

Interagency Advisory on the Accounting Treatment of Accrued Interest Receivable Related to Credit Card Securitizations

Purpose

The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) (collectively, the agencies) are issuing this advisory to clarify the appropriate accounting treatment for banks and thrift institutions (institutions) that securitize credit card receivables and record an asset commonly referred to as Accrued Interest Receivable (AIR).¹ The guidance contained in this issuance is consistent with generally accepted accounting principles (GAAP) as specified in Financial Accounting Standards Board Statement No. 140, “Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities” (FAS 140), and is applicable to institutions preparing regulatory reports filed with the federal banking agencies.² The agencies consulted with the staffs of the Financial Accounting Standards Board (FASB) and the Securities and Exchange Commission (SEC) in developing this guidance.

The AIR asset represents the transferor’s (seller’s) subordinated retained interest in cash flows that are initially allocated to the investors’ portion of a credit card securitization. Prior to the securitization transaction, the transferor directly owns a pool of credit card receivables, including the right to receive all of the accrued fees and finance charges on those receivables. However, through the securitization process, the seller’s right to the cash flows from the collection of the accrued fees and finance charges generally is subordinated to the rights of the other beneficial interest holders.

This guidance clarifies that, when the seller’s right to the AIR cash flows is subordinated as a result of a credit card securitization, the seller generally should include the AIR as one of the financial components in the initial accounting for the sale of credit card receivables in a securitization and in computing the gain or loss on sale. As a result, after a securitization, the allocated carrying amount of the AIR will typically be lower than its face amount. Consistent with the agencies’ May 17, 2002, regulatory capital guidance, the seller should treat this asset as a subordinated retained interest (beneficial interest). In addition, an institution should account for the AIR separately from loans, and report it in “Other Assets” in the institution’s regulatory reports.

¹ For information and guidance on the regulatory capital treatment of the AIR asset, see the “Interagency Advisory on the Regulatory Capital Treatment of Accrued Interest Receivable Related to Credit Card Securitizations,” dated May 17, 2002.

² These regulatory reports include the bank Consolidated Reports of Condition and Income (Call Report), and the Thrift Financial Report (TFR).

Institutions should ensure that they are following the accounting guidance described in this advisory. If an institution has not followed this accounting approach in the past, it should adopt it in the next regulatory report that it files and in all subsequent reports. Institutions that have been properly accounting for the AIR are expected to continue to do so.

Background

Creation of the Accrued Interest Receivable Asset

In a typical credit card securitization, an institution transfers a pool of receivables and the right to receive the future collections of principal, finance charges, and fees on the receivables to a trust. If a securitization transaction qualifies as a sale under FAS 140, the selling institution removes the receivables that were sold from its reported assets and continues to carry any retained interests in the transferred receivables on its balance sheet.

Many credit card securitizers recognize accrued fee and finance charge income on the investors' portion of the transferred credit card receivables (the AIR) as a receivable due from customers, even though the right to receive this income, if and when collected, has been transferred to the trust. An AIR asset reflecting the amount due from the trust is typically reported throughout the life of the securitization because the seller continually transfers new receivables to the trust to replace receivables held by the trust that have been repaid or written off.

Subordination of the Accrued Interest Receivable Asset

The accounting for the securitization of credit card receivables depends upon the terms and requirements of the specific securitization structure. Although some terms and requirements of individual structures vary, most credit card securitizations provide similar credit enhancements to investors and should be accounted for in a similar manner.³ Typically, the seller transfers receivables to the trust consisting of loan principal (credit card purchases and cash advances) as well as accrued fees and finance charges. The AIR typically consists of the seller's retained interest in the investor's portion of (1) the accrued fees and finance charges that have been billed to customer accounts, but have not yet been collected ("billed but uncollected"), and (2) the right to finance charges that have been accrued on cardholder accounts, but have not yet been billed ("accrued but unbilled").

³ The legal documentation and structure of the securitization transaction set forth the specific rights to trust assets and cash flows purchased by the investor and retained by the transferor. In some securitizations, the investor maintains a pro rata share of all trust assets, whether principal, finance charges or fees. In other securitizations, the transferor does not legally sell the accrued fees and finance charges to the trust, but is obligated to remit cash collections of these fees and finance charges to the trust. In either case, the trust will generally have a senior claim on the accrued interest receivable. However, the structure of the transaction may affect how the retained interests (including subordinated retained interests) are measured for accounting (and regulatory capital) purposes. Accordingly, the legal opinion that an institution obtains in connection with recording the securitization as a sale should also address whether the rights to the AIR cash flows have been legally isolated from the transferor, even in the event of the transferor's bankruptcy or other receivership.

An institution with a securitization structure that differs from the fact pattern described in this guidance should ensure its accounting approach is consistent with GAAP. Such institutions may contact their appropriate federal banking agency for further guidance, if appropriate.

While the selling institution retains a right to the excess cash flows generated from the fees and finance charges collected on the transferred receivables, the transferor generally subordinates its right to these cash flows to the investors in the securitization. The seller's right to the excess cash flows related to the AIR asset is similar to other subordinated residual interests in securitized assets in that the AIR serves as a credit enhancement to protect third-party investors in the securitization from credit losses.⁴ If and when cash payments on the accrued fees and finance charges are collected, they flow through the trust, where they are available to satisfy more senior obligations before any excess amount is remitted to the seller. Only after trust expenses (such as servicing fees, investor certificate interest, and investor principal charge-offs) have been paid will the trustee distribute any excess fee and finance charge cash flow back to the seller. Since investors are paid from these cash collections before the selling institution receives the amount of AIR that is due, the seller may or may not realize the full amount of its AIR asset.

Appropriate Accounting Treatment for Accrued Interest Receivable

Accounting at Inception of the Securitization Transaction

Generally, if a securitization transaction meets the criteria for sale treatment and the AIR is subordinated either because the asset has been isolated from the transferor (see paragraph 9(a) of FAS 140) or because of the operation of the cash flow distribution (or "waterfall") through the securitization trust, the total AIR (both the "billed and uncollected" and "accrued and unbilled") should be considered to be one of the components of the sale transaction. Thus, when accounting for a credit card securitization, institutions should allocate the previous carrying amount of the AIR (net of any related allowance for uncollectible amounts) and the other transferred assets between the assets that are sold and the retained interests, based on their relative fair values at the date of transfer. As a result, after a securitization, the allocated carrying amount of the AIR will typically be lower than its face amount.

Subsequent Accounting

After securitization, the AIR asset should be accounted for at its allocated cost basis (as discussed above). In addition, institutions should treat the AIR as a retained (subordinated) beneficial interest. Accordingly, it should be reported in "Other Assets" in regulatory reports⁵ and not as a loan receivable.⁶

In addition, because the AIR is a retained beneficial interest, institutions should follow the guidance provided in FASB Emerging Issues Task Force Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized

⁴ Examples of other retained interests in securitized assets include an Interest-Only Strip and a Cash Collateral or "Spread" account.

⁵ In the Call Report, the carrying value of the AIR asset should be reported in Schedule RC-F, item 5, and in Schedule RC-S, item 2.b, column C (if reported as a stand-alone asset). In the TFR, the AIR should be reported in Schedule SC, line SC 690, and Schedule SI, line SI 404.

⁶ In addition to the regulatory reporting requirements described in the above footnote, the agencies note that for financial statements prepared in accordance with GAAP, the AIR asset would be subject to the disclosure requirements pertaining to retained interests in securitized financial assets that are specified in paragraphs 17(f) and 17(g) of FAS 140.

Financial Assets” (EITF 99-20), in subsequent accounting. EITF 99-20 specifies the accounting approach that an institution should follow to evaluate a retained beneficial interest for impairment and how to account for any impairment that occurs.

Relationship Between the Accrued Interest Receivable and the Interest-Only Strip Asset

In assessing whether the AIR is appropriately measured for regulatory reporting purposes, institutions should carefully consider the accounting treatment for the Interest-Only Strip asset. The Interest-Only Strip and the AIR are closely related. Both represent the seller’s subordinated beneficial interest in excess cash flows from the trust. Despite their close relationship, these cash flows have different risk characteristics. The AIR represents the right to receive the cash flows from fees and finance charges that have already accrued on cardholders’ accounts. The Interest-Only Strip, on the other hand, represents an estimate of cash flows from fees and finance charges that will accrue on cardholders’ accounts in the future. Because the Interest-Only Strip cash flows can be contractually prepaid or settled in such a way that the seller would not recover substantially all of its investment, the Interest-Only Strip must be accounted for at fair value like a trading or available-for-sale security in accordance with paragraph 14 of FAS 140. In contrast, the AIR cannot be contractually prepaid or otherwise settled in such a way that the owner would not recover substantially all of its recorded investment.

Institutions should consider the close relationship between these assets and ensure that the amount of assets recognized for the right to receive excess cash flows from securitizations, in total, is not overstated. In addition, institutions should describe the accounting treatment for the AIR and the Interest-Only Strip in their accounting policies and related disclosures and be able to demonstrate that their accounting approach is consistent with GAAP. Examiners will review this documentation when evaluating an institution’s accounting for securitization activities.

Additional Information

For further information on the appropriate risk-based capital treatment for the AIR asset, please contact Thomas G. Rees, Deputy Chief Accountant at the OCC, at (202) 874-5411; Robert F. Storch, Accounting Section Chief at the FDIC, at (202) 898-8906; Charles H. Holm, Assistant Director, at the Board, at (202) 452-3502; Timothy J. Stier, Chief Accountant, at the OTS, at (202) 906-5699.