activities through retention of servicing. Because the seller is consolidated, the consideration focuses on the accounting for the transfer of interests in the receivables to the conduit.

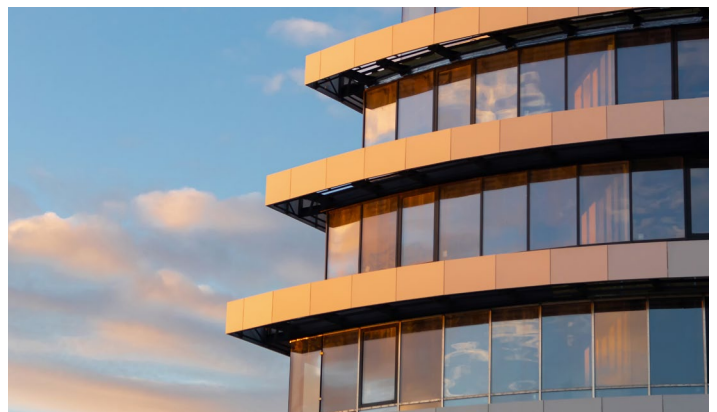
### **Consolidation of the conduit**

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 arranger 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.

There are exceptions to this general conclusion. As originators have continuing involvement with the transferred assets, they 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 ... 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 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 then 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 violates 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 sale accounting 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 seller to prepay the conduit at any time. By definition, the seller 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 seller to use the proceeds to pay off existing commercial paper—this trade would leave the seller and the conduit in the same position. Using cash from collections is a logical thing for the seller 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 seller 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.

**IFRS**

Proceeding through the [IFRS 9 derecognition decision tree](#), the first thing to consider (after considering consolidation of subsidiaries) 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, [IFRS 9 derecognition decision tree](#) 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

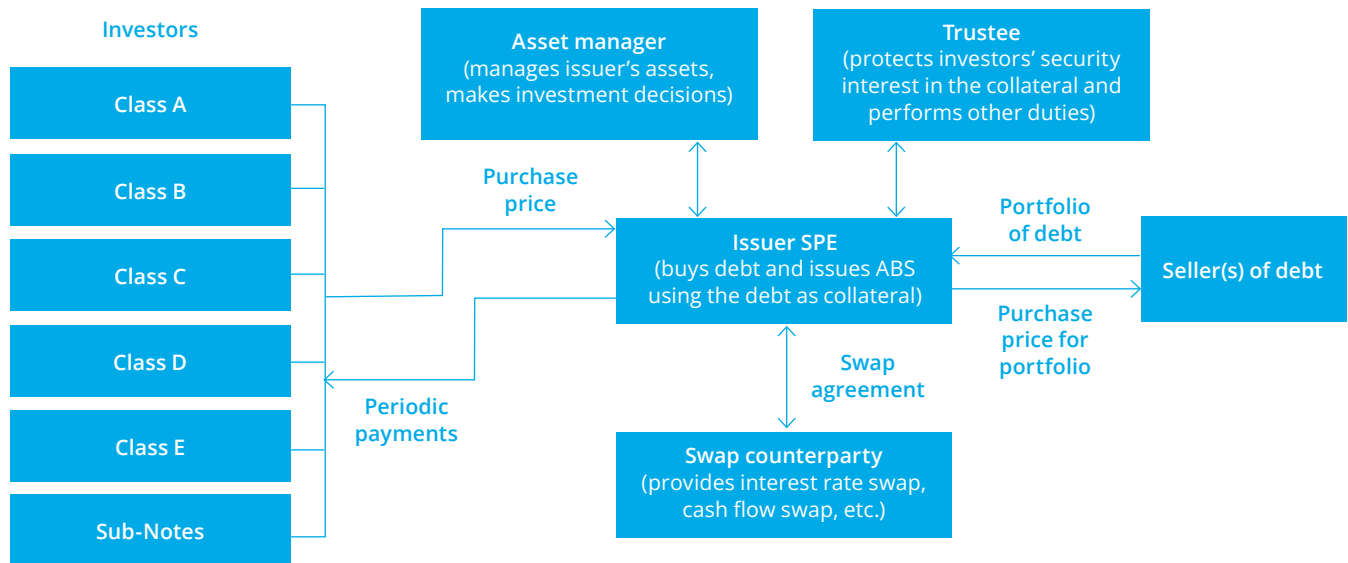
flows back to the investors poses an inherent problem for structures of a revolving nature, where the cash collections are reinvested back into the pool of receivables rather than returned to investors.

Such structures do not meet the pass-through tests in IFRS 9 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 is consistent with discussions of the International Financial Reporting Interpretations Committee (IFRIC).<sup>3</sup>

**CLOs: What's an asset manager to do?**

CLOs are unique securitizations in that there is not a transfer of assets to an 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.

**Will the collateral manager consolidate the CLO?**



<sup>3</sup> A summary of the IFRIC discussion can be found here: <https://www.iasplus.com/en/meeting-notes/ifrs-ic/not-added/2005/ias-39-revolving-structures>.



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.

### **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 is 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 subordinated notes; 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 subordinated notes. The fees would not be a variable interest if the asset manager was receiving fees commensurate and at market, did not hold the equity tranche, and did not indirectly absorb economics through its related parties 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 needs to consolidate the CLO under GAAP. Accounting for a consolidated CLO has its own complications. See [chapter 9](#) for a discussion on consolidating a collateralized financing entity, where the assets and liabilities are measured at fair value.

The GAAP evaluation of whether fees paid to a decision-maker or service provider constitute a variable interest has been simplified over time. Whereas the old model in FIN 46R 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 current model deemphasizes those 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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