Section 6910, *Investment Companies*

.36 Determining Whether Loan Origination Is a Substantive Activity When Assessing Whether an Entity Is an Investment Company

Inquiry—If an entity originates loans to third parties for the purposes of maximizing its returns from capital appreciation, investment income, or both, how does the entity determine whether the loan origination activity represents a substantive activity that precludes the entity from qualifying as an investment company under FASB *Accounting Standards Codification* (ASC) 946-10-15-6?

Reply—In performing its assessment, the entity should consider its design, business purpose (see FASB ASC 946-10-55-4 through 946-10-55-7), and the reason for performing the activities (see FASB ASC 946-10-55-10), including how the entity is marketed and presented to current and potential investors. If an entity believes it is an investment company under FASB ASC 946, Financial Services—Investment Companies, the entity's design, business purpose, and how it holds itself out to investors should be consistent with those of an investment company.

Determining whether loan origination activity represents a substantive activity may require significant judgment. Loan origination would generally be considered inconsistent with the business purpose of capital appreciation, investment income, or both (investing income). Significance of the income generated from the entity's origination and syndication of loans as compared to the income generated through capital appreciation, investment income, or both, is an important factor for entities to consider. Paragraph 4 of FASB ASC 946-10-55 indicates that an investment company should have no substantive activities other than its investing activities and should not have significant assets or liabilities other than those relating to investing activities. The evaluation of loan origination activities generally would include a quantitative and qualitative assessment of the significance of those activities relative to the entity's investing activities. Often, the entity's business strategy with respect to originating loans (for example, if the entity originates and holds the loans versus originating and selling the loans), would correspond to the quantitative significance of loan origination income relative to investing income.

As an example, assume an entity (potential investment company) originates a $100 loan with a 10-year maturity, an expected life of five years, a coupon rate of 6 percent, an origination fee of 1.50 percent, and the entity expects to hold the loan until repayment by the borrower. In this example, the entity receives a $1.50 origination fee ($100 × 1.50%), expects to receive $30 dollars in interest payments ($100 × 6% × 5 years) over the expected holding period of the loan, and expects no capital gain or loss. Because the loan origination fee represents 4.76 percent ($1.50 / $31.50) of the total estimated income over the expected holding period of the loan, this quantitative analysis may indicate that loan origination fees are not a significant source of income. If the entity has investing income from other investments, including loans that are not originated by the entity, it would reduce the percentage of loan origination income to total estimated income (investing income plus other income, such as loan origination fees) over the expected life of the originated loans because the denominator would include the investing income from these other investments. Although an entity may have a significant amount of loan origination income to total income in a particular year (for example, in the early stages of the life of the entity as it expands its portfolio of investments), it would generally be appropriate to consider loan origination income relative to total income over the anticipated holding period of the originated loans. Management should have a reasonable basis for estimating loan origination income relative to total estimated income. For example, management should not estimate long or extended holding periods for loans (a decrease in loan origination activity) that is inconsistent with historical experience, except when warranted by changes in the entity's operations.

Contrast the preceding example with the origination of the same loan; however, assume the loan is expected to be sold in one year at a price of par (no gain or loss). In this example, the loan origination fee of $1.50 would represent 20 percent of the $7.50 total estimated income over the expected holding period of the loan ($1.50 origination fee plus $6 of coupon interest) and indicates that loan origination fees are significant. Although the quantitative analysis should be performed based on all income generated by the entity, as opposed to an individual loan, the preceding simplistic examples are intended to demonstrate the importance of the quantitative analysis in determining whether loan origination is a substantive business activity.

The fee income generated as part of loan origination activities relative to total income represents an important factor for entities to consider. An entity would generally also perform a qualitative analysis in determining whether the loan origination represents a substantive activity of the entity. The following factors are not all-inclusive, and judgment should be applied in determining the importance of each factor in specific circumstances:

- *Investing activity*. The nature and extent of the entity's sale of originated loans relative to purchases and sales of non-originated loans and other investments may be an indicator of whether the loan origination activities are substantive.
- *Regulatory considerations*. The regulations to which an entity is subject may provide an indicator of the entity's purpose and design.
- *Entity ownership and management*. The ownership of the entity and who manages the entity (for example, investment adviser) may be an indicator of whether the loan origination activities are substantive.
- *Customization of the loans*. Whether the loans are uniquely customized and specific to each borrower may be an indicator of whether the loans are originated for an investment purpose rather than to earn origination fees.
- *Loan retention*. When an entity holds loans as part of its investment portfolio to match its investment horizon, rather than selling loans (through securitizations or otherwise) shortly after origination, it may be an indicator that loan origination services are not a separate substantial business activity for the entity.
- *Embedded features*. Embedded features, particularly those that would indicate the loan is more akin to equity than debt (for example, conversion feature, dividend participation rights, and so on), may be an indicator that the entity's intent is for investment purposes, rather than to earn a loan origination fee.

FASB ASC 946-10-25-1 indicates that an entity shall reassess whether it is an investment company only if there is a subsequent change in the purpose and design of the entity. A change in the level of loan origination activity or holding period for self-originated loans that would affect the preceding quantitative analysis, as well as changes to the qualitative factors listed previously, may indicate that the purpose and design of the entity have changed.

Appendix A—Factors to Consider in Determining Whether Loan Origination Represents a Substantive Activity of the Entity

Factor	Example	
	More indicative of an investment company	**Less indicative of an investment company**
Fees	Fee income generated from the entity's loan origination activities is insignificant relative to total income.	Fee income generated from the entity's loan origination activities is significant to total income.
Investing activity	The entity's purchases and sales of non-originated securities are significant in relation to its origination of loans.	The entity may originate loans and sell them primarily for the purpose of generating origination fees. Loans originated by the entity are its primary investments.
Regulatory considerations	The party that manages the entity is registered with the SEC or a state as an investment adviser.	The entity is required to operate like a bank by a banking authority, for example, licensing and capital requirements.
Entity ownership and management	The entity is managed by an investment adviser, and substantially all investors are unrelated third parties.	The entity is a bank, an entity owned by a bank, or a captive finance company.
Customization of the loans	Loans are originated with unique features specific to each individual loan.	Loans are originated using standard terms and agreements (generally in higher volumes).
Loan retention	Loans are created and held as part of the investment portfolio to match the investment horizon of the entity.	Loans are sold shortly after origination through securitizations or otherwise.

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