

Financial reporting developments

A comprehensive guide

Transfers and servicing of financial assets

September 2025



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To our clients and other friends

We are pleased to provide you with the latest edition of our Financial reporting developments (FRD) publication on accounting for transfers and servicing of financial assets.

Applying ASC 860 in practice continues to be challenging. ASC 860's scope is wide and applies to more than just securitizations. Moreover, ASC 860 relies in part on legal interpretations to determine the accounting for the transfer. Additionally, a transferor's continuing involvement – which can vary significantly from transaction to transaction – will also affect the accounting analysis, requiring a complete understanding of both the business purpose and the form of the transaction.

This publication includes excerpts from and references to the FASB's Accounting Standards Codification, interpretive guidance and examples. Practice continues to develop and additional authoritative guidance in this area could be issued subsequent to the issuance of this publication. While we will update this publication as additional authoritative guidance is issued, affected entities and interested parties should closely monitor developments in this area.

Entities that are often involved in transfers and servicing of financial assets may be familiar with many of the issues described in this publication. However, others may need the assistance of professional advisors to navigate through the accounting implications of terms and conditions associated with complex securitization and/or transfer arrangements. EY professionals are available to answer your questions and discuss any concerns you may have.

The logo for Ernst & Young LLP, featuring the company name in a stylized, handwritten-style script.

September 2025

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Notice to readers:

This publication includes excerpts from and references to the Financial Accounting Standards Board (FASB or Board) Accounting Standards Codification (Codification or ASC). The Codification uses a hierarchy that includes Topics, Subtopics, Sections and Paragraphs. Each Topic includes an Overall Subtopic that generally includes pervasive guidance for the Topic and additional Subtopics, as needed, with incremental or unique guidance. Each Subtopic includes Sections that in turn include numbered Paragraphs. Thus, a Codification reference includes the Topic (XXX), Subtopic (YY), Section (ZZ) and Paragraph (PP).

Throughout this publication references to guidance in the Codification are shown using these reference numbers. References are also made to certain pre-Codification standards (and specific sections or paragraphs of pre-Codification standards) in situations in which the content being discussed is excluded from the Codification.

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1 Basic principles and scope

1.1 Overview

Transfers of financial assets take many forms, including sales, assignments, factoring arrangements and securitizations. Often transfers involve the seller (transferor) having some continuing involvement either with the transferred assets or with the buyer (transferee). Continuing involvement can exist in different forms (as discussed in section 4.2.1) such as seller recourse provisions, servicing arrangements and call options.

Accounting for transfers in which the transferor has no continuing involvement with the transferred financial assets or with the transferee is not a controversial topic. However, transfers of financial assets with continuing involvement often raise questions about the circumstances under which the transfers should be accounted for as sales (i.e., assets are removed from the balance sheet and a resulting gain or loss is recognized) or secured borrowings (i.e., assets remain on the balance sheet with no change in measurement).

ASC 860, *Transfers and Servicing*, establishes principles and a control-based accounting framework for evaluating transfers of financial assets, which can be summarized as follows:

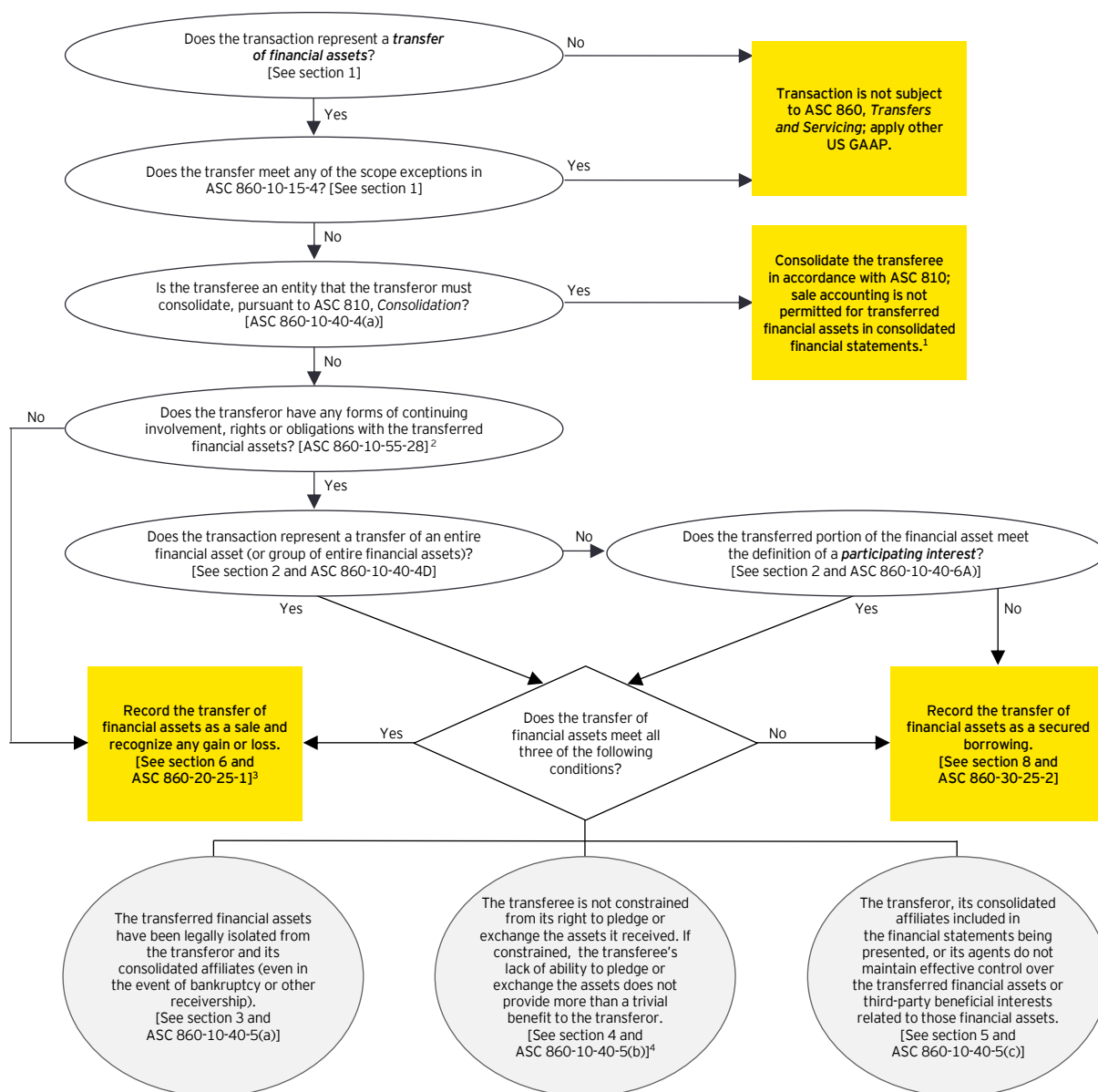
- ▶ The economic benefits provided by a financial asset (generally, the right to future cash flows) are derived from the contractual provisions of that asset, and the entity that controls those benefits should recognize them as its asset.
- ▶ An entire financial asset cannot be divided into components prior to a transfer unless all of the components meet the definition of a participating interest.
- ▶ A transferred financial asset should be considered sold and, therefore, should be derecognized if “control” is surrendered.
- ▶ A transferred financial asset should be considered pledged as collateral to secure an obligation of the transferor (and, therefore, should not be derecognized) if the transferor has not surrendered control.
- ▶ The recognition or derecognition of financial assets and liabilities should not be affected by the sequence of transactions that led to their existence unless the effect of those transactions is to maintain effective control over a transferred financial asset.
- ▶ To the extent that a transfer of financial assets does not qualify for sale accounting, the transferor’s contractual rights or obligations related to the transferred assets are not accounted for separately if doing so would result in recognizing the same rights or obligations twice. For example, a call option retained by the transferor may prevent a transfer from being accounted for as a sale. In that case, the call option is not separately recognized as a derivative asset.
- ▶ Transferors and transferees generally should account symmetrically for transfers of financial assets.
- ▶ When determining whether control has been surrendered over transferred financial assets, the transferor (and its consolidated affiliates included in the financial statements being presented) should consider its continuing involvement in the transferred financial assets and all arrangements or agreements made contemporaneously with, or in contemplation of, the transfer, even if they were not entered into at the time of the transfer. Certain exceptions apply (e.g., accounting for repurchase financings, as defined).

This section provides an overview of the accounting model for transfers of financial assets and discusses which assets and transactions are in the scope of ASC 860. Following this section is a more detailed discussion of the fundamental principles of ASC 860’s control-based approach, including the criteria for

determining when transfers should be accounted for as sales or secured borrowings. Later sections provide guidance on transfers of financial assets that are accounted for as secured borrowings and those that qualify as sales, including the initial and subsequent accounting for assets obtained and liabilities incurred (e.g., servicing contracts, beneficial interests) from sales.

Transfer decision tree

The following decision tree summarizes the process of evaluating the accounting treatment for transfers of financial assets:



¹ The consolidated transferee should recognize the transferred financial assets in its separate entity financial statements unless the nature of the transfer is a secured borrowing with a pledge of collateral (see ASC 860-10-55-17D).

² If the transfer is a routine transfer of financial assets that does not result in *any* continuing involvement by the transferor, a legal opinion is typically not required to support the assertion that the transferred financial assets are legally isolated from the transferor and the other sales criteria of ASC 860-10-40-5 are satisfied.

³ Pursuant to ASC 860-20-25-8 through 25-9, transfers accounted for as sales must be continuously evaluated for changes that may result in the transferor regaining effective control of the previously transferred financial assets.

⁴ Special “look-through” provisions apply when the transferee is an entity whose sole purpose is to facilitate a securitization or asset-backed financing.

1.2 Scope and scope exceptions

ASC 860 applies to all entities.¹ To understand and appropriately apply ASC 860's accounting framework for transfers of financial assets, certain fundamental questions must be answered, including:

- ▶ What is a financial asset?
- ▶ What is considered a transfer of financial assets and which transfers are in the scope of ASC 860?

1.2.1 Definition of a financial asset

The definition of a financial asset must be carefully considered to determine whether a transfer is within the scope of ASC 860. All assets are not financial assets. ASC 860 applies only to transfers of recognized financial assets. A financial asset is defined in the ASC Master Glossary as follows:

Excerpt from Accounting Standards Codification

Glossary

860-10-20

Financial Asset

Cash, evidence of an ownership interest in an entity, or a contract that conveys to one entity a right to do either of the following:

- a. Receive cash or another financial instrument from a second entity
- b. Exchange other financial instruments on potentially favorable terms with the second entity.

Refer to sections 1.3.1 and 1.3.2 for examples of instruments and contractual arrangements within and outside of the scope of ASC 860, respectively.

1.2.1.1 Nonfinancial derivatives and financial instruments that have the potential to be liabilities

Transfers of assets that are derivative instruments and subject to the requirements of ASC 815, *Derivatives and Hedging*, but that are not financial assets (e.g., a forward contract to purchase a physically settled nonfinancial asset such as crude oil or gold) are accounted for by analogy to ASC 860, in accordance with ASC 860-10-15-5.²

Certain recognized financial instruments, such as forward contracts and swaps, have the potential to be financial assets or financial liabilities. ASC 860-10-40-40 requires that transfers of those financial instruments meet the conditions of both ASC 405-20-40-1 and ASC 860-10-40-5 to be derecognized. The same criteria apply to transfers of nonfinancial derivative instruments that have the potential to become either assets or liabilities.³ Refer to our FRD, *Issuer's accounting for debt and equity financings*, as applicable, for further discussion on ASC 405-20 and section 1.5.2 for an overview of the criteria in ASC 860-10-40-5.

¹ See ASC 860-10-15-2 and 15-3.

² See also ASC 815-10-40-2.

³ See ASC 815-10-40-3.

1.2.2

Definition of a transfer

As used in ASC 860-10, the ASC Master Glossary narrowly defines a transfer as follows:

Excerpt from Accounting Standards Codification

Glossary

860-10-20

Transfer

The conveyance of a noncash financial asset by and to someone other than the issuer of that financial asset.

A transfer includes the following:

- a. Selling a receivable
- b. Putting a receivable into a securitization trust
- c. Posting a receivable as collateral.

A transfer excludes the following:

- a. The origination of a receivable
- b. Settlement of a receivable
- c. The restructuring of a receivable into a security in a troubled debt restructuring.

The following are common examples of transactions that involve transfers of financial assets subject to ASC 860:

| | Description | Additional information and references |
|-------------------------------|---|---|
| Banker's acceptances | <p>They provide a way for a bank to finance a customer's purchase of goods from a vendor for periods usually not exceeding six months.</p> <p>Under an agreement between the bank, the customer and the vendor, the bank agrees to pay the customer's liability to the vendor upon presentation of specified documents that provide evidence of delivery and acceptance of the purchased goods. The principal document is a draft or bill of exchange drawn by the customer that the bank stamps to show its acceptance of the liability to make payment on the draft on its due date.</p> <p>Once the bank accepts a draft, the customer is liable to repay the bank at the time the draft matures. The bank recognizes a receivable from the customer and a liability for the acceptance it has issued to the vendor. The accepted draft becomes a negotiable financial instrument. The vendor typically sells the accepted draft at a discount either to the accepting bank or in the marketplace.</p> | <ul style="list-style-type: none"> ▶ A risk participation is a contract between the accepting bank and a participating bank in which the participating bank agrees, in exchange for a fee, to reimburse the accepting bank in the event that the accepting bank's customer fails to honor its liability to the accepting bank in connection with the banker's acceptance. ▶ The participating bank becomes a guarantor of the credit of the accepting bank's customer. ▶ Refer to Illustration 6-8 in section 6.5.4.1 for an example of a transfer involving banker's acceptances. |
| Factoring arrangements | <p>They provide a way for discounting accounts receivable on a nonrecourse, notification basis.</p> <p>Accounts receivable are sold outright, usually to a transferee (the factor) that assumes the full risk of collection, without recourse to the transferor in the event of a loss. Debtors are directed to send payments to the transferee.</p> | <ul style="list-style-type: none"> ▶ Refer to Illustration 6-5 in section 6.5.4.1 for an example of a factoring arrangement accounted for as a sale. |

| | Description | Additional information and references |
|---|---|---|
| Loan participations and assignments | A borrower's needs may exceed its bank's legal lending limits. To accommodate the borrower, the bank may originate the entire loan and participate or assign portions of the loan to other banks. These transfers may take the legal form of either participations (i.e., participation agreements for portions of the borrower's loan) or assignments (i.e., addition of the other banks as assignees to the borrower's loan agreement). | <ul style="list-style-type: none"> ▶ The transfers are usually on a nonrecourse basis, and the transferor (originating lender) continues to service the loan. ▶ The transferee (participating entity) may or may not have the right to sell or transfer its participation during the term of the loan, depending on the terms of the participation agreement. ▶ Section 2, <i>Unit of account</i>, provides guidance for determining when a transfer of a portion of an entire financial asset meets the requirements for sale accounting. |
| Repurchase agreements ('repos') | Repos are securities lending arrangements in which one party agrees to sell financial assets to another party against the transfer of funds, with a simultaneous agreement to repurchase the same or equivalent financial assets at a specific price at a later date. | <ul style="list-style-type: none"> ▶ Section 9, <i>Repurchase agreements, securities lending transactions and similar arrangements</i>, provides an overview of common securities lending transactions and repurchase agreements, including dollar-roll transactions. In addition to discussing the market participants and the typical structure of these secured borrowing arrangements, the section also addresses the relevant accounting considerations. |
| Securities lending arrangements | These arrangements involve the temporary exchange of securities, usually for other securities or cash of an approximately equivalent value (or occasionally a mixture of cash and securities), with an obligation to redeliver a like quantity of the same securities at a future date. | |
| Transfers of receivables with recourse | Such transfers may involve an entire receivable, a group of entire receivables, or a portion of an entire receivable. The terms of the recourse arrangement require the transferor to make payments to the transferee, or to repurchase receivables sold, under certain circumstances (e.g., default on the receivable). Recourse may be full or limited (e.g., defaults up to a specified percentage). | <ul style="list-style-type: none"> ▶ Refer to sections 2.3.3, 3.4.6 and 6.5.3.5 for further guidance on transfers of financial assets involving transferor recourse obligations. |
| Securitizations | A securitization is a structured finance process that involves pooling and repackaging of cash-flow-producing financial assets (e.g., mortgage loans, trade receivables, credit card receivables) into an entity formed for the specific purpose funding the asset. Asset-backed securities, a type of beneficial interest, are then sold to investors by the securitization entity. | <ul style="list-style-type: none"> ▶ The FASB provides an overview of the securitization process in ASC 860-10-05-7 through 05-13. ▶ Refer to section 10, <i>Securitizations</i>, for further guidance on the fundamentals of securitization transactions. |
| Wash sales | Wash sales are transactions in which an entity sells a security and then repurchases the same or substantially the same security at some future date (typically within 30 days). | <ul style="list-style-type: none"> ▶ Refer to section 9.8 for additional guidance regarding the accounting and tax implications of wash sale transactions. |

Refer to sections 1.3.1 and 1.3.2 for examples of instruments and contractual arrangements within and outside of the scope of ASC 860, respectively.

1.2.3 Other scope considerations

Certain transactions and activities fall outside the scope of ASC 860.

Excerpt from Accounting Standards Codification

Transfers and Servicing – Overall

Scope and Scope Exceptions

Transactions

860-10-15-4

The guidance in this Topic does not apply to the following transactions and activities:

- a. Except for transfers of servicing assets (see Section 860-50-40) and for the transfers noted in the following paragraph, transfers of nonfinancial assets
- b. Transfers of unrecognized financial assets, for example, lease payments to be received under operating leases
- c. Transfers of custody of financial assets for safekeeping
- d. Contributions (for guidance on accounting for contributions, see Subtopic 958-605)
- e. Transfers of **in substance nonfinancial assets**, see Subtopic 610-20
- f. Investments by owners or distributions to owners of a business entity
- g. Employee benefits subject to the provisions of Topic 712
- h. Leveraged leases subject to Topic 842
- i. **Money-over-money** and wrap lease transactions involving nonrecourse debt subject to Topic 842.

Although servicing rights (e.g., mortgage servicing rights) have characteristics that are similar to financial instruments (e.g., the right to receive contractual cash flows), such rights are nonfinancial assets because they stem from executory contracts, which are contracts to receive future consideration for services. Transfers of servicing rights are accounted for in accordance with ASC 860-50-40. Refer to section 7, *Servicing of financial assets*, for further guidance on the accounting for servicing rights, including transfers of such rights.

1.2.3.1 Transfers of equity method investments

A conveyance of an equity method investment is accounted for as a transfer under ASC 860 unless one of the following applies:

- ▶ It is accounted for under ASC 610-20⁴ because the equity method investment is included in a sale of a group of assets where substantially all of the fair value of the assets in the transaction is concentrated in nonfinancial assets.
- ▶ It is accounted for under ASC 810 because the equity method investment is included in the derecognition of a business or subsidiary that is not a business if the substance of the transaction is not addressed by other guidance (e.g., ASC 610-20).
- ▶ It does not meet ASC 860's definition of a transfer or is otherwise outside the scope of ASC 860, in which case, other guidance is applied.

⁴ ASC 610-20, *Other Income – Gains and Losses from the Derecognition of Nonfinancial Assets*.

When transferring an equity method investment, a transferor should not “look through” to the underlying assets and liabilities of the equity method investment to determine the applicable derecognition guidance. A transfer of an equity method investment will only be considered a transfer of an in substance nonfinancial asset when the transfer is included in a contract in which substantially all of the fair value of the assets promised in the contract is concentrated in nonfinancial assets. In determining whether an in substance nonfinancial asset has been transferred, consideration of the fair value of promised assets that have not been recognized by the seller, such as in-process research and development, internally generated intangibles or off-market contracts is required. However, cash and cash equivalents and liabilities (both assumed and relieved) are excluded from the analysis.

See section 6.5.3.1 for further discussion on the accounting for beneficial interests.

1.3 Examples of instruments and contractual arrangements within and outside the scope of ASC 860

Careful consideration is necessary in determining whether an asset meets the definition of a financial asset and if its transfer is within the scope of ASC 860. Instances may exist in which the item may be considered an asset, but not a financial asset as defined by US GAAP. Some instruments are more easily identified as financial assets than others. Except for transfers of servicing assets, if the transfer of an asset involves nonfinancial assets, the relevant accounting guidance is outside the scope of ASC 860. For example, guidance on the accounting for revenue related to sales of products or services includes ASC 606, *Revenue from Contracts with Customers*.

Section 1.3.1 lists some typical instruments and arrangements that meet the definition of a recognized financial asset. Then, section 1.3.2 follows with a list of certain instruments and arrangements that are not considered recognized financial assets or are specifically excluded from the scope of ASC 860. These lists also include explanations of why such items are within or outside the scope of the accounting framework for transfers of financial assets. Refer to section 1.2.1 for a discussion on the definition of a financial asset and other instruments in the scope of ASC 860. Further, refer to section 1.2.2 for the definition of a “transfer” and common examples of transfers in the scope of ASC 860.

1.3.1 Examples of instruments and contractual arrangements within the scope of ASC 860

| Illustration 1-1: Instruments and contractual arrangements within the scope of ASC 860 | | |
|---|--|--|
| (a) | Common stock or another form of ownership interest (e.g., certain equity method investments) | Common stock, including those accounted for as equity-method investments, are typically considered financial assets because they represent an ownership interest. However, any transfer of an investment that is in substance a nonfinancial asset, as defined in ASC 610-20, is specifically excluded from the scope of ASC 860 (see ASC 860-10-15-4(e)). |
| (b) | Common stock of a consolidated subsidiary that holds only financial assets | Normally, an ownership interest in a consolidated subsidiary is evidence of control of the entity’s individual assets and liabilities. It is not evidence of an investment in a single financial asset or a group of financial assets. However, ASC 860 applies to the transfer of an equity interest in a consolidated subsidiary that is not a “business” and holds only financial assets. ⁵ |
| (c) | Derivative assets that are not financial assets such as a physically settled commodity forward contract | As an exception to the general principle that ASC 860 applies only to recognized financial assets, transfers of assets that are derivative instruments subject to ASC 815, <i>Derivatives and Hedging</i> , but are not financial assets (e.g., transfer of a forward contract to purchase gold that requires physical settlement) should be accounted for by analogy to ASC 860. See ASC 815-10-40-2 for further details. |

⁵ SEC Professional Accounting Fellow Brian W. Fields, Speech at the 2009 AICPA National Conference on Current SEC and PCAOB Developments <http://www.sec.gov/news/speech/2009/spch120709bwf.htm>.

| | | |
|-----|---|--|
| (d) | Forward contract on a financial instrument that must be (or may be) physically settled | A forward contract on a financial instrument that must be (or may be) physically settled is generally considered a financial asset because it conveys to a second entity a contractual right (a) to receive cash or another financial instrument from the first entity or (b) to exchange other financial instruments on potentially favorable terms with the first entity. ASC 405-20-40-1 applies when a forward contract is a financial liability. |
| (e) | Investment in a controlled, but unconsolidated, investee that is measured at fair value | An entity that carries an investment in a subsidiary at fair value will realize its investment by disposing of it rather than by realizing the values of the underlying assets through operations (e.g., a private equity fund or other investment company subject to ASC 946 that holds a controlling financial interest in a company). Therefore, a transfer of an investment in a subsidiary by that entity is a transfer of the investment (a financial asset), not the underlying assets and liabilities (which might include nonfinancial assets). See ASC 860-10-55-14. |
| (f) | Debt securities and beneficial interests⁶ in a securitization entity (including those holding non-financial assets) | Debt securities and beneficial interests represent a contract that conveys to a second entity a contractual right to receive cash or another financial instrument from the first entity. |
| (g) | Lease residual values that are guaranteed at lease commencement | ASC 860-10-55-6 states that residual values meet the definition of financial assets to the extent they are guaranteed at the commencement of the lease. |
| (h) | Mortgages, commercial loans, credit card receivables, installment loans, reverse mortgages and balloon notes | Loans are typically considered financial assets because they represent a contract that conveys to a second entity a contractual right to receive cash or another financial instrument from a first entity. |
| (i) | Notes and trade receivables | Notes and trade receivables are considered financial assets because they represent a contract that conveys to a second entity a contractual right to receive cash or another financial instrument from a first entity. |
| (j) | Repurchase agreements, certain dollar rolls and securities lending transactions | Repurchase agreements, dollar rolls (involving existing securities) and securities lending transactions are considered financial assets because they represent a contract that conveys to a second entity a contractual right to receive cash or another financial instrument from the first entity. |
| (k) | Sales-type and direct-financing lease receivables | Sales-type and direct-financing lease receivables are considered financial assets because they represent a contract that conveys to a second entity a contractual right to receive cash or another financial instrument from the first entity. |
| (l) | Acquisition, development and construction (ADC) arrangements | ADC arrangements ⁷ accounted for as loans under ASC 310 are financial assets because they represent a contract that conveys to a second entity a contractual right to receive cash or another financial instrument from the first entity. However, transfers of ADC arrangements that are not loans under ASC 310 may be in the scope of ASC 860 or other guidance (e.g., ASC 360-10) depending on how the ADC arrangements are accounted for (i.e., as equity method investments or as investments in real estate). |

⁶ Beneficial interests are further discussed in section 6, *Recognition and measurement*, and section 10, *Securitizations*.

⁷ ADC arrangements are acquisition, development or construction arrangements, in which a lender, usually a financial institution, participates in expected residual profit from the sale or refinancing of property. ADC arrangements are accounted for as either loans or investments in real estate or joint venture pursuant to the guidance in ASC 310-10-25.

1.3.2 Examples of instruments and contractual arrangements that are outside the scope of ASC 860

| Illustration 1-2: Instruments and contractual arrangements that are outside the scope of ASC 860 | | |
|---|---|--|
| (a) | Common stock of a consolidated subsidiary | An ownership interest in a consolidated subsidiary is evidence of control of the entity's individual assets and liabilities. It is not evidence of an investment in a single financial asset or a group of financial assets (see ASC 860-10-55-13). However, the accounting guidance in ASC 860 does apply to the transfer of an equity interest in a consolidated subsidiary by its parent if that consolidated subsidiary is not a "business" and holds only financial assets (refer to section 1.3.1(b)). |
| (b) | Contingent receivables (e.g., litigation judgment or certain insurance claims) | Contingent assets, such as a receivable from a litigation judgment, become financial assets subject to ASC 860 only when they are reduced to a fixed payment schedule enforceable by contract. The determination of whether amounts to be received under legal settlements represent financial assets depends on the specific facts and circumstances. See ASC 860-10-55-10 and 55-11. |
| (c) | Distributions of financial assets to shareholders | When an entity distributes financial assets (e.g., loans receivable) to its owners by forming a subsidiary, transferring those assets to the subsidiary, and distributing the stock of the subsidiary to its shareholders, the transaction is considered a nonreciprocal transfer. Such transactions are outside the scope of ASC 860. See ASC 845-10-25-3 for additional guidance. |
| (d) | Dollar roll transactions involving mortgage-backed securities that do not yet exist | Dollar roll repurchase agreements for which the underlying securities being sold do not yet exist are outside the scope of ASC 860 because those transactions do not arise in connection with a transfer of recognized financial assets (see ASC 860-10-55-17). Refer to section 9.5.1.1.1 for additional guidance. |
| (e) | Insurance contracts | Under an insurance contract, a premium is received over time in return for protection from specified losses. Those future revenue streams are not currently recognized as financial assets. See ASC 470-10-25 for further information about sales of future revenues or various other measures of income. |
| (f) | Lease residual values that are guaranteed after lease commencement and unguaranteed lease residuals | Both unguaranteed residual assets and residual values guaranteed after commencement are not financial assets and are not subject to the requirements of ASC 860 (refer to other GAAP, including ASC 842, ASC 326 and ASC 606, as applicable). |
| (g) | Loan syndications | ASC 860-10-55-4 states that a loan syndication is not a transfer of financial assets. Rather, loan syndications are accounted for according to ASC 310-10-25-4, which explains that each lender in a syndication must account for the amounts it is owed by the borrower. |
| (h) | Lease payments to be received under an operating lease | Lease payments to be received under an operating lease do not meet the definition of a financial asset. Operating leases differ from direct-financing or sales-type leases because the rights to receive lease payments under an operating lease are not a recognized asset. See ASC 860-10-55-6. |
| (i) | Nonreciprocal transfers with other than owners | Contributions of financial assets (e.g., marketable securities) to an entity (e.g., a charitable organization) or a settlement or cancellation of its liabilities in a voluntary nonreciprocal transfer by another entity other than its owners is outside the scope of ASC 860. See ASC 860-10-15-4(d). |
| (j) | Reacquisition by an entity of its own securities | As explained in ASC 860-10-55-15, a reacquisition by an entity of its own securities by exchanging noncash financial assets (e.g., US Treasury bonds or shares of an unconsolidated investee) for its common shares constitutes a distribution by an entity to its owners and is outside the scope of ASC 860. Refer to Question 1-3 below for a further discussion. |
| (k) | Rights to future mutual fund 12b-1 fees | Rights to future mutual fund 12b-1 fees are not recognized financial assets of the party who is owed the fee. ASC 860 does not apply to transfers of unrecognized financial assets. See 860-10-15-4(b). |

| | | |
|-----|--|--|
| (l) | Sale of future revenues | In a sale of future revenues, future revenue streams are committed in return for a current payment. Those future revenue streams are not currently recognized financial assets. To be in the scope of ASC 860, we generally believe the earnings process should be complete such that the revenue associated with the receivable has been fully recognized. Refer to ASC 470-10-25 for further guidance. |
| (m) | Shareholder note – classified in equity | A shareholder note classified in equity is not a financial asset because it is classified as a component of equity and, therefore, is outside the scope of ASC 860. |
| (n) | Stranded costs | Stranded costs (e.g., stranded utility costs) are not financial assets because they are not contractual rights to receive cash from another party. However, a beneficial interest in a securitization trust that holds securitized stranded costs would be considered a financial asset by the third-party investor, unless that third party must consolidate the trust. See ASC 860-10-55-7 through 55-9 for further information. |
| (o) | Settlement of an obligation | ASC 860-10-55-4 states that a payment of cash or a conveyance of noncash financial assets to the holder of a loan or other receivable in full or partial settlement of an obligation is outside the scope of ASC 860. |
| (p) | Tax receivable | A tax receivable typically is not considered a financial asset because the payment terms do not result from a contractual arrangement. However, a tax receivable resulting from a legal settlement plan, which includes payment terms reduced to a contract, would be a financial asset. |

1.3.2.1

Certain transfers of non-performing assets

In certain cases, financial institutions may convey their nonperforming assets to a newly formed entity in exchange for cash proceeds or a redeemable instrument issued by the new entity. The SEC staff provided interpretive guidance to apply to such conveyances when they fall outside the scope of ASC 860-10.⁸

Excerpt from Accounting Standards Codification

Financial Services – Depository and Lending

SEC materials

942-810-S99-1 (SAB Topic 5.V, Certain Transfer of Non-performing Assets)

The following is the text of SAB Topic 5.V, Certain Transfer of Non-performing Assets.

Facts: A financial institution desires to reduce its nonaccrual or reduced rate loans and other nonearning assets, including foreclosed real estate (collectively, "nonperforming assets"). Some or all of such nonperforming assets are transferred to a newly-formed entity (the "new entity"). The financial institution, as consideration for transferring the nonperforming assets, may receive (a) the cash proceeds of debt issued by the new entity to third parties, (b) a note or other redeemable instrument issued by the new entity, or (c) a combination of (a) and (b). The residual equity interests in the new entity, which carry voting rights, initially owned by the financial institution, are transferred to outsiders (for example, via distribution to the financial institution's shareholders or sale or contribution to an unrelated third party).

The financial institution typically will manage the assets for a fee, providing necessary services to liquidate the assets, but otherwise does not have the right to appoint directors or legally control the operations of the new entity.

⁸ While the SEC staff's guidance addresses public entities, we generally believe that nonpublic entities can also apply this guidance.

FASB ASC Topic 860, Transfers and Servicing, provides guidance for determining when a transfer of financial assets can be recognized as a sale. The interpretive guidance provided in response to Questions 1 and 2 of this SAB does not apply to transfers of financial assets falling within the scope of FASB ASC Topic 860. Because FASB ASC Topic 860 does not apply to distributions of financial assets to shareholders or a contribution of such assets to unrelated third parties, the interpretive guidance provided in response to Questions 1 and 2 of this SAB would apply to such conveyances.

Further, registrants should consider the guidance contained in FASB ASC Topic 810, Consolidation, in determining whether it should consolidate the newly-formed entity.

Question 1: What factors should be considered in determining whether such transfer of nonperforming assets can be accounted for as a disposition by the financial institution?

Interpretive Response: The staff believes that determining whether nonperforming assets have been disposed of in substance requires an assessment as to whether the risks and rewards of ownership have been transferred. FN38 The staff believes that the transfer described should not be accounted for as a sale or disposition if (a) the transfer of nonperforming assets to the new entity provides for recourse by the new entity to the transferor financial institution, (b) the financial institution directly or indirectly guarantees debt of the new entity in whole or in part, (c) the financial institution retains a participation in the rewards of ownership of the transferred assets, for example through a higher than normal incentive or other management fee arrangement, FN39 or (d) the fair value of any material non-cash consideration received by the financial institution (for example, a note or other redeemable instrument) cannot be reasonably estimated. Additionally, the staff believes that the accounting for the transfer as a sale or disposition generally is not appropriate where the financial institution retains rewards of ownership through the holding of significant residual equity interests or where third party holders of such interests do not have a significant amount of capital at risk.

FN38 [Original footnote removed by SAB 114.]

FN39 The staff recognizes that the determination of whether the financial institution retains a participation in the rewards of ownership will require an analysis of the facts and circumstances of each individual transaction. Generally, the staff believes that, in order to conclude that the financial institution has disposed of the assets in substance, the management fee arrangement should not enable the financial institution to participate to any significant extent in the potential increases in cash flows or value of the assets, and the terms of the arrangement, including provisions for discontinuance of services, must be substantially similar to management arrangements with third parties.

Where accounting for the transfer as a sale or disposition is not appropriate, the nonperforming assets should remain on the financial institution's balance sheet and should continue to be disclosed as nonaccrual, past due, restructured or foreclosed, as appropriate, and the debt of the new entity should be recorded by the financial institution.

Question 2: If the transaction is accounted for as a sale to an unconsolidated party, at what value should the transfer be recorded by the financial institution?

Interpretive Response: The staff believes that the transfer should be recorded by the financial institution at the fair value of assets transferred (or, if more clearly evident, the fair value of assets received) and a loss recognized by the financial institution for any excess of the net carrying value FN40 over the fair value. FN41 Fair value is the amount that would be realizable in an outright sale to an unrelated third party for cash. FN42 The same concepts should be applied in determining fair value of the transferred assets, i.e., if an active market exists for the assets transferred, then fair value is equal to the market value. If no active market exists, but one exists

for similar assets, the selling prices in that market may be helpful in estimating the fair value. If no such market price is available, a forecast of expected cash flows, discounted at a rate commensurate with the risks involved, may be used to aid in estimating the fair value. In situations where discounted cash flows are used to estimate fair value of nonperforming assets, the staff would expect that the interest rate used in such computations will be substantially higher than the cost of funds of the financial institution and appropriately reflect the risk of holding these nonperforming assets. Therefore, the fair value determined in such a way will be lower than the amount at which the assets would have been carried by the financial institution had the transfer not occurred, unless the financial institution had been required under GAAP to carry such assets at market value or the lower of cost or market value.

FN40 The carrying value should be reduced by any allocable allowance for credit losses or other valuation allowances. The staff believes that the loss recognized for the excess of the net carrying value over the fair value should be considered a credit loss and this should not be included by the financial institution as loss on disposition.

FN41 The staff notes that FASB ASC paragraph 942-810-45-2 (Financial Services—Depository and Lending Topic) provides guidance that the newly created "liquidating bank" should continue to report its assets and liabilities at fair values at the date of the financial statements.

FN42 FASB ASC paragraph 845-10-30-14 (Nonmonetary Transactions Topic) provides guidance that an enterprise that distributes loans to its owners should report such distribution at fair value.

Question 3: Where the transaction may appropriately be accounted for as a sale to an unconsolidated party and the financial institution receives a note receivable or other redeemable instrument from the new entity, how should such asset be disclosed pursuant to Item III C, "Risk Elements," of Industry Guide 3? What factors should be considered related to the subsequent accounting for such instruments received?

Interpretive Response: The staff believes that the financial institution may exclude the note receivable or other asset from its Risk Elements disclosures under Guide 3 provided that: (a) the receivable itself does not constitute a nonaccrual, past due, restructured, or potential problem loan that would require disclosure under Guide 3, and (b) the underlying collateral is described in sufficient detail to enable investors to understand the nature of the note receivable or other asset, if material, including the extent of any over-collateralization. The description of the collateral normally would include material information similar to that which would be provided if such assets were owned by the financial institution, including pertinent Risk Element disclosures.

The staff notes that, in situations in which the transaction is accounted for as a sale to an unconsolidated party and a portion of the consideration received by the registrant is debt or another redeemable instrument, careful consideration must be given to the appropriateness of recording profits on the management fee arrangement, or interest or dividends on the instrument received, including consideration of whether it is necessary to defer such amounts or to treat such payments on a cost recovery basis. Further, if the new entity incurs losses to the point that its permanent equity based on GAAP is eliminated, it would ordinarily be necessary for the financial institution, at a minimum, to record further operating losses as its best estimate of the loss in realizable value of its investment. FN43

FN43 Typically, the financial institution's claim on the new entity is subordinate to other debt instruments and thus the financial institution will incur any losses beyond those incurred by the permanent equity holders.

1.4 Consolidation by the transferor

One of the first considerations for a transfer of financial assets to be accounted for as a sale in the consolidated financial statements of the transferor is whether the transferee (including any newly created entities that hold the “disposed” financial assets) would be consolidated by the transferor. That is because a sale to a consolidated affiliate would not result in a transfer of the risks and rewards of ownership to new owners. ASC 810, *Consolidation*, provides guidance for determining when and how to consolidate an entity and requires all entities to be evaluated as either a variable interest entity or a voting interest entity. The Variable Interest Model may be particularly relevant for transfers of financial assets involving special purpose entities (e.g., a securitization).

When a transferor is required to consolidate the transferee under ASC 810, the transferor’s consolidated financial statements will continue to reflect any transferred financial assets. In such cases, because the consolidated entity has not surrendered control over transferred financial assets, assessing the requirements for sale accounting under ASC 860-10-40-5 is not necessary for purposes of preparing the transferor’s consolidated financial statements. Any consideration received from third parties in the transaction is recognized as a secured borrowing, as described in section 8. Any intercompany transactions (e.g., servicing arrangements) would be eliminated from the consolidated financial statements.

In some cases, a transferor may change its determination of whether the transferee should be consolidated under ASC 810 after transferring financial assets (e.g., the transferor acquires or disposes of beneficial interests issued by the transferee in a securitization). If the transferor subsequently consolidates a transferee after recognizing a sale on those transferred financial assets, it would regain control of the transferred financial assets, as discussed in section 6.6. Alternatively, if the transferor deconsolidates a previously consolidated transferee, it would need to consider all the requirements in ASC 860-10-40-5 to determine whether sale accounting is appropriate, as discussed in section 1.5, before recognizing any gain or loss. See also Question 1-1 for guidance on the accounting when a consolidated special purpose entity issues beneficial interests to third parties in connection with the transfer of financial assets to that special purpose entity.

Refer to our FRD, *Consolidation*, for guidance on applying ASC 810.

1.4.1 Transfers of financial assets to a consolidated transferee

Excerpt from Accounting Standards Codification

Transfers and Servicing – Overall

Implementation Guidance and Illustrations

Consolidation of Transferee by Transferor

860-10-55-17D

Paragraph 860-10-40-4 states that the determination of whether a transferor and its **consolidated affiliates** included in the financial statements being presented have surrendered control over transferred financial assets shall first consider whether the transferee would be consolidated by the transferor. If all other provisions of this Topic are met with respect to a particular transfer, and the transferee would be consolidated by the transferor, then the transferred financial assets would not be treated as having been sold in the financial statements being presented. However, if the transferee is a consolidated subsidiary of the transferor (its parent), the transferee shall recognize the transferred financial assets in its separate entity financial statements, unless the nature of the transfer is a secured borrowing with a pledge of collateral (for example, a repurchase agreement that would not be accounted for as a sale under the provisions of paragraph 860-10-40-24).

ASC 860-10-55-17D clarifies that if the transferee is a consolidated subsidiary of the transferor (its parent), the transferee should recognize the transferred financial assets in its separate entity financial statements, unless the nature of the transfer is a secured borrowing with a pledge of collateral. In determining whether the nature of a transfer is a sale, reporting entities should consider how closely the terms of an arrangement align with typical transfers between third parties that are accounted for as sales. For example, a contractual provision that entitles or obligates the parent to repurchase the transferred financial assets at a fixed price likely indicates that the nature of the transfer is more akin to a secured borrowing with a pledge of collateral, in which case the subsidiary (i.e., transferee) should not recognize the transferred financial assets in its separate entity financial statements.

1.4.2

Transfers of ownership interests in a consolidated entity that is not a business that holds substantially all financial assets

A parent's transfer of an ownership interest in a consolidated entity (i.e., a subsidiary) that meets the definition of a business (or a transfer of a group of assets that meets the definition of a business) is generally accounted for in accordance with ASC 810. This guidance also applies to a parent's transfer of an ownership interest in a consolidated entity that does not meet the definition of a business if the substance of the transaction is not addressed directly in other guidance (e.g., transfers of financial assets as discussed in ASC 860, revenue recognition as discussed in ASC 606, a sale of nonfinancial assets as discussed in ASC 610-20).

When a parent transfers an ownership interest in a consolidated entity that is not a business, ASC 860-10 may apply to the transaction. More specifically, the guidance in ASC 860-10 should be applied to a transfer of an ownership interest in a consolidated entity that is not a business if (1) the consolidated entity holds only financial assets or (2) the consolidated entity holds both financial assets and nonfinancial assets, but the amount of nonfinancial assets held by the consolidated entity is not substantive. If the consolidated entity held a substantive amount of nonfinancial assets, the transfer would not be in the scope of ASC 860-10. This view is consistent with the views expressed by the SEC staff in two speeches that the guidance on the transfers of financial assets (i.e., ASC 860) should be applied to the parent entity's transfer of ownership interests in consolidated entities that held only financial assets.⁹

Determining whether a transfer of an ownership interest in a consolidated entity that is not a business represents a transfer of financial assets in substance will require judgment and depend on the facts and circumstances. If it is determined that the transaction is in the scope of ASC 860-10, the parent must evaluate whether the transfer meets the requirements for derecognition in ASC 860-10-40-5. In addition, the parent must evaluate whether it will continue to be required to consolidate the entity that holds the financial assets under ASC 810, because if the parent continues to be required to consolidate the entity that holds the financial assets, the parent cannot be viewed as surrendering control over the financial assets in the entity.

Unless the parent's transfer of the ownership interest in the consolidated entity (and the transfer of financial assets to a newly created entity, in the case when a parent first transfers financial assets to a newly created entity and then transfers the ownership interests in that entity to a third party) meets the criteria in ASC 860-10-40-5 for sale accounting, and the parent is no longer required to consolidate the entity that holds the financial assets under ASC 810, the parent should not derecognize the financial assets from the consolidated financial statements of the parent. In circumstances where the parent cannot derecognize the financial assets from its consolidated financial statements, the transaction should be accounted for as a secured borrowing.

Refer to Question 1-1 for additional discussion.

⁹ SEC Professional Accounting Fellow Armando Pimentel, Speech on various issues relating to the transfer of financial assets (1997), and SEC Professional Accounting Fellow Brian W. Fields, Speech at the 2009 AICPA National Conference on Current SEC and PCAOB Developments, <http://www.sec.gov/news/speech/2009/spch120709bwf.htm>.

1.5

Sale accounting

Transfers of financial assets in the scope of ASC 860 are accounted for as a sale by the transferor only when all three conditions in ASC 860-10-40-5 for surrendering control of those financial assets are met. Those conditions are further discussed in section 1.5.2. ASC 860-10-40-4 provides the general framework for transferors to consider when assessing the conditions in ASC 860-10-40-5 to determine whether a transfer of financial assets may be accounted for as a sale.

Excerpt from Accounting Standards Codification

Transfers and Servicing – Overall

Derecognition

Conditions for a Sale of Financial Assets

860-10-40-4

The objective of paragraph 860-10-40-5 and related implementation guidance is to determine whether a transferor and its **consolidated affiliates** included in the financial statements being presented have surrendered control over **transferred financial assets** or third-party **beneficial interests**. This determination:

- a. Shall first consider whether the **transferee** would be consolidated by the transferor (for implementation guidance, see paragraph 860-10-55-17D)
- b. Shall consider the transferor's continuing involvement in the transferred financial assets
- c. Requires the use of judgment that shall consider all arrangements or agreements made contemporaneously with, or in contemplation of, the **transfer**, even if they were not entered into at the time of the transfer.

With respect to item (b), all continuing involvement by the transferor, its consolidated affiliates included in the financial statements being presented, or its **agents** shall be considered continuing involvement by the transferor. In a transfer between two subsidiaries of a common parent, the transferor-subsidiary shall not consider parent involvements with the transferred financial assets in applying paragraph 860-10-40-5.

As discussed further in section 4.2.1, continuing involvement constitutes any involvement with transferred financial assets that either (1) permits the transferor to receive cash flows or other benefits that arise from the transferred financial assets or (2) obligates the transferor to provide additional cash flows or other assets to any party related to the transfer. When applying the derecognition model in ASC 860, transferors should consider any continuing involvement in the transferred financial assets. This includes a review of all arrangements or agreements made contemporaneously with the transfer, as well as those in contemplation of the transfer but not entered into at the time of the transfer.

However, as discussed further in section 9.7, the considerations described in ASC 860-10-40-4(b) and 40-4(c) above do not apply when evaluating a transfer of financial assets and a related "repurchase financing," as defined in the ASC Master Glossary.

1.5.1 Unit of account eligible for sale accounting

Excerpt from Accounting Standards Codification

Transfers and Servicing – Overall

Derecognition

Conditions for a Sale of Financial Assets

860-10-40-4D

To be eligible for sale accounting, an entire financial asset cannot be divided into components before a transfer unless all of the components meet the definition of a **participating interest**. The legal form of the asset and what the asset conveys to its holders shall be considered in determining what constitutes an entire financial asset (for implementation guidance, see paragraph 860-10-55-17E). An entity shall not account for a transfer of an entire financial asset or a participating interest in an entire financial asset partially as a sale and partially as a secured borrowing.

860-10-40-4E

If a transfer of a portion of an entire financial asset meets the definition of a participating interest, the transferor shall apply the guidance in the following paragraph [EY Note: that is, ASC 860-10-40-5, the conditions for sale accounting]. If a transfer of a portion of a financial asset does not meet the definition of a participating interest, the transferor and transferee shall account for the transfer in accordance with the guidance in paragraph 860-30-25-2 [EY Note: that is, as a secured borrowing]. However, if the transferor transfers an entire financial asset in portions that do not individually meet the participating interest definition, the following paragraph shall be applied to the entire financial asset once all portions have been transferred.

The accounting analysis for a transfer of financial assets under ASC 860 depends on whether the transfer involves an entire financial asset (or a group of entire financial assets) or only a portion of an entire financial asset. In practice, it is difficult to determine whether a transferor has surrendered control over a portion of a financial asset if the transferor continues to maintain custody of the original financial asset. Therefore, the FASB decided that sale accounting for a transfer of a portion of an entire financial asset is permitted only when the transferred portion mirrors the characteristics of the original financial asset, which the FASB defined as a “participating interest.” A participating interest has each of the following characteristics:

- ▶ It represents a proportionate (pro rata) ownership interest in an entire financial asset.
- ▶ It entitles each participating interest holder to all of the cash flows received from an entire financial asset in proportion to its share of ownership. However, cash flows allocated as compensation for services performed are not included in that determination provided certain conditions are met.
- ▶ It requires that each participating interest holder have the same priority and no participating interest holder is subordinated to another – that is, it involves no recourse to, or subordination by, any participating interest holder and it does not entitle any participating interest holder to receive cash before any other participating interest holder.
- ▶ No party has the right to pledge or exchange the entire financial asset unless all participating interest holders agree to pledge or exchange the entire financial asset.

Refer to section 2, *Unit of account*, for further guidance on the unit of account eligible for derecognition.

1.5.2 Requirements for sale accounting

ASC 860-10-40-5 states that a transfer of an entire financial asset, a group of entire financial assets, or a participating interest in an entire financial asset in which the transferor surrenders control over those financial assets is accounted for as a sale if and only if all of the following conditions are met:

- ▶ The transferred financial assets have been isolated from the transferor – put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership. Refer to section 3, *Criteria for a sale – Legal isolation*, for further guidance on this condition.
- ▶ Each transferee (or, if the transferee is an entity whose sole purpose is to engage in securitization or asset-backed financing activities and that entity is constrained from pledging or exchanging the assets it receives, each third-party holder of its beneficial interests) has the right to pledge or exchange the assets (or beneficial interests) it received, and no condition both constrains the transferee (or third-party holder of its beneficial interests) from taking advantage of its right to pledge or exchange the asset and provides more than a trivial benefit to the transferor. Refer to section 4, *Criteria for a sale – Right to pledge or exchange*, for further guidance on this condition.
- ▶ The transferor, its consolidated affiliates included in the financial statements being presented or its agents do not maintain effective control over the transferred financial assets or third-party beneficial interests related to those transferred assets. Refer to section 5, *Criteria for a sale – Effective control*, for further guidance on this condition.

1.5.3 Transactions between entities under common control

ASC 860-10-55-78 provides that a transfer from one subsidiary (the transferor) to another subsidiary (the transferee) of a common parent would be accounted for as a sale in each subsidiary's separate-entity financial statements if both of the following requirements are met:

- ▶ All of the conditions in ASC 860-10-40-5 (including the condition on isolation of the transferred financial assets) are met.
- ▶ The transferee's assets and liabilities are not consolidated into the separate-entity financial statements of the transferor.

In a transfer between two subsidiaries of a common parent, the transferor-subsiary should not consider parent involvements with the transferred financial assets in applying ASC 860-10-40-5.¹⁰

1.6 Recognition and measurement

Upon completion of a transfer of a financial asset (or participating interest) to be accounted for as a sale, an entity should recognize in earnings any resulting gain or loss as determined under ASC 860-20-40-1A and 40-1B. The proceeds consist of the cash and any other assets obtained in the transfer, including beneficial interests and separately recognized servicing assets, less any liabilities incurred, including separately recognized servicing liabilities. Any derivative financial instrument entered into concurrently with a transfer of financial assets is either an asset obtained or a liability incurred and is part of the proceeds received. ASC 860 requires that all proceeds and reductions of proceeds from a sale be initially measured at fair value.

¹⁰ See ASC 860-10-40-4.

For transfers involving participating interests, the participating interests in financial assets that continue to be held by the transferor are not part of the proceeds of the transfer. Rather, the transferor has surrendered control over only those transferred participating interests transferred to third parties. Consequently, the carrying amount of the participating interests that the transferor continues to hold should be measured at the date of the transfer by allocating the previous carrying amount between the portions of the asset transferred and the portion that continues to be held by the transferor based on their relative fair values.

Assets and liabilities recognized as a result of applying ASC 860 subsequently will be accounted for as if they had been acquired or incurred in an independent transaction, in accordance with other US GAAP.

Refer to section 6, *Recognition and measurement*, for further guidance on the recognition and measurement requirements related to the transfer of financial assets or participating interests that satisfy the conditions for sale accounting.

1.7 Proceeds from a transfer of financial assets accounted for as sold

An entity that transfers financial assets in a transfer that qualifies for sale accounting recognizes all assets obtained and liabilities incurred relating to the transfer at fair value. The following table lists common examples of proceeds¹¹ received, other than cash, resulting from transfers of financial assets that qualify as sales.

| Examples of proceeds | Description and reference |
|-----------------------------|--|
| Servicing rights | A transferor's right to service financial assets it has sold is recognized and accounted for in accordance with ASC 860-50. See section 1.7.1 for an overview of accounting for servicing assets and liabilities, and section 7 for more detailed guidance on accounting for servicing assets and servicing liabilities recognized. |
| Beneficial interests | Beneficial interests represent rights to receive specified cash inflows received by a trust or other entity. As discussed in section 1.7.2, ASC 860 requires beneficial interests received as part of the proceeds on a sale of financial assets to be recognized initially at fair value. However, the subsequent accounting will be based on other applicable accounting guidance. See section 6.5.3.1.2 for further discussion on the subsequent accounting for beneficial interests. |
| Derivatives | Derivatives that are received as proceeds from a sale of financial assets should be initially measured at fair value. Derivatives that are in the scope of ASC 815 are subsequently measured at fair value with changes in fair value recognized in earnings. As discussed in section 6.5.3.3, common derivatives include options, forwards and swaps. Further, certain beneficial interests and guarantees may meet the definition of a derivative that must be accounted for in accordance with ASC 815. |
| Guarantees | Transferors may guarantee or otherwise enhance the credit risk of financial assets that are sold. See section 6.5.3.4 for further discussion on the accounting for guarantees. |
| Recourse obligations | Recourse obligations require a transferor to compensate the transferee for certain events (e.g., failure of underlying borrower to make payments when due). See section 6.5.3.5 for further discussion on the accounting for recourse obligations. |

Refer to section 6.5 for further guidance on the accounting for typical assets obtained and liabilities incurred as proceeds from transfers of financial assets that meet the requirements for sale accounting.

¹¹ The ASC Master Glossary defines proceeds as "cash, beneficial interests, servicing assets, derivative instruments, or other assets that are obtained in a transfer of financial assets, less any liabilities incurred."

1.7.1 Servicing assets and liabilities

An entity that retains servicing rights over financial assets sold will recognize a servicing asset or liability, depending on whether the servicing fee is above or below “adequate compensation.” The ASC Master Glossary defines adequate compensation as the “amount of benefits of servicing that would fairly compensate a substitute servicer should one be required, which includes the profit that would be demanded in the marketplace. It is the amount demanded by the marketplace to perform the specific type of servicing.” The key point of this definition is that adequate compensation is the amount demanded by the marketplace to perform the specific type of servicing; it does not vary according to the specific servicing costs of the servicer.

The recognition and measurement of a servicing asset or servicing liability should occur each time an entity undertakes an obligation to service financial assets in either of the following situations:

- ▶ A servicer’s transfer of an entire financial asset, a group of entire financial assets or a participating interest that meets the requirements for sale accounting
- ▶ An acquisition or assumption of a servicing obligation that does not relate to financial assets of the servicer or its consolidated affiliates included in the financial statements being presented

The resulting servicing asset or servicing liability should be recognized and initially measured at fair value. However, an entity is permitted to choose either the amortization method or the fair-value-measurement method to subsequently measure each class of separately recognized servicing assets or servicing liabilities.

Refer to section 7, *Servicing of financial assets*, for further guidance on the accounting for servicing assets and servicing liabilities.

1.7.2 Beneficial interests, including financial assets subject to prepayment

Transferors may retain rights to receive specified cash inflows from the financial assets sold to the transferee. These rights are referred to as beneficial interests. Examples of such beneficial interests include interest-only strips, retained interests, as well as a deferred purchase price (DPP) from the sale of receivables. ASC 860 requires transferors to initially measure beneficial interests received as proceeds at fair value, however, it provides limited guidance on subsequent accounting. Refer to section 6.5.3.1.2 for further discussion on the subsequent accounting for beneficial interests.

Certain beneficial interests that are not derivatives under ASC 815 may be in the scope of ASC 320, *Investments – Debt Securities* (e.g., certain interest-only strips that meet the definition of securities), and all relevant provisions of that accounting topic (including the disclosure requirements) should be applied to them.

However, even if beneficial interests are not in the scope of ASC 320, ASC 860 requires financial assets that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment to be subsequently measured like investments in debt securities classified as available for sale or trading under ASC 320. These financial assets subject to prepayment are discussed further in section 6.5.3.1.2.3.

1.8 Changes that result in a transferor regaining effective control of previously transferred financial assets

A change in law or other circumstance (e.g., resolution of a contingency) may result in (1) a transferred portion of an entire financial asset no longer meeting the conditions of a participating interest (as defined in ASC 860-10-40-6A) or (2) the transferor’s regaining control of transferred financial assets after a transfer that was previously accounted for as a sale, because one or more of the conditions for sale treatment in ASC 860-10-40-5 are no longer met. Such changes, unless they arise from circumstances specifically exempted by ASC 860-20-25-9 (e.g., a change in market price that causes an option to become in the money), should be accounted for in the same manner as a purchase of the transferred financial assets from the former transferee(s) in exchange for liabilities assumed (ASC 860-20-25-1). In other words, the previously sold assets should be recorded at fair value on the date control is regained.

The accounting for changes that result in the transferor regaining control of previously sold assets is complex and is further discussed in section 6.6.

1.9 Secured borrowings and collateral

If a transfer of financial assets fails to meet ASC 860-10-40-5's criteria for sale accounting, the transferor and transferee should account for the transaction as a secured borrowing (financing) with a pledge of collateral. In a secured borrowing the transferor (debtor) recognizes any proceeds (e.g., cash) received as a liability while continuing to report the transferred assets on its balance sheet with no change in the basis of accounting. In most cases, the transferee (lender) records a receivable (loan) for the amount of the funds advanced. In subsequent periods, the transferor recognizes any income on the transferred assets and any expense incurred on the liability based on the requirements of other ASC topics.

In many financing transactions, a debtor may grant a security interest in certain assets to a lender (secured party) to serve as collateral for its obligation under a borrowing, with or without recourse to other assets of the debtor. If collateral is transferred to the secured party, the custodial arrangement is commonly referred to as a pledge. Secured parties sometimes are permitted to sell or re-pledge collateral held under a pledge. In a transfer of collateral that is accounted for as a secured borrowing, the recognition of the collateral by the secured party and the reclassification of the collateral by the debtor depend on whether the secured party has the right to sell or re-pledge the collateral and whether the debtor has defaulted under the terms of the borrowing.

Refer to section 8, *Secured borrowings and collateral*, for further guidance.

1.10 Disclosures

The disclosure requirements of ASC 860, which apply to both public and nonpublic entities, are designed to provide users of the financial statements with an understanding of all of the following:

- ▶ A transferor's continuing involvement in transferred financial assets
- ▶ The nature of any restriction on assets reported by a transferor in its statement of financial position, including the carrying amounts of such assets
- ▶ How servicing assets and servicing liabilities are reported by a transferor under ASC 860
- ▶ How a transfer of financial assets affects an entity's financial position, financial performance and cash flows

To that end, ASC 860 requires specific disclosures about each of the following:

- ▶ Securitizations or asset-backed financing arrangements accounted for as sales when the transferor has continuing involvement
- ▶ Transactions accounted for as sales that result in the transferor retaining substantially all of the exposure to the economic return on the transferred financial asset
- ▶ Transfers of financial assets accounted for as secured borrowings
- ▶ Repurchase agreements, securities lending transactions and repurchase-to-maturity transactions accounted for as secured borrowings
- ▶ Collateral
- ▶ All servicing assets and servicing liabilities
- ▶ Servicing assets and servicing liabilities subsequently measured at fair value
- ▶ Servicing assets and servicing liabilities subsequently amortized

Refer to section 11, *Disclosures*, for a complete listing of ASC 860's disclosure requirements.

1.11 Questions and interpretive responses (updated September 2025)

Question 1-1

Transfers of an interest in a consolidated special-purpose entity

Assume an entity transfers loans to a consolidated special-purpose entity (SPE) in exchange for cash and subordinated beneficial interests. Concurrently, the SPE issues senior beneficial interests, which pay a prescribed rate of return each period, to third-party investors. Would the issuance of senior beneficial interests be within the scope of ASC 810, *Consolidation*, which may result in the proceeds received being accounted for as noncontrolling interests? Or, would this transaction be within the scope of ASC 860, which would require the entity to determine whether the transaction should be accounted for as a sale of financial assets or as a secured borrowing (i.e., collateralized debt)?

It depends on whether the subsidiary meets the definition of a “business.” ASC 860-10-15-4 notes that the guidance in ASC 860 does not apply to “investments by owners or distributions to owners of a business entity.” Additionally, the SEC staff has indicated that “when a subsidiary is created simply to issue beneficial interests backed by financial assets rather than to engage in substantive business activities, [the SEC staff has] concluded that sales of interests in the subsidiary should be viewed as transfers of interests in the financial assets themselves.”¹²

Accordingly, if the subsidiary in the example described above is a “business,” the guidance in ASC 810 should be applied to determine whether the proceeds received for the senior beneficial interests should be accounted for as noncontrolling interests (assuming the senior beneficial interests are classified as equity instruments). Alternatively, if a subsidiary does not meet the definition of business (which is likely the case in the above example), the senior beneficial interests in such entities are effectively transfers of interests in the financial assets of the subsidiary and are within the scope of ASC 860. In that case, sale accounting would be appropriate only if both the initial transfer of loans to the SPE and the subsequent transfer of senior beneficial interests to third party investors meets the derecognition requirements of ASC 860 and the transferor is not the primary beneficiary of the SPE under ASC 810.

Question 1-2

Transfers of rights to future cash receipts

An entity may enter into a transaction to transfer to a third party its rights to future cash receipts arising from a sales transaction. The form of such a transaction may vary. For example, an entity may decide to transfer its rights to future cash receipts (e.g., accounts receivable) through a factoring arrangement with a third party to raise capital to fund its operations and improve its credit position with its lenders. The accounts receivable would generally be sold at a discount to face value, and the third party would assume the full risk of collection, without recourse to the entity in the event of a loss. How should an entity account for the transfer to a third party of its rights to future cash receipts arising from a sales transaction?

If an entity has satisfied the criteria to recognize revenue under ASC 606 for the underlying sales transaction, the subsequent transfer of any related accounts receivable should be accounted for under ASC 860. In contrast, contract assets are not in the scope of ASC 860-10. See our FRD, *Revenue from Contracts with Customers*, for further details on revenue recognition under ASC 606.

¹² SEC Professional Accounting Fellow Brian W. Fields, Speech at the 2009 AICPA National Conference on Current SEC and PCAOB Developments <http://www.sec.gov/news/speech/2009/spch120709bwf.htm>.



Proposed FASB amendments

In January 2025, the FASB proposed amendments to clarify, correct errors in or make other improvements to a variety of topics in the Codification, including a proposal to clarify the guidance for the transfer of receivables from contracts with customers. The proposed amendments to ASC 860 would clarify that the transfer of receivables from contracts with customers recognized in accordance with the guidance in ASC 606-10-45-4 would be accounted for as a transfer of financial assets and subject to the requirements of ASC 860-10. Therefore, an entity that has not transferred control of a good or service would still apply ASC 860 to evaluate the transfer of the receivable, as long as the right to consideration is unconditional.

Status: The FASB is expected to issue a final ASU in the fourth quarter of 2025. Readers should monitor developments.

Question 1-3

Reacquisition by an entity of its own securities

Assume an entity enters into a transaction to reacquire its own securities by exchanging a noncash financial assets (for example, US Treasury bonds or shares of an unconsolidated investee) for common shares. Would this transaction be in the scope of ASC 860?

No. ASC 860-10-15-4 notes that the guidance in ASC 860 does not apply to “investments by owners or distributions to owners of a business entity.” The transaction to reacquire its own securities constitutes a distribution by an entity to its owners, and it would be excluded from the scope of ASC 860. This scope exclusion applies to both the transferor and the transferee in the transaction.

2 Unit of account

2.1 Introduction

The derecognition criteria of ASC 860-10-40-5 is applied only to the transfer of

- ▶ An entire financial asset
- ▶ A group of entire financial assets, or
- ▶ A participating interest, as defined, in an entire financial asset.

This section discusses considerations in determining what constitutes an entire financial asset and whether a portion of a transferred financial asset meets the definition of a participating interest.

2.2 Entire financial asset

As explained in ASC 860-10-40-4D, determining what constitutes an entire financial asset requires a reporting entity to consider both (a) the financial asset's legal form and (b) what rights and characteristics it conveys to the transferee(s). ASC 860-10-55-17F through 860-10-55-17H provides examples that illustrate these concepts:

Excerpt from Accounting Standards Codification

Transfers and Servicing – Overall

Implementation Guidance and Illustrations

Meaning of the Term Entire Financial Asset

860-10-55-17F

A loan to one borrower in accordance with a single contract that is transferred to a securitization entity before securitization shall be considered an entire financial asset. Similarly, a beneficial interest in securitized financial assets after the securitization process has been completed shall be considered an entire financial asset. In contrast, a transferred interest in an individual loan shall not be considered an entire financial asset; however, if the transferred interest meets the definition of a **participating interest**, the participating interest would be eligible for sale accounting.

860-10-55-17G

In a transaction in which the transferor creates an interest-only strip from a loan and transfers the interest-only strip, the interest-only strip does not meet the definition of an entire financial asset (and an interest-only strip does not meet the definition of a participating interest; therefore, sale accounting would be precluded). In contrast, if an entire financial asset is transferred to a securitization entity that it does not consolidate and the transfer meets the conditions for sale accounting, the transferor may obtain an interest-only strip as proceeds from the sale. An interest-only strip received as proceeds of a sale is an entire financial asset for purposes of evaluating any future transfers that could then be eligible for sale accounting.

860-10-55-17H

If multiple advances are made to one borrower in accordance with a single contract (such as a line of credit, credit card loan, or a construction loan), an advance on that contract would be a separate unit of account if the advance retains its identity, does not become part of a larger loan balance, and is transferred in its entirety. However, if the transferor transfers an advance in its entirety and the advance loses its identity and becomes part of a larger loan balance, the transfer would be eligible

for sale accounting only if the transfer of the advance does not result in the transferor retaining any interest in the larger balance or if the transfer results in the transferor's interest in the larger balance meeting the definition of a participating interest. Similarly, if the transferor transfers an interest in an advance that has lost its identity, the interest must be a participating interest in the larger balance to be eligible for sale accounting.

Refer to section 1, *Basic principles and scope*, for examples of common transfers of financial assets that may involve transfers of entire financial assets or groups of entire financial assets.

2.3

Participating interest

If the financial asset being evaluated represents an ownership interest in a portion of an entire financial asset that ownership interest will need to meet the definition of a participating interest to be eligible for sale accounting. Inherent in this concept is that an entire financial asset cannot be divided into components unless all of the resulting portions mirror the entire financial asset in a way that the transferor and all transferees proportionately share all of the rights, risks and benefits of the entire financial asset.

Excerpt from Accounting Standards Codification

Transfers and Servicing – Overall

Derecognition

Meaning of the Term Participating Interest

860-10-40-6A

A participating interest has all of the following characteristics:

- a. From the date of the transfer, it represents a proportionate (pro rata) ownership interest in an entire financial asset. The percentage of ownership interests held by the transferor in the entire financial asset may vary over time, while the entire financial asset remains outstanding as long as the resulting portions held by the transferor (including any participating interest retained by the transferor, its consolidated affiliates included in the financial statements being presented, or its agents) and the transferee(s) meet the other characteristics of a participating interest. For example, if the transferor's interest in an entire financial asset changes because it subsequently sells another interest in the entire financial asset, the interest held initially and subsequently by the transferor must meet the definition of a participating interest.
- b. From the date of the transfer, all cash flows received from the entire financial asset are divided proportionately among the participating interest holders (including any interest retained by the transferor, its consolidated affiliates included in the financial statements being presented, or its agents) in an amount equal to their share of ownership. An allocation of specified cash flows is not an allowed characteristic of a participating interest unless each cash flow is proportionately allocated to the participating interest holders. In determining proportionate cash flows:
 1. Cash flows allocated as compensation for services performed, if any, shall not be included provided those cash flows meet both of the following conditions:
 - i. They are not subordinate to the proportionate cash flows of the participating interest.
 - ii. They are not significantly above an amount that would fairly compensate a substitute service provider, should one be required, which includes the profit that would be demanded in the marketplace.
 2. Any cash flows received by the transferor as proceeds of the transfer of the participating interest shall be excluded provided that the transfer does not result in the transferor receiving an ownership interest in the financial asset that permits it to receive disproportionate cash flows.

- c. The priority of cash flows has all of the following characteristics:
1. The rights of each participating interest holder (including the transferor in its role as a participating interest holder) have the same priority.
 2. No participating interest holder's interest is subordinated to the interest of another participating interest holder.
 3. The priority does not change in the event of bankruptcy or other receivership of the transferor, the original debtor, or any other participating interest holder.
 4. Participating interest holders have no recourse to the transferor (or its consolidated affiliates included in the financial statements being presented or its agents) or to each other, other than any of the following:
 - i. **Standard representations and warranties**
 - ii. Ongoing contractual obligations to service the entire financial asset and administer the transfer contract
 - iii. Contractual obligations to share in any set-off benefits received by any participating interest holder.

That is, no participating interest holder is entitled to receive cash before any other participating interest holder under its contractual rights as a participating interest holder. For example, if a participating interest holder also is the servicer of the entire financial asset and receives cash in its role as servicer, that arrangement would not violate this requirement.

- d. No party has the right to pledge or exchange the entire financial asset unless all participating interest holders agree to pledge or exchange the entire financial asset.

A set-off right is not an impediment to meeting the participating interest definition. For implementation guidance on the application of the term *participating interest*, see paragraphs 860-10-55-17I through 55-17N.

As noted in the definition above, the requirements for a participating interest do not allow for the allocation of specified cash flows unless each cash flow is proportionately allocated to the participating interest holders. ASC 860-10-55-17I provides the following examples illustrating the requirements of a participating interest:

Excerpt from Accounting Standards Codification

Transfers and Servicing – Overall

Implementation Guidance and Illustrations

Application of the Term Participating Interest

860-10-55-17I

Paragraph 860-10-40-6A(b) states that an allocation of specified cash flows precludes a portion from meeting the definition of a participating interest unless each cash flow is proportionately allocated to the participating interest holders. Following are several examples implementing that guidance:

- a. In the circumstance of an individual loan in which the borrower is required to make a contractual payment that consists of a principal amount and interest amount on the loan, the transferor and transferee shall share in the principal and interest payments on the basis of their proportionate ownership interest in the loan.

- b. In contrast, if the transferor is entitled to receive an amount that represents the principal payments and the transferee is entitled to receive an amount that represents the interest payments on the loan, that arrangement would not be consistent with the participating interest definition because the transferor and transferee do not share proportionately in the cash flows received from the loan.
- c. In other circumstances, a transferor may transfer a portion of an individual loan that represents either a senior interest or a junior interest in an individual loan. In both of those circumstances, the transferor would account for the transfer as a secured borrowing because the senior interest or junior interest in the loan do not meet the requirements to be participating interests (see paragraph 860-10-40-6A(c)).

ASC 860-10-40-6A and 860-10-55-17M state that certain cash flows should be excluded when evaluating whether all cash flows received from the entire financial asset are divided proportionately among the participating interest holders. Such exclusions include compensation for services performed, proceeds from sales of participating interests and recourse in the form of an independent third-party guarantee, which are discussed further below.

2.3.1 Compensation for services performed

As noted in ASC 860-10-55-17J, compensation for services performed includes all of the following:

- ▶ Loan origination fees paid by the borrower to the transferor
- ▶ Fees necessary to arrange and complete the transfer paid by the transferee to the transferor
- ▶ Fees for servicing the financial asset (i.e., compensation to process the collection and remittance of contractual cash flows of a financial asset)

Pursuant to ASC 860-10-40-6A, cash flows allocated as compensation for services performed, if any, are excluded from the cash flows required to be allocated proportionately to participating interest holders provided payment for such services are *both*:

- ▶ Not subordinate to the proportionate cash flows allocated to the participating interest holders
- ▶ Not significantly above an amount that would fairly compensate a substitute service provider, should one be required, which includes the profit that would be demanded in the marketplace (“adequate compensation,” as defined in the ASC Master Glossary)

The FASB included the second criterion to prevent an excess interest spread retained in the entire financial asset being classified as a servicing fee. Servicing fee payments that are significantly above “adequate compensation” essentially entitle the recipient to a disproportionate interest in the contractual cash flows of the underlying financial asset, thus preventing the transferred portion from meeting the definition of a participating interest.

This concept is further discussed in the following Codification excerpt.

Excerpt from Accounting Standards Codification

Transfers and Servicing – Overall

Implementation Guidance and Illustrations

Application of the Term Participating Interest

860-10-55-17K

The transfer of a portion of an entire financial asset may result in a gain or loss on the transfer if the contractual interest rate on the entire financial asset differs from the market rate at the time of transfer. Paragraph 860-10-40-6A(b)(2) precludes a portion from meeting the definition of a participating interest if the transfer results in the transferor receiving an ownership interest in the financial asset that permits it to receive disproportionate cash flows. For example, if the transferor transfers an interest in an entire financial asset and the transferee agrees to incorporate the excess interest (between the contractual interest rate on the financial asset and the market interest rate at the date of transfer) into the contractually specified servicing fee, the excess interest would likely result in the conveyance of an interest-only strip to the transferor from the transferee. An interest-only strip would result in a disproportionate division of cash flows of the financial asset among the participating interest holders and would preclude the portion from meeting the definition of a participating interest.

The FASB does not define “not significantly above” adequate compensation. Determining whether amounts are not significantly above adequate compensation is a matter of facts and circumstances requiring use of professional judgment. Refer to section 7.3.2 for further information about the meaning of adequate compensation. We believe this determination requires consideration of various quantitative and qualitative factors, including:

| Factor | Example consideration |
|--|--|
| Type of financial asset being serviced | Compared to a fixed-rate corporate loan with a quarterly payment schedule, a variable-rate loan backed by commercial real estate with scheduled monthly interest payments may require greater servicing effort, and demand a higher servicing fee, because of the interest rate resets and higher frequency of payments that require processing. |
| The inherent risks associated with the financial asset being serviced | The credit worthiness of the underlying debtor (i.e., the likelihood of default) and market conditions may require varying degrees of servicing efforts and commensurate compensation. |
| The availability and reliability of observable market inputs to estimate adequate compensation and the degree to which the valuation inputs (i.e., market-based cost and profit elements) typically vary (e.g., based on asset class and size) | The absence of observable market inputs may result in a wider reasonably estimated range of values that may constitute adequate compensation. |
| The rights and obligations conveyed by the servicing agreement relative to what is customary in the market for similar arrangements to service similar participating interests | Whether the arrangement entitles the servicer to other sources of income, including interest “float” and ancillary fees (e.g., late fees) and the interaction of these rights compared to customary arrangements and related fees. |

Entities should evaluate any cash flows allocated as compensation for services performed in connection with the transfer of a portion of an entire financial asset and document the basis for its participating interest conclusions.

2.3.2 Proceeds from sales of participating interests

Because a participating interest in an entire financial asset may be sold after the purchase or origination of the financial asset itself (or after the purchaser or lender has committed to purchase or originate the financial asset), the contractual interest rate passed through for the portion of the financial asset sold may differ from market interest rates at the time of sale of the participating interest. Differences between the asset's contractual and market interest rates at the time of sale (which may result from changes in the risk-free rate, changes in credit spreads or other factors) will likely result in portions of financial assets being sold at either discounts or premiums to the face amount of the participating interest. If the participating interest entitles the transferee to a current market interest rate that differs from the financial asset's contractual interest rate, the portion transferred would not be considered a participating interest (see ASC 860-10-40-6A(b)(2)).

Illustration 2-1: Considering changes in market interest rates when evaluating whether transferred portions of an entire financial asset meet the participating interest requirements

An entity originates a loan of \$100,000 with a contractual coupon of 5% and subsequently sells a 50% interest in that loan in a declining interest rate environment where market rates for the loan are 4%.

If the transferor retains an interest only-strip to compensate for the difference, the transaction would fail to meet the participating interest requirement under ASC 860-10-40-6A(b). Similarly, in a rising interest rate environment, if the transferor agrees to pay an interest rate higher than the loan's stated coupon the transaction would not meet the definition of a participating interest.

However, if the transferor and transferee agree to make up the difference in interest rates through higher or lower proceeds up-front, rather than by retaining a future right and/or obligation, the transfer could satisfy the requirements of a participating interest and, therefore, would be eligible for derecognition.

2.3.3 Guarantees and recourse provisions

ASC 860-10-40-6A(c)(4)(i) explains that recourse in the form of standard representations and warranties would not preclude a portion of an entire financial asset from being considered a participating interest. Additionally, the implementation guidance in ASC 860-10-55-17M indicates that an independent third-party guarantee, including any cash flows allocated to a third-party guarantor for the guarantee fee, is excluded from the participating interest evaluation.

As noted in Statement 166's Basis for Conclusions, the FASB reasoned an independent third-party guarantee should be excluded because it is an arrangement in which a third-party guarantor would assume a participating interest in the event of default and, accordingly, does not result in recourse to the transferor or other participating interest holders. Refer to Illustration 2-3 in section 2.3.6 for an example of how a third-party guarantee should be considered in the participating interest determination.

Conversely, recourse provided by the transferor (other than in the form of standard representations and warranties) would preclude the transferred portion of an entire financial asset from meeting the definition of a participating interest. As explained in ASC 860-10-55-46(b), a transfer of a portion of a receivable with recourse, other than that permitted in ASC 860-10-40-6A(c)(4), does not meet the requirements of a participating interest and should be accounted for as a secured borrowing. For example, in certain transfers, recourse is provided to the transferee that requires the transferor to reimburse any premium paid by the transferee if the underlying financial asset is prepaid within a defined time frame of the transfer date. Such recourse would preclude the transferred portion from meeting the definition of a participating interest (see ASC 860-10-55-17L). However, once the recourse provision expires, the transferred portion should be reevaluated to determine if it meets the participating interest definition.

2.3.4 Other exceptions – Rights of set-off

As further discussed in section 3, *Criteria for a sale – Legal isolation*, in the event of bankruptcy or receivership of the transferor, set-off rights of the borrower do not prevent a transfer of a portion of a financial asset from meeting the legal isolation requirements as long as each participating interest holder is contractually entitled to proportionately share in any set-off benefits received.

2.3.5 Accounting for transfers that fail the participating interest requirements

A transfer of a portion of an entire financial asset that fails to meet the requirements of a participating interest is accounted for as a secured borrowing because the participating interest criteria are a prerequisite for being able to apply the derecognition requirements of ASC 860-10-40-5 to transfers of portions of an entire financial asset.

Additionally, such a transfer causes all other transfers associated with the same entire financial asset to fail the requirements of a participating interest, thus precluding sale accounting for those transfers. For example, if a previous transfer of a portion of an entire financial asset met the requirements of a participating interest and otherwise met the derecognition requirements of ASC 860-10-40-5, a subsequent transfer of a portion of that same financial asset that did not meet the requirements of a participating interest would require the transferor to re-recognize the previously transferred asset(s). In these circumstances, the transferor initially measures the financial assets “reacquired” from the transferees and related liabilities at fair value on the date of the subsequent transfer of a portion of an entire financial asset that did not meet the participating interest criteria. The fair value of the reacquired financial assets would typically approximate the fair value of the related liabilities assumed by the original transferor when such liabilities are non-recourse. Refer to section 6.6 for additional discussion on regaining control of previously derecognized financial assets.

An entity may transfer portions of an entire financial asset that do not individually meet the participating interest criteria to another entity (or other entities) without conveying full legal title to the underlying entire financial asset. Once an entity has transferred all interests in an entire financial asset such that the percentage of ownership interests held by the transferor is zero, we believe the transferor is no longer required to determine whether the portions transferred individually meet the participating interest definition to apply the derecognition requirements of ASC 860-10-40-5.

Refer to Illustration 2-2(a) and 2-2(b) in section 2.3.6 and questions 2-1 to 2-4 for additional interpretive guidance.

2.3.6 Illustrative examples

The following examples illustrate the participating interest requirements:

Illustration 2-2: Transfers of portions of an entire financial asset that meet the participating interest requirements

Bank A originates a loan to Company B (the Borrower) with a principal amount of \$100,000 and an interest rate of 8%. One month later, Bank A transfers a 30% participating interest to Investor C for \$30,000 and retains servicing rights. Bank A is obligated to pass through 30% of both the remaining contractual principal and interest cash flows received from the borrower (after deducting servicing fees) to Investor C. The compensation received by Bank A to service the loan is neither significantly in excess nor below “adequate compensation.” In addition, any servicing payments are deducted from the cash flows, if any, received from the underlying borrower (Company B) and are senior in priority to the proportionate cash flows allocated to the participating interest holder(s).

Months later, Bank A transfers an additional 20% participating interest in the remaining original loan to Trust D. Bank A is obligated to pass-through 20% of both the remaining contractual principal and interest cash flows received from the borrower (after deducting servicing fees) to Trust D. Because of the second transfer, Bank A, Investor C and Trust D are legally entitled to 50%, 30% and 20%, respectively, of the original loan's remaining contractual principal and interest cash flows (after deducting Bank A's servicing fee). In this example, both the initial and subsequent transfers meet the requirements of a participating interest and are accounted for as sales assuming the derecognition requirements of ASC 860-10-40-5 have been met.

Illustration 2-2(a): Transfers of portions of an entire financial asset that do not meet the participating interest requirements

Assume the same facts as in Illustration 2-2, except that the second transfer conveys 20% of the original loan's remaining principal balance, but only 19% of the remaining interest cash flows.

In this instance, the transfer would not meet the definition of a participating interest because the transfer would not convey to Trust D a proportionate ownership interest in an entire financial asset. Additionally, the transfer to Trust D causes the previous transfer to Investor C to also fail the requirements of a participating interest, thus precluding sale accounting for all transfers associated with the loan to Company B.

After that change, Bank A (the transferor) recognizes in its financial statements the previously transferred financial assets (i.e., the portions of the loan to Company B that previously qualified as a participating interest) with corresponding liabilities to the former transferee(s). Bank A initially measures the financial asset "reacquired" from Investor C and the related liability at fair value on the date of the transaction with Trust D, as if Bank A purchased the transferred financial asset and assumed the liability on that date.

Accordingly, Bank A would report on its balance sheet the entire Company B loan (70% of which would be measured at historical carrying value and 30% of which would be measured based on its fair value at the date of the transaction with Trust D) as an asset, with corresponding non-recourse liabilities for its contractual obligation to pass-through portions of the loan's cash flows to both Investor C (measured at fair value on the date of the transaction with Trust D) and Trust D (measured at the consideration received from Trust D). The fair value of the loan "reacquired" from Investor C approximates the fair value of the related non-recourse liability assumed by Bank A.

Illustration 2-2(b): Eligibility for sale accounting when an entire financial asset is transferred in portions that individually do not meet the participating interest requirements

Assume the same facts as in Illustration 2-2(a), except that Bank A transfers its remaining 50% and 51% ownership interest in the contractual principal and interest cash flows of the Company B loan to Hedge Fund E. Bank A retains legal title to the loan and continues to service the loan for Investor C, Trust D and Hedge Fund E. Cash flows received by Bank A represent "adequate compensation" for servicing the loan and are senior in priority to cash flows allocated to owners of 100% of the loan's contractual principal and interest.

Because Bank A continues to retain legal title, it must evaluate whether it has transferred all of its ownership interest in the entire loan. In making this determination, Bank A (including its consolidated affiliates and its agents) should evaluate whether (1) it has transferred all direct and indirect economic interests in the cash flows generated from the Company B loan, other than servicing and (2) it has no involvement in, nor does it place any restrictions on, the ability of Investor C, Trust D or Hedge Fund E to pledge or exchange the loan.

If Bank A determines that it has transferred all of its ownership interest in the entire loan, it would need to assess the derecognition requirements of ASC 860-10-40-5 for the transfers to Investor C, Trust D and Hedge Fund E. Assuming these requirements are met, Bank A would derecognize the loan receivable, the liabilities to Investor C and Trust D and recognize any resulting gain or loss on sale.

Illustration 2-3: Analysis of cash flows required to be proportionately allocated among participating interest holders and those excluded from the participating interest requirements

The following example illustrates cash flows that may be excluded from a participating interest determination. It assumes that all other participating interest requirements are met.

Bank A originates a ten-year loan to Company B (the Borrower) with a contractual principal amount and interest rate of \$200,000 and 7%, respectively. The loan meets the qualifications of the Small Business Administration (SBA) and the lender has received, in exchange for a fee, an SBA guarantee for 75% of the loan's contractual payments in the event the borrower defaults. Shortly after its origination, Bank A transfers the guaranteed portion (i.e., 75%) of the qualifying SBA loan to Bank C for \$157,500 (a 5% premium) and retains servicing rights. Assume the following:

- ▶ Bank A and Bank C have the same priority and neither one is subordinated to the other – that is, neither Bank A nor Bank C are entitled to receive cash from the borrower before the other.
- ▶ The servicing fee is 100 basis points (1%) per annum of the outstanding balance of the SBA guaranteed portion and is not subordinate to the proportionate cash flows of the participating interests.
- ▶ The servicing fee is not considered significantly above an amount that would fairly compensate a substitute service provider.¹³
- ▶ In the event of default by the borrower, Bank A has no recourse to Bank C; however, Bank C is entitled to recourse from the SBA through the guarantee.
- ▶ A one-time guarantee fee equal to 3% of the total amount guaranteed (i.e., 3% of \$150,000, or \$4,500) is assessed by the SBA and remitted by Bank A to the SBA at the loan's origination.
- ▶ Neither Bank A nor Bank C has the right to pledge or exchange the entire loan unless both entities agree to pledge or exchange the entire loan.

¹³ This example assumes that the 100-basis-point servicing fee does not entitle a servicer to an amount that would be significantly above adequate compensation. It is meant only for illustrative purposes. Any evaluation of the adequacy of servicing fees should be based on the specific facts and circumstances.

Accordingly, the total cash flows received from the borrower of the loan will be allocated among Bank A and Bank C as follows:

| Cash flows¹⁴ | Bank A | Bank C |
|--|---------------|---------------|
| Principal | \$ 50,000 | \$ 150,000 |
| Interest | 19,665 | 58,995 |
| Total principal and interest cash flows | 69,665 | 208,995 |
| <i>Proportionate interest of principal and interest</i> | 25% | 75% |
| Servicing fee (total amount over the life of the loan) | 8,300 | (8,300) |
| Guarantee premium | (4,500) | n/a |
| Premium on transfer (i.e., price in excess of par value) | 7,500 | (7,500) |
| Total cash flows | \$ 80,965 | \$ 193,195 |

The following cash flows are appropriately excluded from the determination of whether the cash flows are divided proportionately among participating interest holders:

- ▶ The cash flows allocated to Bank A as compensation for servicing
- ▶ The guarantee premium paid by Bank A (transferor) to the SBA (i.e., a third-party guarantor)
- ▶ The premium paid by Bank C (transferee) to Bank A to acquire the participating interest

Because the contractual cash flows from the transferred loan (i.e., principal and interest amounts) are proportionately allocated to the participating interest holders, the portion of the loan transferred to Bank C meets the definition of a participating interest.¹⁵

2.4 Questions and interpretive responses (updated May 2024)

Question 2-1 Investments in sales-type or direct-financing lease receivables

May a portion of an interest in the lease receivable, but not the unguaranteed residual value, qualify as a participating interest?

A lessor's lease receivable in a sales-type or a direct financing lease is composed of lease payments and guaranteed residual values. Lease payments and residual values that are guaranteed at the commencement of the lease meet the definition of financial assets. However, unguaranteed residual values and residual values guaranteed after commencement are not financial assets, and therefore, the transfer of these assets is not subject to the requirements of ASC 860.

If a transferred interest in a sales-type or direct-financing lease receivable represents a participating interest, that interest is eligible for sale accounting pursuant to ASC 860-20-55-58. See Question 2-2 on the determination of whether interests in lease receivables that include residual values guaranteed at commencement meet the definition of a participating interest.

¹⁴ The cash flows in the table represent those of an amortizing loan and assume no prepayments.

¹⁵ Any guarantee payments made by the SBA to Bank C in the event of the borrower's default are also excluded from the participating interest determination because the guarantee (1) is provided by an entity (SBA) unrelated to the transferor (Bank A) and (2) does not provide the transferee (Bank C) any recourse against the transferor. See section 2.3.3 and ASC 860-10-55-17M for further discussion about whether a guarantee precludes a portion of a financial asset from meeting the definition of a participating interest.

Question 2-2 Interests in lease residual value guaranteed at commencement

May a pro rata portion of the lease payments from a sales-type or direct-financing lease receivable secured by leased assets be considered a participating interest without also selling a pro rata portion of the residual value guaranteed at commencement?

We believe the answer to this question depends on whether the residual value is a separate unit of account, and that determination is based on whether the residual value is guaranteed by the lessee or by a third-party guarantor (i.e., unrelated to the lessee and lessor).

If the lessee guarantees the residual value, the lease payments and residual value should be viewed as a single unit of account. This is consistent with the guidance about the unit of account eligible for sale accounting in ASC 860-10-40-4D, which states, “[t]he legal form of the asset and what the asset conveys to its holders shall be considered in determining what constitutes an entire financial asset.”

If the residual value is guaranteed by a third party, we believe that the residual value may be excluded from the determination of whether a portion of the gross investment in lease receivables meets the definition of a participating interest because that residual value portion is an obligation of a party different than the obligor under the lease contract. This conclusion is consistent with the implementation guidance in ASC 860-10-55-17M, which states “[r]ecourse in the form of an independent third-party guarantee shall be excluded from the evaluation of whether the participating interest definition is met.”

Question 2-3 Determining the effect of guarantees or recourse provisions

How does a guarantee or recourse arrangement affect the determination of whether a transfer of a portion of an entire financial asset meets the requirements of a participating interest?

A third-party guarantee or recourse arrangement is considered a separate unit of account that is specifically excluded from the evaluation of whether the participating interest definition is met. Similarly, cash flows allocated to a third-party guarantor (e.g., premiums or fees) are excluded from the determination of whether the cash flows are divided proportionately among the participating interest holders. Refer to section 2.3.3 for implementation guidance about addressing recourse in a participating interest.

Conversely, credit guarantees or recourse arrangements provided by the transferor in conjunction with the sale of a portion of an entire financial asset are forms of continuing involvement that would cause the transfer to fail the participating interest requirements.¹⁶ For example, in certain loan participations, the transferee may retain recourse requiring the transferor to reimburse it for any premiums paid if the entire underlying loan is prepaid within 90 days of the transfer date. This type of recourse substantively differs from standard representations and warranties and, therefore, would preclude the transferred portion from meeting the participating interest definition. However, once this type of 90-day recourse provision expires, the transfer should be reevaluated to determine if it meets the participating interest criteria.

¹⁶ See ASC 860-10-40-6A(c)(4) for the requirement related to recourse when evaluating whether a portion of a financial asset is a participating interest.

Question 2-4 Traditional commercial paper programs

May an entity transfer an entire financial asset to a securitization entity (e.g., a commercial paper conduit) in exchange for cash and a subordinated interest in the transferred asset (e.g., a deferred purchase price contingent on the performance of the transferred assets) and achieve sale accounting? Would the entity reach the same accounting conclusion if it transferred only a portion of a financial asset?

If the transfer involves an entire financial asset (or a group of financial assets in its entirety), sale accounting is permissible if each of the derecognition conditions in ASC 860-10-40-5 have been met. The subordinated interest would be evaluated as part of the proceeds received similar to the interest-only strip referred to in ASC 860-10-55-17G.

A transfer of only a portion of a financial asset would not qualify for sale accounting. Prior to Accounting Standards Update (ASU) 2009-16, transfers to commercial paper conduits often involved an entity transferring a senior interest in a pool of trade receivables (typically through a “two-step securitization”) while retaining a junior or subordinated interest in the transferred assets. After the adoption of ASU 2009-16, such transfers would not be eligible for sale accounting because the portion of the financial assets transferred to the commercial paper conduit (i.e., the senior interest) would not meet the requirements of a participating interest because each of the participating interest holders would not have the same priority to the cash flows from the underlying asset (see ASC 860-10-40-4D).

While the economic substance (risks and rewards) of the transfer of (1) a senior interest in an individual financial asset and (2) an entire financial asset in exchange for cash and a subordinated non-recourse interest in the transferred asset is similar, the legal form of the transfer is different. ASU 2009-16 amends and limits the unit of account eligible for derecognition. An entire financial asset cannot be divided into components before a transfer unless all of the components meet the definition of a participating interest (see ASC 860-10-40-6A).

Question 2-5 Fractional shares

A broker-dealer allows its customers to buy portions of whole shares of public companies’ common stock (referred to as fractional shares). Because fractional shares do not exist in the open market, the broker-dealer facilitates the customer’s request by purchasing a whole share in the open market and transferring a portion of the whole share (i.e., the fractional share) into the customer’s account. Is the transfer of the fractional share to the customer in the scope of ASC 860?

It depends. The broker-dealer must determine whether it is acting as a principal or an agent in the transaction that results in the transfer of the fractional share into the customer’s account. In making such a determination, the broker-dealer considers all relevant facts and circumstances and may consider the principal versus agent guidance in ASC 606. The broker-dealer also may consider the legal relationships among the parties to determine whether it, as a matter of law, is a principal or an agent in the transaction. Relevant to this determination is whether the broker-dealer is the legal or beneficial owner of the whole share from which the fractional share is derived.

If the broker-dealer determines it is acting as an agent, the transfer of the fractional share into the customer’s account is not in the scope of ASC 860. If the broker-dealer determines it is acting as a principal, we believe the transfer of the fractional share into the customer’s account would be in the scope of ASC 860, and the derecognition criteria in ASC 860-10-40-5 should be applied to determine whether the transfer should be accounted for as a sale or a secured borrowing.

3 Criteria for a sale – Legal isolation

3.1 Overview

This section focuses on the first criterion for sale accounting outlined in ASC 860-10-40-5, commonly referred to as the “legal isolation criterion.”

Excerpt from Accounting Standards Codification

Transfers and Servicing – Overall

Derecognition

Conditions for a Sale of Financial Assets

860-10-40-5

A transfer of an entire financial asset, a group of entire financial assets, or a participating interest in an entire financial asset in which the transferor surrenders control over those financial assets shall be accounted for as a sale if and only if all of the following conditions are met:

- a. Isolation of transferred financial assets. The transferred financial assets have been isolated from the transferor – put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership. Transferred financial assets are isolated in bankruptcy or other receivership only if the transferred financial assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its consolidated affiliates included in the financial statements being presented. For multiple step transfers, a **bankruptcy-remote entity** is not considered a consolidated affiliate for purposes of performing the isolation analysis. Notwithstanding the isolation analysis, each entity involved in the transfer is subject to the applicable guidance on whether it shall be consolidated (see paragraphs 860-10-40-7 through 40-14 and the guidance beginning in paragraph 860-10-55-18). A **set-off right** is not an impediment to meeting the isolation condition.
- b. [EY note: Condition omitted; see section 4, *Criteria for a sale – Right to pledge or exchange*]
- c. [EY note: Condition omitted; see section 5, *Criteria for a sale – Effective control*]

The legal isolation criterion is important to credit rating agencies and investors in securitization transactions. If the transferred financial assets are not legally isolated from the transferor, they could be reclaimed by the receiver in the event of the transferor’s bankruptcy or receivership, increasing the risks that the investors will not receive all of the benefits associated with the transferred financial assets. Accordingly, credit rating agencies and investors commonly demand transaction structures that minimize these risks.

ASC 860’s provisions require that, in order for a transfer to be accounted for as a sale, the assets must be legally isolated from the transferor, as well as its consolidated affiliates (except for bankruptcy-remote entities, which are described below), such that they could not be reacquired by the transferor’s creditors, even in the event of the transferor’s bankruptcy or other receivership. The legal isolation test is applicable to all transfers of financial assets within the scope of ASC 860. The probability of the transferor’s bankruptcy is not relevant. Because the transfer must meet all of the conditions in ASC 860-10-40-5 throughout the life of the assets to be accounted for as a sale, the legal isolation test is an ongoing one.

Certain entities are formed for the specific purpose of reducing the likelihood that they will be involved in a bankruptcy proceeding or otherwise become insolvent. These entities, commonly referred to as bankruptcy-remote entities, are organized to operate for a limited purpose and as a separate legal entity with assets and liabilities that are isolated from its equity owners. The specific manner in which they are required to be

designed and operated is based on the relevant laws of the jurisdiction in which the entities operate. A bankruptcy-remote entity may be wholly owned and consolidated for financial reporting purposes but should not be considered a consolidated affiliate for purposes of assessing the legal isolation criterion.

3.2

Legal isolation and supporting evidence

Excerpt from Accounting Standards Codification

Transfers and Servicing – Overall

Derecognition

Isolation of Transferred Assets

860-10-40-7

The guidance in the following paragraphs and the related implementation guidance beginning in paragraph 860-10-55-18 applies to transfers by all entities, including institutions for which the Federal Deposit Insurance Corporation (FDIC) would be the receiver.

860-10-40-8

Derecognition of transferred financial assets is appropriate only if the available evidence provides reasonable assurance that the transferred financial assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its consolidated affiliates (that are not bankruptcy-remote entities) included in the financial statements being presented and its creditors (see paragraph 860-10-55-23(c)).

860-10-40-9

The nature and extent of supporting evidence required for an assertion in financial statements that transferred financial assets have been isolated – put presumptively beyond the reach of the transferor, any of its consolidated affiliates (that are not bankruptcy-remote entities) included in the financial statements being presented, and its creditors, either by a single transaction or a series of transactions taken as a whole – depend on the facts and circumstances.

860-10-40-10

All available evidence that either supports or questions an assertion shall be considered, including whether the contract or circumstances permit the transferor to revoke the transfer. It also may include consideration of the legal consequences of the transfer in the jurisdiction in which bankruptcy or other receivership would take place, including all of the following:

- a. Whether a transfer of financial assets would likely be deemed a true sale at law (see paragraph 860-10-55-18A) or otherwise isolated (see paragraph 860-10-55-18C)
- b. Whether the transferor is **affiliated** with the transferee
- c. Other factors pertinent under applicable law.

860-10-40-11

The requirement of paragraph 860-10-40-5(a) that transferred financial assets be isolated focuses on whether transferred financial assets would be isolated from the transferor in the event of bankruptcy or other receivership regardless of how remote or probable bankruptcy or other receivership is at the date of transfer. That is, the requirement would not be satisfied simply because the likelihood of bankruptcy of the transferor is determined to be remote.

860-10-40-12

A transferor's power to require the return of the transferred financial assets arising solely from a contract with the transferee, for example, a call option or removal-of-accounts provision, would not necessarily preclude a conclusion that transferred financial assets have been isolated from the transferor. However, such a power might preclude sale treatment if through it the transferor maintains effective control over the

transferred financial assets. Some common financial transactions, for example, typical **repurchase agreements** and securities lending transactions, may isolate transferred financial assets from the transferor, although they may not meet the other conditions for surrender of control (see paragraph 860-10-40-5).

860-10-40-13

Whether securitizations isolate transferred financial assets may depend on such factors as whether the securitization is accomplished in one-step or multiple-step transfers. That is, the condition can be satisfied either by a single transaction or by a series of transactions considered as a whole. A securitization carried out in one transfer or a series of transfers may or may not isolate the transferred financial assets beyond the reach of the transferor, its consolidated affiliates (that are not bankruptcy-remote entities) included in the financial statements being presented, and its creditors. Whether it does depends on the structure of the securitization transaction taken as a whole, considering such factors as the type and extent of further involvement in arrangements to protect investors from credit, interest rate, and other risks, the availability of other financial assets, and the powers of bankruptcy courts or other receivers.

The nature and extent of the evidence to support the legal isolation assertion depends on the facts and circumstances of each transaction. Derecognition of transferred financial assets is appropriate only if the available evidence provides reasonable assurance that the transfer of the financial assets would be considered legally isolated (i.e., a true sale at law) beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor and its consolidated affiliates (affiliates that are not entities designed to make remote the possibility that they would enter bankruptcy or other receivership) included in the financial statements being presented, and its creditors. When the transfer involves securitization or an asset-backed financing transaction, an assessment of legal isolation would also include an opinion as to whether a bankruptcy court or receiver would substantively consolidate the securitization entity (e.g., trusts, and LLCs) with the transferor from a legal perspective. Thus, a determination of whether the legal isolation criterion has been met to support a conclusion about surrender of control is largely a matter of law and needs to be assessed primarily from a legal perspective.

Whenever the transferor has continuing involvement with the transferred financial assets or the transferee, a legal opinion from a specialist is generally required to support this assessment. Additionally, the transferor needs to periodically evaluate whether it is necessary to obtain an updated legal opinion. This frequently will be necessary when there are changes to the structure of the transaction or the relationship between the transferor or transferees. It may also be necessary to determine whether any changes in law could impact the ongoing applicability of the legal opinion, given the new circumstances.

When a legal opinion is required, the transferor and its auditor must first assess the qualifications of the attorneys involved and determine that they are experts in bankruptcy law or other receivership (e.g., Federal Deposit Insurance Corporation (FDIC)), as applicable. In addition, the transferor and its auditor must be authorized to use the opinion as evidential matter in support of the evaluation of the transferor's assertion that the transfer meets the legal isolation criterion of ASC 860. Permission to use the opinion should be provided directly in the legal opinion addressed to the transferor, or in a separate authorization letter in connection with providing a legal opinion to the transferor.

The standards for use of a legal opinion as evidence to support the legal isolation criterion of ASC 860 are contained in Public Company Accounting Oversight Board (PCAOB) Auditing Interpretation 11, *Using the Work of a Specialist: Auditing Interpretations* (AI 11), and American Institute of Certified Public Accountants (AICPA) Auditing Interpretation 9620, *Using the Work of an Auditor's Specialist: Auditing Interpretations of Section 620* (AU-C 9620). Paragraph 7 of AI 11 and AU-C 9620 requires the auditor to obtain persuasive evidence that the legal isolation criterion has been met not only at the inception of the transfer of the financial assets, but also in subsequent periods. That is, periodic updates are required to support the transferor's assertion that the financial assets have been legally isolated and to confirm that there have been no subsequent changes in relevant laws or applicable regulations that may affect the conclusions reached in the previous opinion.

Excerpt from Accounting Standards Codification

Transfers and Servicing – Overall

Implementation Guidance and Illustrations

Isolation of Transferred Assets

860-10-55-18

This implementation guidance addresses the isolation condition in paragraph 860-10-40-5(a) and applies to transfers of all entities, including institutions for which the FDIC would be the receiver.

860-10-55-18A

In the context of U.S. bankruptcy laws, a true sale opinion from an attorney is often required to support a conclusion that transferred financial assets are isolated from the transferor, any of its consolidated affiliates included in the financial statements being presented, and its creditors. In addition, a nonconsolidation opinion is often required if the transfer is to an affiliated entity. In the context of U.S. bankruptcy laws:

- a. A true sale opinion is an attorney's conclusion that the transferred financial assets have been sold and are beyond the reach of the transferor's creditors and that a court would conclude that the transferred financial assets would not be included in the transferor's bankruptcy estate.
- b. A nonconsolidation opinion is an attorney's conclusion that a court would recognize that an entity holding the transferred financial assets exists separately from the transferor. Additionally, a nonconsolidation opinion is an attorney's conclusion that a court would not order the substantive consolidation of the assets and liabilities of the entity holding the transferred financial assets and the assets and liabilities of the transferor (and its consolidated affiliates included in the financial statements being presented) in the event of the transferor's bankruptcy or receivership.

860-10-55-18B

A legal opinion may not be required if a transferor has a reasonable basis to conclude that the appropriate legal opinion(s) would be given if requested. For example, the transferor might reach a conclusion without consulting an attorney if either of the following conditions exists:

- a. The transfer is a routine transfer of financial assets that does not result in any continuing involvement by the transferor.
- b. The transferor had experience with other transfers with similar facts and circumstances under the same applicable laws and regulations.

860-10-55-18C

For entities that are subject to other possible bankruptcy, conservatorship, or other receivership procedures (for example, banks subject to receivership by the Federal Deposit Insurance Corporation [FDIC]) in the United States or other jurisdictions, judgments about whether transferred financial assets have been isolated shall be made in relation to the powers of bankruptcy courts or trustees, conservators, or receivers in those jurisdictions.

3.2.1

True sale opinion

Generally, when the transferor retains some form of continuing involvement (e.g., recourse) in the transferred financial assets, a true-sale-at-law opinion from a qualified bankruptcy attorney is obtained to support the conclusion that the transferred financial assets have been legally isolated – put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy.

In assessing a true sale at law, attorneys will consider, among other matters:

- ▶ Recourse to the transferor
- ▶ Intention of the parties
- ▶ Economics of the transaction, including adequacy of consideration
- ▶ Whether or not the transfer is irrevocable
- ▶ Whether the transferee will bear ultimate credit risk of the transferred financial assets
- ▶ Whether a creditor or prospective creditor would be misled as to the nature of the transactions

Typically, recourse is the single most important factor in determining whether a transfer of financial assets is a true sale at law. However, a transferor is not necessarily required to have limited or no recourse in the transferred financial assets to be considered a true sale at law.

3.2.2 Substantive nonconsolidation opinion

Although a true-sale-at-law opinion provides support that the transferred financial assets have been legally isolated from the transferor, if the transferred financial assets can be substantively consolidated into the bankruptcy estate of the transferor, the financial assets are not considered isolated under ASC 860.

Substantive consolidation is a concept that is not explicitly provided by the US Bankruptcy Code. Rather, it is a bankruptcy concept that comes from “federal common law,” permitting a bankruptcy court to treat a group of affiliated entities as if they are one, merging their assets and liabilities for purposes of the bankruptcy proceeding. This concept even allows the court to merge affiliates that have not filed for bankruptcy with the affiliates that have if the court finds that substantive consolidation is required. For example, the risk in a securitization transaction is that the financial assets transferred to the securitization entity will be consolidated with the assets of an insolvent transferor and the third-party beneficial interest holders will be considered creditors of the combined entity. In this case, the creditors of the transferor could recover some benefit from the securitized assets to the detriment of the beneficial interest holders.

The power to order substantive consolidation is derived from the jurisdiction of the bankruptcy court, and the issue is determined on a case-by-case basis. As a general matter, the assets and liabilities of separate entities are not consolidated in insolvency proceedings. If the affairs of two or more entities are so intertwined that it would be impossible or very difficult to separate their assets and/or their liabilities, a court can order that the assets and liabilities be substantively consolidated. Courts will not order consolidation unless it is clear that doing so will not prejudice the creditors of one of the entities unfairly. Generally, the court must be satisfied that substantive consolidation will benefit the creditors of all of the entities as a whole.

Under the substantive consolidation doctrine, a bankruptcy-remote entity must meet certain conditions such that it typically would not be legally consolidated with its parent in a bankruptcy proceeding, even though it may be wholly owned and consolidated for financial reporting purposes. Although the characteristics of a bankruptcy-remote entity may vary among different jurisdictions, such an entity will generally possess the following characteristics to be considered an entity that is legally separate from its parent:

- ▶ Observes corporate formalities
- ▶ Has at least one independent director on its board of directors
- ▶ Holds itself out as a legal entity separate and distinct from the transferor
- ▶ Conducts its activities separate from those of the transferor
- ▶ Does not commingle its assets with those of its parent or related affiliates (the transferor)
- ▶ Pays its own liabilities with its own funds (i.e., it does not use the funds of its parent to satisfy its obligations)

- ▶ Maintains books and records separate from the transferor
- ▶ Maintains bank accounts separate from the transferor

3.3

Legal isolation and securitization transactions

Although the concept of legal isolation applies to all transfers of financial assets, it was included as one of the criteria for a financial asset transfer to be accounted for as a sale in large part due to considerations associated with securitization transactions. Legal isolation of transferred financial assets in securitization transactions depends on the structure of the securitization transaction taken as a whole, including the level of continuing involvement of the transferor, the availability of other assets and the powers of bankruptcy courts or other receivers. This section focuses on how the structure of a securitization can affect the assessment of legal isolation.

Securitization transactions are generally accomplished through a single transfer (single-step) or two transfers (two-step). The following diagrams illustrate these two securitization structures:

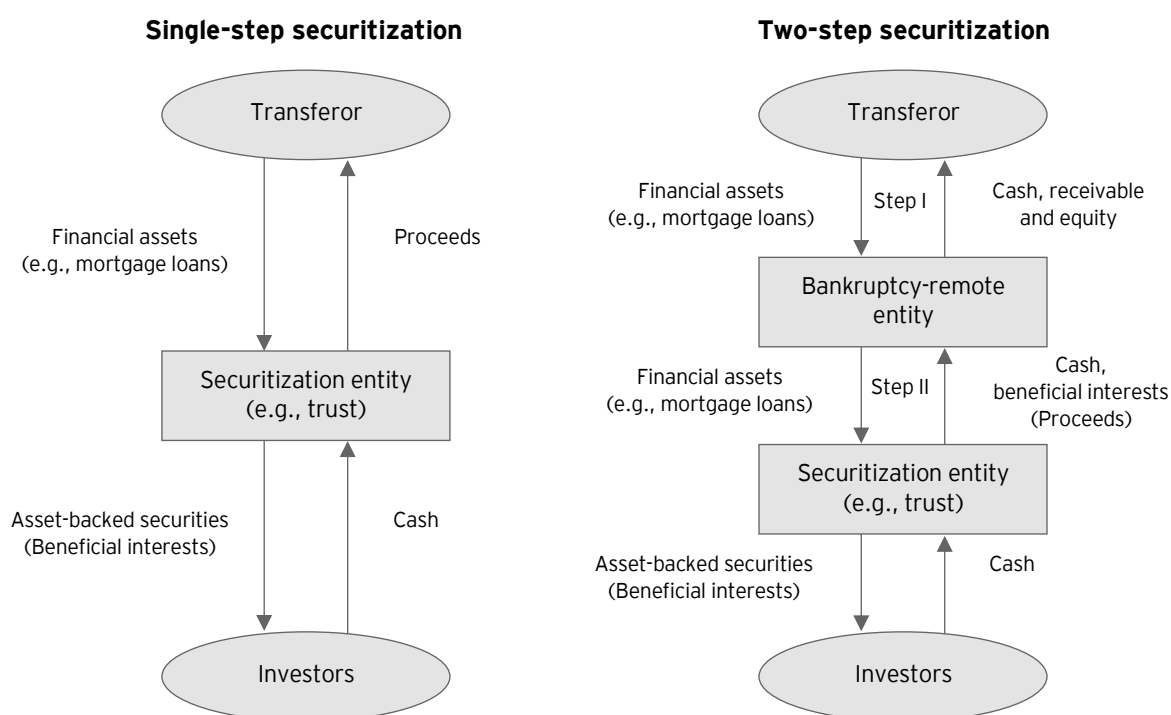


Diagram note:

In the single-step securitization diagram, the assets are transferred to a securitization entity (e.g., Trust) that sells an asset-backed security directly to investors. The proceeds from the sale of the asset-backed security are remitted back to the transferor. If the transferor held any beneficial interests created in the transaction or had any other form of continuing involvement with the transferred financial assets, it would be difficult to obtain reasonable assurance that the transferred financial assets were legally isolated from the transferor.

In the two-step securitization diagram, the transferor transfers the financial assets to a wholly owned bankruptcy-remote entity. This transfer would be judged a true sale at law, as the transferor does not provide excessive credit protection in the transfer to the wholly owned bankruptcy-remote entity. As the bankruptcy-remote entity is an affiliate of the transferor, a substantive nonconsolidation opinion is required to address whether the transferred financial assets would be legally consolidated with the transferor in the event of the transferor's bankruptcy. The bankruptcy-remote entity then transfers the assets to a securitization entity (e.g., Trust) that issues beneficial interests in the form of asset-backed securities to investors for cash. The bankruptcy-remote entity would typically receive as part of the proceeds a subordinated beneficial interest in the assets transferred to the securitization entity (e.g., Trust), representing the credit enhancement offered to investors in the transaction. The cash received from investors would be passed back through the structure to the transferor with the bankruptcy-remote entity holding the subordinated beneficial interest as its only asset. The transferor would hold an intercompany receivable or equity interest from the bankruptcy-remote entity equal to the difference between the proceeds received and the value of the assets transferred. In consolidation, the intercompany receivable or equity interest would eliminate with the transferor reporting the subordinated beneficial interest and the cash proceeds from the transaction (assuming there are no other beneficial interests to record).

3.3.1 Single-step securitization

In a single-step securitization, which is explained in ASC 860-10-55-19, an entity transfers financial assets to a securitization entity (corporation or trust) in exchange for cash. If there is no continuing involvement by the transferor, there exists reasonable assurance that the transfer would be judged a true legal sale, effectively placing the assets beyond the reach of the transferor and its creditors. For example, legal isolation might occur if a securitization entity issues beneficial interests only to third-party investors for cash, which is given to the transferor in exchange for the transferred financial assets. That is, the transferor receives only cash as proceeds (i.e., no beneficial interests, servicing rights, etc.) and has no further involvement with the securitization entity or the transferred financial assets subsequent to the transfer date.

While this simple structure would generally achieve the legal isolation criterion of ASC 860-10-40-5(a), from a business perspective, it may not result in a security that investors would find attractive. Generally, investors seek some form of protection from credit or interest rate risk – elements of continuing involvement often provided or assumed by the transferor that may make it less certain whether the legal isolation requirement of ASC 860 has been met.

Consider a transfer of a group of entire financial assets to a securitization entity in exchange for cash and a junior beneficial interest (i.e., an interest that absorbs initial credit losses) in the transferred financial assets. The securitization entity raises cash by issuing commercial paper to investors granting them a senior beneficial interest (e.g., a credit enhanced interest) in any cash received from the financial assets. In this example, the transferor maintains continuing involvement with the transferred financial assets by providing credit loss protection to the holders of the senior interest in exchange for a lower cost of the transaction. This continuing involvement by the transferor could make it difficult to obtain reasonable assurance that the transfer would be found to be a true legal sale.

ASC 860-10-55-21 indicates that, depending on facts and circumstances, this latter example of a single-step securitization often would be judged in the US as not having legally isolated the assets from the transferor or its creditors in a US bankruptcy. Many single-step transactions continue to allow rights of redemption that could be exercised by the transferor, receiver or other creditors under certain circumstances. Under such rights, the transferred financial assets are subject to being reclaimed by the transferor, trustee, receiver or other creditor by paying principal and interest earned (at the contractual yield) to the date investors are paid.

The FASB has indicated that such rights are inconsistent with the legal isolation requirements of ASC 860 because if the assets could be reclaimed under such a right and investors were paid only principal and interest through the payment date, the investors would not be compensated for the fair value of their investment on that date. We understand that unless a structure isolates against the right of redemption, single-step transfers with the transferor's continuing involvement in the transferred financial assets typically will not legally isolate assets of entities subject to the US Bankruptcy Code or other receivership laws in the manner required by ASC 860. This issue should also be carefully considered in transactions completed in foreign jurisdictions.

3.3.2 Two-step securitization

A two-step securitization uses two transfers to both isolate transferred financial assets from the transferor and its creditors, while also providing a credit-enhanced interest for investors (see the diagram in section 3.3). Typical two-step structures are constructed as follows:

- ▶ First, the transferor transfers a group of entire financial assets to a special-purpose entity that, although wholly owned, is designed so that the possibility is remote that the transferor, its other consolidated affiliates included in the financial statements being presented, or its creditors could reclaim the financial assets (i.e., a bankruptcy-remote entity). This first step is designed to be judged a true sale at law, in part because the transferor does not provide “excessive” credit protection. In addition, the bankruptcy-remote entity typically has a board of directors that is independent of the transferor and is

not permitted by its charter to undertake any other business or to incur any liabilities. Its dedication to a single transaction and the other circumstances surrounding it make it extremely unlikely that it would enter bankruptcy and, even if it did, that a receiver could reclaim the transferred financial assets. This transfer is intended to legally isolate the transferred financial assets from the transferor.

- ▶ Second, the bankruptcy-remote entity transfers the group of entire financial assets to a securitization entity (e.g., a trust or other type of legal entity) and provides the credit enhancement necessary to obtain the high credit rating sought by third-party investors on their interests (e.g., beneficial interests or asset-backed securities). The credit enhancement is provided by the bankruptcy-remote entity's junior (subordinated) beneficial interest in the transferred financial assets or other means. Because of the credit enhancement provided in the second transfer, it might not be judged to be a true sale at law. Thus, the bankruptcy trustee for the bankruptcy-remote entity could, at least in theory, reach the transferred financial assets. However, the transaction has been designed to make remote the possibility that the bankruptcy-remote entity would enter bankruptcy, either by itself or by substantive consolidation into a bankruptcy of the original transferor, should that occur.

A true sale and a substantive nonconsolidation opinion are generally required for the first step in a two-step securitization.¹⁷ This legal determination requires consideration of the transactions taken as a whole.

ASC 860-10-55-22 states that two-step securitizations, taken as a whole, generally would be judged under present US law as having isolated the financial assets beyond the reach of the transferor, its consolidated affiliates (that are not bankruptcy-remote entities) included in the financial statements presented, and its creditors, even in bankruptcy or other receivership. However, even if the transaction is structured as described, the determination of whether the financial assets are legally isolated from the transferor is a legal determination that is based on the individual facts and circumstances.

3.3.2.1

Other considerations

A bankruptcy-remote entity in a two-step securitization transaction is not necessarily required to account for the second step transfer as a secured borrowing when, as typically occurs, the bankruptcy-remote entity is not able to obtain a true sale opinion for its transfer of financial assets to the securitization entity. Despite the lack of legal isolation between the bankruptcy-remote entity and the securitization entity, the consolidated entity should account for the second step transfer as a sale, assuming the transfer meets the other ASC 860 derecognition requirements (i.e., ASC 860-10-40-5(b) and 40-5(c)), when each of the following conditions is met:

- ▶ The transferor has obtained a true sale and substantive nonconsolidation opinion for the transfer to the bankruptcy-remote entity (i.e., step one in the two-step transfer described above).
- ▶ The transferor has obtained a substantive nonconsolidation opinion regarding the securitization entity (assuming the securitization entity is deemed to be an affiliate).
- ▶ Neither the transferor nor its consolidated bankruptcy-remote entity is required to consolidate the securitization entity in accordance with applicable consolidation accounting guidance (i.e., ASC 810, *Consolidation*).

In an alternative structure to the traditional two-step securitization transactions described above, the bankruptcy-remote entity may issue a guarantee to the securitization entity as a credit enhancement, instead of retaining any beneficial interest in the financial assets transferred from the bankruptcy-remote entity to the securitization entity. The guarantee is in the form of an overcollateralization of financial assets retained by the bankruptcy-remote entity (that is, pledged collateral).

¹⁷ The description of the two-step structures designed to achieve legal isolation is based on implementation guidance provided in ASC 860-10-55-23.

To qualify for sale accounting, the agreement between the bankruptcy-remote entity and the securitization entity should state clearly that the securitization entity cannot petition the bankruptcy-remote entity into bankruptcy in the event that the bankruptcy-remote entity's pledged collateral is not sufficient to cover the losses from the transferred financial assets in the securitization entity. Without such a provision, the bankruptcy-remote entity could enter into a bankruptcy, and the transferred financial assets could be reached by the bankruptcy trustee of the bankruptcy-remote entity.

3.4 Considerations when reviewing legal opinions

The following are common practice issues to consider when determining whether a legal opinion provides adequate support that the transferred financial assets are legally isolated. These issues are not all inclusive.

3.4.1 Instructions to perform additional analysis

Limitations in the legal opinion could negate an otherwise satisfactory opinion by instructing the reader (user) to perform additional legal analysis of the factors mentioned, thereby implying that those factors have not been considered by the legal specialist in forming his/her opinion. For example, the following limitation would generally preclude reliance on the legal opinion:

“We note that legal opinions on bankruptcy law matters unavoidably have inherent limitations that generally do not exist in respect of other legal issues on which opinions to third parties are typically given. These inherent limitations exist primarily because of the pervasive powers of bankruptcy courts and other factors. The recipients of this opinion should take these limitations into account in analyzing the bankruptcy risk associated with the transactions as contemplated by the agreements.”

3.4.2 Assumptions regarding accounting treatment

Legal opinions sometimes include an assumption that the transaction qualifies for sale accounting treatment under the criteria of ASC 860. This assumption is circular and is not appropriate because one of the criteria for the transfer to be considered a sale is that the transferred financial asset is legally isolated. Since the legal opinion is required to satisfy this criterion, it is not appropriate for the legal opinion to include this assumption. If this type of language is included in a legal opinion, the assumption should specifically exclude the legal isolation criterion of ASC 860-10-40-5(a).

3.4.3 Right of redemption

An opinion may acknowledge the ability by the transferor or its creditors, under certain circumstances, to reacquire the transferred financial assets by paying the original purchase price plus interest. While the FASB provided limited relief with respect to this issue for certain regulated entities (e.g., insured depository institutions subject to the special powers of the FDIC and other similar entities that may not be subject to the US Bankruptcy Code; refer to section 3.5 for additional information about such circumstances), such provisions are generally not sufficient to support the legal isolation criteria of ASC 860-10-40-5(a).

3.4.4 Exclusion of side agreements or related transactions

A legal opinion should explicitly address or contemplate all forms of the reporting entity's continuing involvement with the transferred financial assets, including any side agreements or related transactions. An example of a side agreement that may not be explicitly considered in the legal opinion (that may cause the transfer not to be accounted for as a sale) is when the parent of, or company affiliated with, the transferor provides the transferee with a guarantee or other recourse, either directly or through arrangements made contemporaneously with, or in contemplation of, the transfer – even if they were not entered into at the time of the transfer.

Additionally, attorneys may explicitly assume side agreements or known transactions with affiliated parties or agents were not present with the transaction. Accordingly, management of the transferor should ensure that the list of applicable documents considered by the attorneys in preparing the legal opinion is complete and that the legal opinion addresses the legal isolation criterion considering all other subsidiaries in a consolidated group, particularly when such subsidiaries have involvement with the assets or are parties to the transaction.

3.4.5 “Look back” period for bankruptcy

Qualifying language in the legal opinion may state that the opinion was not applicable to the extent the transferor filed bankruptcy within a certain extended time period after the transfer (or held an assumption that such a filing would not take place). While an assumption with respect to the transferor’s solvency at the time of transfer would be appropriate, provisions that extend beyond the actual transfer date likely lead to a “springing true-sale-at-law opinion.” Such an opinion concludes that the asset is not appropriately isolated until the “look back” period expires.

3.4.6 Level of recourse

Qualifying language in some opinions discusses how a court would view the level of recourse, with the legal specialist not providing an opinion with respect to this aspect of the transaction. Retained recourse is a key component considered by legal specialists when rendering their opinions; thus, it is usually inappropriate for the opinion to not address this issue.

When recourse provisions are included in the transaction, the transferor’s legal isolation analysis should consider whether the legal specialist has evaluated whether the level of recourse present adversely affects the true sale opinion and substantive nonconsolidation opinion, if applicable. Limited historical information, heterogeneous assets or significant changes in underwriting are a few factors that may cause the legal specialist’s analyses to be more difficult.

In legal opinions that address the level of recourse in a given transfer and conclude based on reference to case law as to whether the amount of recourse retained is considered appropriate for sale treatment, care must be taken to ensure that the assumptions used to make this conclusion are consistent with the expected results of the transferred financial assets.

Illustration 3-1: Legal opinion for a transfer with recourse

Assume that a transferor agrees to provide the transferee recourse for any losses incurred during the first 18 months after the transfer of a group of automobile loans. The transferor estimates that the recourse obligation assumed is only 5% of the transferred assets even though actual losses during this period have historically been around 10% and nothing has changed significantly in the economy, loan structure or customer demographics to support a lower estimate. If the attorney’s opinion letter concludes that the level of recourse obligation retained by the transferor (i.e., 5%) is reasonable, the assumption of 5% upon which the opinion is based would be inconsistent with the expected future losses of 10%.

3.4.7 Requirement to notify underlying debtors

Legal opinions may contain assumptions that notification of the transaction has been made to the debtors when in fact the parties do not intend to notify the debtors. In some transfers, notification to the borrower that its loan has been sold to a third party will be a requirement for a true sale, particularly under the laws of certain foreign countries. In these cases, legal title to the loan will transfer only upon notification. Some countries’ laws require that each borrower be notified directly, while other countries’ laws require only that the transfer be included in a registry. Typically, the legal opinion will assume notification when required by applicable law. The transferor should determine that notification has occurred (and continues to occur in revolving transactions), if required by the applicable jurisdiction, prior to concluding a transfer meets the criteria to be accounted for as a sale.

3.4.8 Inconsistency with tax treatment

Assumptions of the tax analysis and the legal sale analysis should be compared to determine whether they conflict. In addition to raising a question regarding the fair value used for US GAAP reporting purposes, different fair values ascribed to the loans sold and/or interests retained for tax reporting may challenge the validity of a legal opinion assumption about the appropriateness of the consideration paid for the assets transferred.

3.4.9 Foreign jurisdictions

Achieving the legal isolation criterion when the transaction occurs in a foreign market is even more complex. It is important to remember that the legal isolation requirement is the same (i.e., the assets must be legally isolated from the transferor and any of its consolidated affiliates included in the financial statements being presented, even in the event of bankruptcy or other receivership or the applicable jurisdiction's equivalent). However, the language in the legal opinion supporting legal isolation may differ due to the difference in legal environments in various countries. In addition, the transferor should consider the need to receive a legal opinion in each country in which assets may have originated for transactions involving global transfers of financial assets.

The effect of a recourse provision on the legal isolation criteria of ASC 860 may vary by jurisdiction. In some jurisdictions, transfers with full recourse may not place transferred financial assets beyond the reach of the transferor and its creditors, but transfers with limited recourse may. Legal isolation may need to be assessed either in the jurisdiction in which assets were originated, in which they were transferred, or both.

3.4.10 Set-off rights

A set-off right is a common law right of a party that is both a debtor and a creditor to the same counterparty to reduce its obligation to that counterparty if that counterparty fails to pay its obligation. The existence of set-off rights is not considered by a court when assessing whether a transaction would be deemed to be a true sale. In the event of bankruptcy or receivership of either the obligor of the financial asset or the transferor of the financial asset, both parties could retain the ability to exercise a set-off right involving a financial asset that had been transferred. In the event of the bankruptcy of the transferor, the transferee may have only an unsecured claim against the transferor for its share of the amount of set off.

Illustration 3-2: Transfer with set-off rights

Assume that a transferor originates a loan for \$10,000 and transfers a 20% participating interest in the loan to a third party. In addition, assume that the original obligor (i.e., the borrower of the \$10,000 loan from the transferor) has a deposit with the transferor of \$10,000. The loan and the deposit are subject to set-off rights. If the transferor entered bankruptcy and did not pay to settle its customer deposit, the original obligor (depositor) would be able to set off its deposit with the transferor against the \$10,000 loan and would not be required to make any further payments to the transferor. In this example, the transferor would not receive cash on the settlement (via set-off) of the loan, but also would not be required to repay the deposit. The set-off causes the third-party transferee to become an unsecured creditor of the transferor.

The FASB considered whether set-off rights related to a transferred financial asset should be severed to meet the legal isolation requirements but learned that it may not be possible to sever them. For example, certain consumer protection laws prevent consumers from waiving their ability to exercise set-off rights against a seller of goods financed under a contract with the seller. In other cases, it may be impractical or infeasible for a transferor to sever set-off rights related to transferred financial assets because doing so would require the involvement of an obligor on the original financial assets who may not even be aware of or otherwise involved in the transfer.

Attorneys told the FASB that a court likely would compel a transferor that benefited from an exercise of set-off rights on a transferred financial asset to pass through a proportionate share of that benefit to any transferee that held a share of the related original financial asset. Constituents also told the FASB that set-off risks are assessed and included in the price for the transaction like other dilutive risks, such as warranties and returns. Based on this, the FASB decided that set-off rights would not be an impediment to meeting the isolation requirement.

3.5 Considerations applicable for entities not subject to the US Bankruptcy Code

Excerpt from Accounting Standards Codification

Transfers and Servicing – Overall

Implementation Guidance and Illustrations

Isolation of Transferred Assets

860-10-55-24

The powers of receivers for entities not subject to the U.S. Bankruptcy Code (for example, banks subject to receivership by the Federal Deposit Insurance Corporation [FDIC]) vary considerably, and therefore some receivers may be able to reach financial assets transferred under a particular arrangement and others may not. A securitization may isolate transferred financial assets from a transferor subject to such a receiver and its creditors even though it is accomplished by only one transfer directly to a securitization entity that issues beneficial interests to investors and the transferor provides credit or yield protection. For entities that are subject to other possible bankruptcy, conservatorship, or other receivership procedures in the United States or other jurisdictions, judgments about whether transferred financial assets have been isolated need to be made in relation to the powers of bankruptcy courts or trustees, conservators, or receivers in those jurisdictions.

860-10-55-24A

Depending on the facts and circumstances, transferred financial assets can be isolated from the transferor if the Federal Deposit Insurance Corporation (FDIC) would be the receiver should the transferor fail. In July 2000, the FDIC adopted a final rule (subsequently amended), *Treatment by the Federal Deposit Insurance Corporation as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection with a Securitization or Participation*. The final amended rule modifies the FDIC's receivership powers so that, subject to certain conditions, it shall not recover, reclaim, or recharacterize as property of the institution or the receivership any financial assets transferred by an insured depository institution that meet all conditions for sale accounting treatment under GAAP, other than the *legal isolation* condition in connection with a securitization or participation.^[18]

860-10-55-24B

Financial assets transferred by an entity subject to possible receivership by the FDIC are isolated from the transferor if the FDIC or another creditor either cannot require return of the transferred financial assets or can only require return in receivership, after a default, and in exchange for payment of, at a minimum, principal and interest earned (at the contractual yield) to the date investors are paid.

¹⁸ EY note: Refer to section 3.5.1 for a discussion on the FDIC's amendments to its safe harbor rule.

860-10-55-25

Conversely, financial assets transferred by an entity shall not be considered isolated from the transferor if circumstances can arise under which the transferor can require their return, but only in exchange for payment of principal and interest earned (at the contractual yield) to the date investors are paid, unless the transferor's power to require the return of the transferred financial assets arises solely from a contract with the transferee. A noncontractual power to require the return of transferred assets is inconsistent with the limitations in paragraph 860-10-40-5(a) that, to be accounted for as having been sold, transferred financial assets shall be isolated from the transferor. That is the circumstance even if the noncontractual power appears unlikely to be exercised or is dependent on the uncertain future actions of other entities (for example, insufficiency of collections on underlying transferred financial assets or determinations by court of law). Under that guidance, a single-step securitization commonly used by financial institutions subject to receivership by the FDIC and sometimes used by other entities is likely not to be judged as having isolated the assets. One reason for that is because it would be difficult to obtain reasonable assurance that the transferor would be unable to recover the transferred financial assets under the **equitable right of redemption** available to secured debtors, after default, under U.S. law.

860-10-55-25A

For entities that are subject to possible receivership under jurisdictions other than the FDIC or the U.S. Bankruptcy Code, whether assets transferred by an entity can be considered isolated from the transferor depends on the circumstances that apply to those types of entities. As discussed in paragraph 860-10-55-24, for entities that are subject to other possible bankruptcy, conservatorship, or other receivership procedures in the United States or other jurisdictions, judgments about whether transferred financial assets have been isolated need to be made in relation to the powers of bankruptcy courts or trustees, conservators, or receivers in those jurisdictions. The same sorts of judgments may need to be made in relation to powers of the transferor or its creditors.

3.5.1**Insured depository institutions and similar entities**

Since 2000, the FDIC has clarified that it would not exercise its statutory power to disaffirm or repudiate contracts to reclaim from an insured depository institution (IDI) any of its financial assets transferred in connection with a securitization or participation in the receivership or conservatorship of an IDI provided the IDI's transfers met certain conditions, including the conditions for sale accounting under US GAAP.

The FDIC's legal isolation safe harbor has been relied on by securitization participants as assurance that investors could look to securitized financial assets for payment without concern that the financial assets would be interfered with by the FDIC as conservator or receiver.

However, the implementation of ASU 2009-16 and ASU 2009-17 (which was codified in ASC 810) for transfers of financial assets and consolidation of variable interest entities (e.g., special-purpose vehicles), respectively, has resulted in more securitizations to be accounted for as secured borrowings and has created uncertainty for securitization participants (because sale accounting is a precondition for the FDIC's safe harbor).

In response to market concerns over the accounting changes, on 27 September 2010, the FDIC adopted an amended safe harbor rule (Final Rule¹⁹). The Final Rule continues the legal isolation safe harbor for financial assets transferred in compliance with previous FDIC rules (including the Interim Final Rule²⁰ of November 2009). Additionally, it modifies the original safe harbor provisions in two significant ways:

- ▶ It establishes two types of safe harbors for securitizations and participations depending on whether the transactions are accounted for as sales or secured borrowings under ASC 860 (previously, only transfers that met the conditions for sale accounting under US GAAP qualified for the FDIC's safe harbor)
- ▶ It establishes new conditions, including new disclosure and risk retention requirements, for a securitization to qualify for either safe harbor

To ensure that the Final Rule fully conforms with the risk retention regulations required by the Dodd-Frank Act,²¹ the FDIC's new safe harbor rule provides that, upon adoption of those interagency regulations, those final regulations shall exclusively govern the risk retention requirement in the safe harbor regulation.

The audit standards AI 11 and AU-C 9620 provide two alternate forms of legal opinions that are acceptable for transferors subject to receivership or conservatorship under the provisions of the Federal Deposit Insurance Act (FDIA). Either a "true sale" opinion similar to opinions provided to non-FDIC insured transferors or an opinion addressing isolation both prior to the appointment of the FDIC as a receiver and following the appointment of the FDIC as receiver may be obtained. Additionally, the opinion must address the doctrine of "substantive consolidation" when the entity to which the financial assets are transferred is an affiliate of the selling entity (e.g., to a bankruptcy-remote entity in a two-step transaction) and in other situations as noted by a legal specialist. In all cases, the appropriate jurisdiction's laws should be considered. See Question 3-9 for additional guidance.

3.5.2 Entities subject to US state insurance regulations

In the event of an insurance company's insolvency, we understand that certain US state insurance regulatory agencies may hold certain receivership rights. Similar to insured depository institutions and other entities not subject to the bankruptcy code, the attorney's true-sale-at-law opinion should address such considerations for a transferor that is regulated by US state insurance regulations. The legal isolation assessment should also address the doctrine of "substantive consolidation" in these circumstances.

¹⁹ FDIC Rule, Treatment by the FDIC as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection with a Securitization after September 30, 2010 (posted to the Federal Register on 30 September 2010); <https://archive.fdic.gov/view/fdc/5677>. The FDIC Rule represents an amendment to Part 360 section 6 of its Resolution and Receivership Rules.

²⁰ FDIC proposed Interim Final Rule; <https://archive.fdic.gov/view/fdc/3638>. The transitional safe harbor provisions of the Interim Rule, which were ultimately extended by the Final Rule, confirms that participations and securitizations completed (or currently in process) on or before 31 December 2010 in reliance on the FDIC's existing regulation will be "grandfathered" and continually protected by the safe harbor, so long as those participations or securitizations comply with US GAAP in effect prior to 15 November 2009 (i.e., ASC 860, prior to its amendment by Statement 166).

²¹ The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), which was signed into law on 21 July 2010.

3.6 Questions and interpretive responses

Legal isolation and the use of legal opinions

Question 3-1 Use of legal opinions for routine transfers of financial assets

What factors should be considered in evaluating the need for a legal opinion for “routine” transfers of financial assets? Can a transferor rely on a legal conclusion reached in a previous transfer if the underlying circumstances are similar?

The nature and extent of evidence to support the legal isolation criterion depends on the facts and circumstances of each transaction.

In evaluating whether a new or updated legal opinion is necessary for routine transfers, a transferor could consider its experience with similar transactions. For example, a transferor might conclude that financial assets are legally isolated if a legal opinion was obtained in connection with a previous transaction that involved the same asset types and key transaction terms and under the same applicable laws and regulations as the transaction being evaluated currently. Indicators that a new or updated legal opinion may be required include (but are not limited to):

- ▶ Lockbox arrangements have not been made in the transferee’s name to legally segregate the cash receipts from customers from the transferor/servicer’s cash (i.e., the transferor’s and transferee’s assets are commingled).
- ▶ The underlying borrowers have not been notified that their loans have been transferred.
- ▶ A history of more than infrequent and insignificant representation and warranty violations might indicate the underwriting process is flawed and sale recognition is not appropriate.
- ▶ Recourse is provided by the transferor/servicer with respect to the asset performance. A common example of recourse in otherwise routine transactions includes a default put that allows the transferee to put back (return) loans in default to the transferor for a fixed price (usually par value plus accrued interest). Default terms are specified in the transaction documents and commonly include the debtor missing one or more payments or failing certain liquidity measures, among other events. When recourse is present, we believe a legal opinion is typically necessary to support management’s assertion.

Question 3-2 Obtaining a legal opinion

Should it be assumed that the transferred financial assets are not legally isolated if a legal opinion is not obtained?

We believe the transferor should evaluate the legal isolation criteria as part of each transfer and not default to accounting for the transfer as a secured borrowing without determining whether the transferred financial assets have been sold. In the event that the transferor does not obtain a required legal opinion, the independent auditor may be required to express a qualified opinion or disclaim an opinion because of the scope limitation.

Question 3-3 Legal opinions prepared by internal counsel

Is a legal opinion prepared by internal counsel adequate support for management’s assertion that the transferred financial assets are legally isolated?

Typically, an opinion from external counsel will be necessary, particularly if external counsel provided opinions to other transaction participants, such as underwriters or rating agencies. The use of opinions from internal counsel would be appropriate only when the transferor can provide proper support that internal counsel has appropriate credentials to render such an opinion given their experience in transactions of the type being addressed as well as the applicable bankruptcy or receivership law.

Question 3-4 Evaluating the legal isolation condition when likelihood of bankruptcy is remote

Is the legal isolation requirement of ASC 860-10-40-5(a) satisfied if the likelihood of bankruptcy is remote?

No. The requirement of ASC 860-10-40-5(a) focuses on whether transferred financial assets would be isolated from the transferor in the event of bankruptcy or other receivership, regardless of how remote or probable bankruptcy or other receivership is at the date of transfer.

Question 3-5 Evaluating legal isolation at the level of the financial statement being presented

Could transferred financial assets be considered legally isolated for purposes of a subsidiary's stand-alone financial statements but not legally isolated in its parent's consolidated financial statements?

ASC 860 requires that the accounting for transfers of financial assets be determined at the level of the financial statements being presented. Accordingly, a transfer may be accounted for as a sale in the transferor's stand-alone financial statements but as a secured borrowing in its parent's consolidated financial statements.

To illustrate, assume a transferor transfers financial assets to a third-party entity and obtains cash and a subordinated interest as proceeds. Simultaneously, the transferor's consolidated subsidiary provides servicing for the transferred financial assets and the transferor's parent provides a limited recourse guarantee on the performance of the transferred assets.

The subordinated interest, the servicing contract and limited recourse guarantee are all forms of involvement with the transferred assets that should be considered in the separate legal isolation analyses to evaluate whether the assets are legally isolated for purposes of (1) the transferor's stand-alone (consolidated) financial statements and (2) its parent's consolidated financial statements. Because of the potential for different legal isolation conclusions, the transfer could be required to be accounted for as a sale in the transferor's stand-alone financial statements, but as a secured borrowing in its parent's consolidated financial statements.

Question 3-6 Legal conclusion that a sale occurred

Should a transfer automatically be accounted for as a sale if a true sale legal opinion is obtained?

For a transfer of financial assets to be accounted for as a sale, all of the criteria in ASC 860-10-40-5 must be met. ASC 860-10-40-5(a) contains the legal isolation requirements, but the transferee's right to pledge or exchange in ASC 860-10-40-5(b) and the transferor's surrender of effective control in ASC 860-10-40-5(c) must also be evaluated prior to concluding the transfer should be accounted for as a sale.

Considerations when reviewing legal opinions**Question 3-7 Legal opinions providing persuasive evidence**

Is there specific language that should be included in the legal opinion to provide persuasive evidence that the transferred financial assets are legally isolated for an entity subject to the US Bankruptcy Code?

An example of the conclusions in a legal opinion for an entity that is subject to the US Bankruptcy Code that provides persuasive evidence, in the absence of contradictory evidence, to support management's assertion that the transferred financial assets have been put presumptively beyond the reach of the entity and its creditors, even in bankruptcy or other receivership is included in paragraph 13 of AI 11 and AU-C 9620:

"We believe (or it is our opinion) that in a properly presented and argued case, as a legal matter, in the event the Seller were to become a Debtor, the transfer of the Financial Assets from the Seller to the Purchaser would be considered to be a sale (or a true sale) of the Financial Assets from the Seller to the Purchaser and not a loan and, accordingly, the Financial Assets and the proceeds

thereof transferred to the Purchaser by the Seller in accordance with the Purchase Agreement would not be deemed to be property of the Seller's estate for purposes of [the relevant sections] of the US Bankruptcy Code."

The following additional paragraph addressing substantive consolidation applies when the entity to which the assets are sold (as described in the opinion) is an affiliate of the selling entity and may also apply in other situations as noted by the legal specialist.

"Based upon the assumptions of fact and the discussion set forth above, and on a reasoned analysis of analogous case law, we are of the opinion that in a properly presented and argued case, as a legal matter, in a proceeding under the US Bankruptcy Code, (footnote reference omitted) in which the Seller is a Debtor, a court would not grant an order consolidating the assets and liabilities of the Purchaser with those of the Seller in a case involving the insolvency of the Seller under the doctrine of substantive consolidation."

Question 3-8 Legal opinions not providing persuasive evidence

What are some examples of language in opinion conclusions that do not provide persuasive evidence that the transferred financial assets have been legally isolated from the transferor?

The following examples of such language are provided in Paragraph 15 of AI 11 and AU-C 9620:

- ▶ "We are unable to express an opinion ..."
- ▶ "It is our opinion, based upon limited facts ..."
- ▶ "We are of the view ..." or "it appears ..."
- ▶ "There is a reasonable basis to conclude that ..."
- ▶ "In our opinion, the transfer would either be a sale or a grant of a perfected security interest ..." (footnote reference omitted)
- ▶ "In our opinion, there is a reasonable possibility ..."
- ▶ "In our opinion, the transfer should be considered a sale ..."
- ▶ "It is our opinion that the company will be able to assert meritorious arguments ..."
- ▶ "In our opinion, it is more likely than not ..."
- ▶ "In our opinion, the transfer would presumptively be ..."
- ▶ "In our opinion, it is probable that ..."

As stated, this language does not provide persuasive evidence that the transferred financial assets have been legally isolated from the transferor and must be replaced with the language in Question 3-7 for entities subject to the US Bankruptcy code or Question 3-9 for entities subject to FDIC receivership.

Entities subject to FDIC receivership

Question 3-9

Legal opinions for entities subject to FDIC receivership

What legal opinion conclusion language provides persuasive evidence that the transferred financial assets are legally isolated for an entity subject to FDIC receivership?

The following two examples of opinion conclusions (see Illustrations 3-3 and 3-4 below) that provide persuasive evidence, in the absence of contradictory evidence, to support management's assertion that the transferred financial assets have been put presumptively beyond the reach of the entity and its creditors, even in conservatorship or receivership are included in paragraph 14 of AI 11 and AU-C 9620.²²

Illustration 3-3: Standard legal opinion conclusion

"We believe (or it is our opinion) that in a properly presented and argued case, as a legal matter, in the event the Seller were to become subject to receivership or conservatorship, the transfer of the Financial Assets from the Seller to the Purchaser would be considered to be a sale (or a true sale) of the Financial Assets from the Seller to the Purchaser and not a loan and, accordingly, the Financial Assets and the proceeds thereof transferred to the Purchaser by the Seller in accordance with the Purchase Agreement would not be deemed to be property of, or subject to repudiation, reclamation, recovery, or recharacterization by, the receiver or conservator appointed with respect to the Seller."

Illustration 3-4: Legal opinion conclusion based on the FDIC's safe harbor

"The Federal Deposit Insurance Corporation (FDIC) has issued a regulation, 'Treatment by the Federal Deposit Insurance Corporation as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection with a Securitization or Participation,' 12 CFR Section 360.6 (the Rule). Based on and subject to the discussion, assumptions, and qualifications herein, it is our opinion that:

- A. Following the appointment of the FDIC as the conservator or receiver for the Bank:
 - (i) The Rule will apply to the Transfers,
 - (ii) Under the Rule, the FDIC acting as conservator or receiver for the Bank could not, by exercise of its authority to disaffirm or repudiate contracts under 12 U.S.C. §1821(e), reclaim or recover the Transferred Assets from the Issuer or recharacterize the Transferred Assets as property of the Bank or of the conservatorship or receivership for the Bank,
 - (iii) Neither the FDIC (acting for itself as a creditor or as representative of the Bank or its shareholders or creditors) nor any creditor of the Bank would have the right, under any bankruptcy or insolvency law applicable in the conservatorship or receivership of the Bank, to avoid the Transfers, to recover the Transferred Assets, or to require the Transferred Assets to be turned over to the FDIC or such creditor, and

²² Insolvency and receivership laws applicable to depository institutions, and how those laws affect the legal isolation criterion, differ depending upon the nature of the depository institution and its chartering authority. Accordingly, legal opinions addressing the legal isolation criterion may be formulated in different ways to accommodate those differences.

For an entity subject to conservatorship or liquidation under the National Credit Union Act, the sample opinions in Illustrations 3-1 and 3-2 and discussion in this paragraph would be modified to make appropriate references to "liquidation" and "liquidating agent" and additional information relating to rights and regulations of the National Credit Union Administration. Refer to paragraph 14 in AI 11 for further guidance.

- (iv) There is no other power exercisable by the FDIC as conservator or receiver for the Bank that would permit the FDIC as such conservator or receiver to reclaim or recover the Transferred Assets from the Issuer, or to recharacterize the Transferred Assets as property of the Bank or of the conservatorship or receivership for the Bank; provided, however, that we offer no opinion as to whether, in receivership, the FDIC or any creditor of the Bank may take any such actions if the Holders [holders of beneficial interests in the transferred assets] receive payment of the principal amount of the Interests and the interest earned thereon (at the contractual yield) through the date the Holders are so paid; and
- B. Prior to the appointment of the FDIC as conservator or receiver for the Bank, the Bank and its other creditors would not have the right to reclaim or recover the Transferred Assets from the Issuer, except by the exercise of a contractual provision [insert appropriate citation] to require the transfer, or return, of the Transferred Assets that exists solely as a result of the contract between the Bank and the Issuer.”²³

The following additional paragraph addressing substantive consolidation applies when the entity to which the assets are sold or transferred (as described in the opinion) is an affiliate of the selling entity and may also apply in other situations as noted by the legal specialist (footnote reference omitted).

“Based upon the assumptions of fact and the discussion set forth above, and on a reasoned analysis of analogous case law, we are of the opinion that in a properly presented and argued case, as a legal matter, in a receivership, conservatorship, or liquidation proceeding in respect of the Seller, a court would not grant an order consolidating the assets and liabilities of the Purchaser with those of the Seller.”

²³ Footnote 9 of AI 11 clarifies that paragraph B in this illustration is not required if the opinion includes both (1) a conclusion, as set forth in Illustration 3-1, that the transfer constitutes a “true sale” and (2) the conclusions set forth of paragraph A of this illustration. It is not necessary to include any provision of this illustration if the opinion is as set forth in Illustration 3-1.

4

Criteria for a sale – Right to pledge or exchange

4.1

Overview

This section focuses on the second criterion commonly referred to as the “transferee’s right to pledge or exchange” criterion, which requires that each transferee or, if the transferee is a “securitization entity,” each third-party holder of its beneficial interests, has the ability to freely pledge and exchange the transferred financial assets or beneficial interests for the transfer to be accounted for as a sale.

Excerpt from Accounting Standards Codification

Transfers and Servicing – Overall

Derecognition

Conditions for a Sale of Financial Assets

860-10-40-5

A transfer of an entire financial asset, a group of entire financial assets, or a participating interest in an entire financial asset in which the transferor surrenders control over those financial assets shall be accounted for as a sale if and only if all of the following conditions are met:

- a. [EY note: Condition omitted; see section 3, *Criteria for a sale – Legal isolation*]
- b. Transferee’s rights to pledge or exchange. This condition is met if both of the following conditions are met:
 1. Each transferee (or, if the transferee is an entity whose sole purpose is to engage in **securitization** or asset-backed financing activities and that entity is constrained from pledging or exchanging the assets it receives, each third-party holder of its beneficial interests) has the right to pledge or exchange the assets (or beneficial interests) it received.
 2. No condition does both of the following:
 - i. Constrains the transferee (or third-party holder of its beneficial interests) from taking advantage of its right to pledge or exchange
 - ii. Provides more than a trivial benefit to the transferor (see paragraphs 860-10-40-15 through 40-21).

If the transferor, its consolidated affiliates included in the financial statements being presented, and its agents have no continuing involvement with the transferred financial assets, the condition under paragraph 860-10-40-5(b) is met.
- c. [EY note: Condition omitted; see section 5, *Criteria for a sale – Effective control*]

If a transferor retains some form of continuing involvement with the transferred financial asset, to account for the transfer as a sale, ASC 860-10-40-5(b) requires each transferee to have the right to pledge or exchange the financial asset it received, and requires that no condition both constrains the transferee from taking advantage of its right and provides more than a trivial benefit to the transferor.

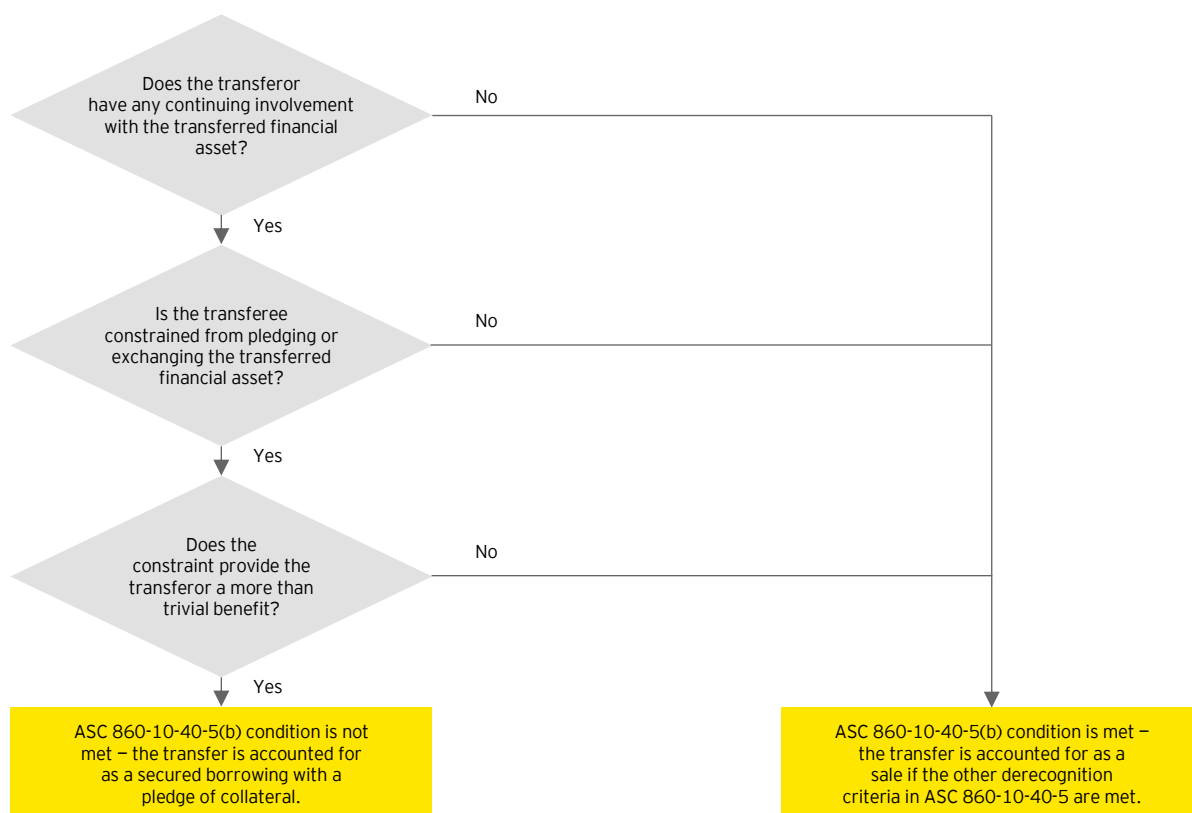
A constraint may be transferor-imposed or imposed by other parties. Judgment is required to assess whether a particular condition represents a constraint on the transferee and provides a more-than-trivial benefit to the transferor.

The ASC 860-10-40-5(b) criterion also applies to entities whose sole purpose is to engage in securitization or asset-backed financing activities (collectively referred to as securitization entities). Often, such entities are constrained from pledging or exchanging the transferred asset. In these circumstances, the criterion is applied to the third-party holders of the securitization entity's beneficial interests rather than the securitization entity (i.e., transferee of the financial asset). The FASB reasoned a third-party holder's right to pledge or exchange those beneficial interests is the counterpart of a transferee's right to pledge or exchange the transferred assets themselves.

For the remainder of this section, when the terms "financial asset" and "transferee" are used, the same principles and guidance would apply to "beneficial interests" and "third-party holders of those beneficial interests" issued by an entity whose sole purpose is to facilitate securitizations or asset-backed financing activities whether or not specifically stated.

4.2 Decision tree related to a transferee's right to pledge or exchange

The following diagram illustrates the process to determine whether the "right to pledge or exchange" condition has been met and the potential effect of that determination.



4.2.1 Does the transferor have any continuing involvement with the transferred financial asset?

A transferor's continuing involvement may involve a variety of activities or arrangements and is defined in the ASC Master Glossary as any involvement with the transferred financial assets that either (1) permits the transferor to receive cash flows or other benefits that arise from the transferred financial assets or (2) obligates the transferor to provide additional cash flows or other assets to any party related to the transfer. However, we generally believe standard representations and warranties that assert the financial asset being transferred is what it is purported to be at the transfer date do not constitute a form of continuing involvement.

When evaluating the existence of continuing involvement, the transferor must also consider the involvement of its consolidated affiliates included in the financial statements being presented and its **agents**. In some cases, conditions that constrain the transferee's ability to pledge or exchange the transferred financial assets may constitute continuing involvement of the transferor. ASC 860-10-55-79A and 55-79B provide examples of evidence to be considered and examples of continuing involvement.

Excerpt from Accounting Standards Codification

Transfers and Servicing – Overall

Implementation Guidance and Illustrations

Application of the Term Continuing Involvement

860-10-55-79A

This implementation guidance addresses the application of the glossary term *continuing involvement*. All available evidence shall be considered, including, but not limited to, all of the following:

- a. Explicit written arrangements
- b. Communications between the transferor and the transferee or its beneficial interest holders
- c. Unwritten arrangements customary in similar transfers.

860-10-55-79B

Examples of continuing involvement include, but are not limited to, all of the following:

- a. Servicing arrangements
- b. Recourse or guarantee arrangements
- c. Agreements to purchase or redeem transferred financial assets
 - cc. Options written or held
- d. Derivative instruments that are entered into contemporaneously with, or in contemplation of, the transfer
- e. Arrangements to provide financial support
- f. Pledges of collateral
- g. The transferor's beneficial interests in the transferred financial assets.

In addition to the examples of continuing involvement provided in the guidance above, other common forms of continuing involvement include indemnification agreements and agreements to purchase or redeem beneficial interests in the transferred financial assets.

See Questions 4-1 to 4-3 for additional interpretive guidance.

4.2.1.1 Transfers of equity method investments

Proceeds from transfers of equity method investments may include future payments from the transferees that are contingent on the performance of the transferred assets. This type of payment generally constitutes continuing involvement, and entities should carefully evaluate all of the conditions for sale accounting under ASC 860-10-40-5 to determine whether the transfer should be accounted for as a sale. To the extent the transfer is accounted for as a sale, the right to receive future payments from the transferee may be viewed as beneficial interest.

4.2.2 Is the transferee constrained from pledging or exchanging the transferred financial asset?

The party that obtains the economic benefits of the financial asset (primarily the future cash inflows of the financial asset) is the party that generally would be considered to control the financial asset. Consequently, to achieve sale accounting, the transferee must be able to obtain the benefits of ownership (i.e., the cash inflows) of the asset either by pledging or exchanging the asset.

Under ASC 860, an entity can generally obtain all or most of the economic benefits (cash flows) from a financial asset either by exchanging the transferred financial asset or by pledging it as collateral. The emphasis in ASC 860-10-40-5(b) regarding such rights focuses on an entity's ability to obtain all or nearly all of the economic benefits from the financial asset.

Excerpt from Accounting Standards Codification

Transfers and Servicing – Overall

Derecognition

Transferee's Rights to Pledge or Exchange Transferred Financial Assets

860-10-40-15

Many transferor-imposed or other conditions on a transferee's right to pledge or exchange both constrain a transferee from pledging or exchanging and, through that constraint, provide more than a trivial benefit to the transferor. Judgment is required to assess whether a particular condition results in a constraint. Judgment also is required to assess whether a constraint provides a more-than-trivial benefit to the transferor. If the transferee is an entity whose sole purpose is to engage in securitization or asset-backed financing activities, that entity may be constrained from pledging or exchanging the transferred financial assets to protect the rights of beneficial interest holders in the financial assets of the entity. Paragraph 860-10-40-5(b) requires that the transferor look through the constrained entity to determine whether each third-party holder of its beneficial interests has the right to pledge or exchange the beneficial interests that it holds. The considerations in paragraphs 860-10-40-16 through 40-18 apply to the transferee or the third-party holders of its beneficial interests in an entity that is constrained from pledging or exchanging the assets it receives and whose sole purpose is to engage in securitization or asset-backed financing activities.

860-10-40-16

A condition imposed by a transferor that constrains the transferee presumptively provides more than a trivial benefit to the transferor. A condition not imposed by the transferor that constrains the transferee may or may not provide more than a trivial benefit to the transferor. For example, if the transferor refrains from imposing its usual contractual constraint on a specific transfer because it knows an equivalent constraint is already imposed on the transferee by a third party, it presumptively benefits more than trivially from that constraint. However, the transferor cannot benefit from a constraint if it is unaware at the time of the transfer that the transferee is constrained.

Grants of security interests

The granting of a security interest in a financial asset is not the same as pledging a financial asset. A security interest is defined as a form of interest in property that provides, upon default of the obligation for which the security interest is given, the property may be sold to satisfy that obligation. In contrast, a pledge transfers custody and legal title of the financial asset to the secured party. Therefore, the condition in ASC 860-10-40-5(b) is not satisfied if the transferee has only a security interest in the financial asset or if the transferee is able to only grant a security interest in the financial asset.

See Questions 4-4 and 4-5 for additional interpretive guidance.

4.2.3

Does the constraint provide the transferor a more than trivial benefit?

Excerpt from Accounting Standards Codification

Transfers and Servicing – Overall

Implementation Guidance and Illustrations

Transferee Is Significantly Limited in Its Ability to Pledge or Exchange the Transferred Financial Assets with No Continuing Involvement

860-10-55-30

For a transfer to fail to meet the condition in paragraph 860-10-40-5(b), the transferee must be constrained from pledging or exchanging the transferred financial asset and the transferor must receive more than a trivial benefit as a result of the constraint.

Determining whether a constraint provides the transferor with more than a trivial benefit is not always clear and often requires significant judgment. The fact that a constraint on a transferee may be explicit or implicit further complicates that judgment. Additionally, the FASB has not defined the concept of “more than a trivial benefit.” However, a key condition in making this determination is whether the transferor is aware of the constraint.

4.2.3.1

Transferor imposed and non-transferor imposed conditions that may constrain a transferee

As a general rule, a condition imposed by a transferor that constrains the transferee presumptively provides more than a trivial benefit to the transferor. However, a condition not imposed by the transferor that constrains the transferee may or may not provide more than a trivial benefit to the transferor.

In concept, transferors incur costs if they impose constraints, because transferees presumably pay less than they would to obtain the financial asset without such constraints. Moreover, transferors presumably incur those costs for a substantive business reason. Consequently, the FASB and SEC staff have generally concluded that, absent evidence to the contrary, a condition imposed by a transferor that constrains the transferee presumptively results in a more-than-trivial benefit to the transferor.

However, it is less clear whether conditions not imposed by the transferor constrain the transferee and provide a more-than-trivial benefit to the transferor. ASC 860-10-40-16 states that a condition not imposed by the transferor that constrains the transferee may or may not provide more than a trivial benefit to the transferor. For example, if the transferor refrains from imposing its usual contractual constraint on a specific transfer because it knows an equivalent constraint is already imposed on the transferee by a third party, it presumptively benefits more than trivially from that constraint.

When determining whether the requirements of ASC 860-10-40-5(b) have been met, entities should consider all relevant facts and circumstances. In practice, it is difficult for a transferor with continuing involvement to overcome the “more than trivial benefit” presumption when the constraint is either imposed by the transferor or imposed by a third party of which the transferor is knowledgeable.

4.3 Examples of conditions that presumptively constrain the transferee

While each condition that constrains a transferee from pledging or exchanging the transferred financial asset should be assessed, not every constraint provides more than a trivial benefit to the transferor. ASC 860-10-40-19 states that judgment is required to assess the significance of some conditions. Examples of conditions that presumably constrain the transferee and may provide more than a trivial benefit to the transferor include the following:

- ▶ A provision that prohibits selling or pledging a transferred loan receivable. This condition not only constrains the transferee but also provides the transferor with the more-than-trivial benefit of knowing who holds the financial asset (a prerequisite to repurchasing the financial asset) and of being able to block the financial asset from being transferred to a competitor for the loan customer's business (ASC 860-10-40-17(a)).
- ▶ Transferor-imposed contractual constraints that narrowly limit timing or terms, for example, allowing a transferee to pledge only on the day assets are obtained or only on terms agreed to with the transferor (ASC 860-10-40-17(b)).

Prohibitions or limitations, whether imposed by the transferor or otherwise known by the transferor, are problematic because they limit the transferee's ability to realize the economic benefits of the transferred financial asset.

An example of such a limitation may include a prohibition from selling a transferred financial asset to the transferor's competitor when that competitor is the only other potential buyer in the marketplace. In these circumstances, the transferee is constrained from obtaining the benefits of the transferred financial asset, and the transferor likely retains a more than trivial benefit. The benefit to the transferor may include knowing who holds the transferred financial asset and preventing that asset from benefiting a competitor.

- ▶ Some rights or obligations to reacquire transferred financial assets or beneficial interests, including all of the following:
 - ▶ A freestanding call option written by a transferee to the transferor may benefit the transferor and, if the transferred financial assets are not readily obtainable in the marketplace, is likely to constrain a transferee because the transferee might have to default if the call option was exercised and the transferee had pledged or exchanged the financial assets (ASC 860-10-40-17(c)(1)).
 - ▶ A freestanding forward purchase-sale contract between the transferor and the transferee on transferred financial assets not readily obtainable in the marketplace would benefit the transferor and is likely to constrain a transferee (ASC 860-10-40-17(c)(3)).
 - ▶ A call option to repurchase third-party beneficial interests at the price paid plus a stated return if the third-party holders of its beneficial interests are constrained from pledging or exchanging their beneficial interests due to that call option (ASC 860-10-40-17(c)(1A)).
 - ▶ A call option written by a transferee to the transferor that is sufficiently deep-in-the-money, if the transferred financial assets are not readily obtainable in the marketplace, because the transferee would be more likely to have to hold the assets to comply with a potential exercise of the call option (ASC 860-10-40-17(c)(2)).
- ▶ A deep-in-the-money written put option on a transferred financial asset effectively constrains the transferee and, therefore, may preclude sale accounting. A constraint exists because the option's exercise price effectively ensures the transferee would forgo its right to pledge or exchange the transferred financial asset to a third party. If it were to seek to reclaim the financial asset, the transferor receives a premium for writing the put option. In this circumstance, the transferor may benefit from knowing the location of the financial asset and preventing its competitors' access to

such financial asset. Deep-in-the-money put options may also preclude sale accounting under ASC 860-10-40-5(c) because it is probable the transferor will obtain the transferred financial asset (refer to section 5, *Criteria for a sale – Effective control*).

4.4 Examples of conditions that presumptively do not constrain the transferee

Some conditions, in and of themselves, do not necessarily constrain a transferee from pledging or exchanging a financial asset, including the following:

- ▶ A transferor's right of first refusal on a bona fide offer from a third party.

A transferor's right of first refusal on the occurrence of a bona fide offer to the transferee from a third party, because that right in itself does not enable the transferor to compel the transferee to sell the financial asset and the transferee would be in a position to receive the sum offered by exchanging the financial asset, albeit possibly from the transferor rather than the third party (ASC 860-10-40-18(a)).

- ▶ A requirement to obtain the transferor's permission to sell or pledge that is not to be unreasonably withheld (ASC 860-10-40-18(b)).

Determining when a requirement to obtain a transferor's approval constrains a transferee from taking advantage of its right to pledge or to exchange the transferred financial asset requires consideration of the nature of the requirement for approval (see ASC 860-10-55-31). A requirement to obtain the transferor's permission to pledge or exchange that cannot be unreasonably withheld by the transferor is generally not considered a substantive constraint. Conversely, if determining whether to grant permission is at the transferor's sole discretion, this condition would effectively constrain the transferee. In the latter instances, the transferor incurs a cost, because the transferee would presumably pay less than it would to obtain the financial asset without the constraint. Additionally, that constraint presumptively provides the transferor with a more-than-trivial benefit because the transferor would only incur such costs if there was a resulting benefit.

- ▶ A prohibition on sale to the transferor's competitor if other potential willing buyers exist (ASC 860-10-40-18(c)).

A prohibition on sale to the transferor's competitor may or may not constrain a transferee from pledging or exchanging the financial asset, depending on how many other potential buyers exist. If there are many other potential willing buyers, the prohibition would not be constraining. In contrast, if that competitor were the only potential willing buyer (other than the transferor), then the condition would be constraining (ASC 860-10-55-32). For example, a new partner in a joint venture (i.e., the transferee in a transaction where the transferor sold its interest in the joint venture to the transferee) may be prohibited from selling its equity-method interest in the joint venture to a third-party that is a competitor of the existing partners in the joint venture. In these cases, the transferor will need to assess the extent of potential willing buyers (other than the transferor) of the equity-method interest to evaluate whether the prohibition on sale constrains the transferee.

- ▶ A regulatory limitation such as on the number or nature of eligible transferees (as in the circumstance of securities issued under Securities Act Rule 144A or debt placed privately) (ASC 860-10-40-18(d)).

Some constraints, not imposed directly by a transferor, originate within certain regulatory environments and do not necessarily represent constraints that provide the transferor a more-than-trivial benefit. For example, issuing beneficial interests in the form of securities issued under Rule 144A presumptively would not constrain a transferee's ability to transfer those beneficial interests for purposes of ASC 860-10-40-5(b). The primary limitation imposed by Rule 144A is that a potential buyer must be a sophisticated investor. If a large number of qualified buyers exist, the holder could transfer those securities to many potential buyers and, thereby, realize the full economic benefit of the assets. In such circumstances, the requirements of Rule 144A would not be a constraint that precludes sale accounting.

- ▶ Illiquidity, for example, the absence of an active market (ASC 860-10-40-18(e)).
Illiquidity, in and of itself, generally does not preclude sale accounting because the transferee is still able to freely pledge or exchange the transferred financial asset if and when the opportunity presents itself.
- ▶ Freestanding rights to reacquire transferred assets that are readily obtainable (ASC 860-10-40-18(g)).
This circumstance differs from the freestanding call option on a non-readily obtainable financial asset discussed in section 4.3 above. In this circumstance, if the transferor were to exercise its rights under the call option, the transferee could always reacquire a similar financial asset from the market place and therefore avoid the risk of defaulting on its obligation. An attached call option²⁴ generally would not constrain the transferee from pledging or exchanging any transferred financial asset (whether that financial asset is readily obtainable or not). An attached call, by definition, follows the financial asset subject to the call such that if the transferee sold the transferred financial asset with an attached call, the obligation to satisfy the call would reside with the subsequent purchaser of the transferred financial asset and not with the transferee. Therefore, upon pledging or exchanging the financial asset, the transferee is no longer the counterparty to the call and thus not exposed to the risk of default.
- ▶ An embedded call option²⁵ does not constrain the transferee and does not maintain the transferor's effective control over the transferred financial asset because that call option is held by the issuer of the financial asset and not the transferor.
- ▶ Deep-out-of-the-money written put options on a transferred non-readily obtainable financial asset are generally not considered to be substantive constraints. In this circumstance, because the option is deep out of the money, it is probable at inception that the option will not be exercised. Therefore, the transferee is free to pledge and exchange the transferred financial asset without a substantive risk of default as discussed above.

The provisions listed above should be considered in connection with the other provisions and restrictions included in the rights retained by the transferor and its consolidated entities and its agents. A single provision may not constrain the transferee individually, but it may do so when considered in combination with other agreements and arrangements.

4.5 Questions and interpretive responses

Question 4-1

Transferee is constrained, but the transferor has no continuing involvement

Assume an entity transfers financial assets to an entity that is neither a securitization entity nor an entity whose sole purpose is to facilitate an asset-backed financing. The transferee is significantly limited in its ability to pledge or exchange the transferred assets. The transferor receives cash in return for the transferred financial assets and has no explicit or implicit continuing involvement with the transferred assets. Does the transfer meet the requirements of ASC 860-10-40-5(b)?

Yes. ASC 860-10-40-16A²⁶ clarifies that if a transferor receives only cash in return for the transferred financial assets and the transferor, its consolidated affiliates included in the financial statements being presented and its agents have no continuing involvement with the transferred financial assets, sale

²⁴ An attached call option is an option held by the transferor of a financial asset that becomes part of and is traded with the underlying instrument. Rather than being an obligation of the transferee, an attached call is traded with and diminishes the value of the underlying instrument transferred subject to that call option.

²⁵ An embedded call option is an option held by the issuer of a financial instrument that is part of and trades with the underlying instrument. For example, a bond may allow the issuer to call it by posting a public notice well before its stated maturity that asks the current holder to submit it for early redemption and provides that interest ceases to accrue on the bond after the early redemption date. Rather than being an obligation of the initial purchaser of the bond, an embedded call trades with and diminishes the value of the underlying bond.

²⁶ Also refer to ASC 860-10-55-28 and 55-29.

accounting is allowed under ASC 860-10-40-5(b) even if the transferee entity is significantly limited in its ability to pledge or exchange the transferred assets. The FASB reasoned that a transferred financial asset from which the transferor can obtain no further benefits is no longer its financial asset and should be removed from its statement of financial position.

However, any further involvement with the transferred financial asset, other than standard representations and warranties, is considered continuing involvement. Therefore, the level of continuing involvement with the transferred financial asset, inclusive of the effect of any existing constraint, must be assessed to determine if that constraint provides the transferor with more than a trivial benefit. If so, the transferor has not relinquished control over the transferred financial asset, and sale accounting is precluded.

Question 4-2 Forms of continuing involvement that do not preclude sale accounting

If the transferee is constrained from pledging or exchanging the asset received, does any form of continuing involvement provide the transferor with more than a trivial benefit?

No. The nature of the continuing involvement should be evaluated. For example, continuing involvement in the form of custodial services or other limited administrative services, which do not constitute control over the transferred financial asset, would not provide the transferor with more than a trivial benefit if such services are provided at a price that is not contingent upon the performance of the underlying asset.

Question 4-3 Transfers between entities under common control

Should a transferor-subsidiary consider the involvements of its parent if it transfers a financial asset to another subsidiary of the parent?

ASC 860-10-40-4 states that in a transfer between two subsidiaries of a common parent, the transferor-subsidiary shall not consider its parent's involvement with the transferred financial assets in applying the derecognition conditions specified in ASC 860-10-40-5.

Question 4-4 Transferee's ability to pledge or exchange

To not be constrained, must a transferee be able to both pledge and exchange the transferred financial asset?

ASC 860-10-55-27 clarifies that the answer depends on the facts and circumstances. The key aspect of the analysis is the determination of whether the transferee is able to obtain all or most of the economic benefit from the transferred financial asset (i.e., the ability to obtain all or most of the cash inflows, either by exchanging the transferred financial asset or by pledging it as collateral).

Question 4-5 Transferee's limited ability to pledge or exchange

Does the transferee's ability to pledge or exchange only credit impaired financial assets satisfy the derecognition requirements specified in ASC 860-10-40-5(b)? Assume the transferee is not an entity whose sole purpose is designed to facilitate securitization or asset-backed financing activities.

No. As indicated in ASC 860-10-40-16A and ASC 860-10-55-28, when the transferee has only a limited ability to pledge or exchange the transferred financial asset, the transferee would not be able to sell or pledge in a way that allows it to realize all (or most) of the cash flows from the transferred financial asset. Being able to freely pledge or exchange its financial asset, such as to realize appreciation in value, is a substantial right that must be conveyed to a transferee for control to have been relinquished.

Question 4-6 **Considering the role of the portfolio manager when assessing constraints**

Could the transferor's role as portfolio manager of transferred financial assets be considered a constraint?

Based on the facts and circumstances, a transferor's role as a portfolio manager may effectively constrain the transferee. For example, in a transaction that does not involve a securitization entity, the transferee may have the contractual right to pledge or exchange the assets but be constrained from doing so because of the transferor's ability as portfolio manager to control all asset disposition decisions. ASC 860-10-40-17 indicates that the ability to pledge or exchange financial assets only on terms agreed to by the transferor is considered a constraint and could provide more than a trivial benefit to the transferor. One factor to consider is whether the transferee has substantive "kick-out rights." If the transferee has the ability to replace the portfolio manager, the manager's control over investment decisions may not be considered a transferee constraint.

In situations in which the transferee is an asset-backed or securitization entity, the evaluation would instead consider the beneficial interest holders' rights to pledge or exchange their beneficial interests. Because such restrictions are not typical, the fact that the transferor is also the portfolio manager may not preclude sale accounting.

Question 4-7 **Financial assets transferred in a commercial mortgage-backed securities (CMBS) issuance**

Can financial assets transferred in a CMBS issuance qualify for derecognition if the sponsor has transferred a risk retention interest to a qualified third-party purchaser in accordance with the credit risk retention requirements of the Dodd-Frank Act?

Yes, in certain circumstances.

Under a rule adopted by certain federal agencies in 2014 and mandated by the Dodd-Frank Act, sponsors of asset-backed securities (ABS), including commercial mortgage-backed securities, are generally required to retain at least 5% of the credit risk (hereinafter referred to as a "risk retention interest") related to transferred assets collateralizing the ABS issuance. Limited exceptions are provided for assets that satisfy specific credit criteria.

The risk retention interest can be retained in a variety of ways, including:

- ▶ Vertical – A sponsor could retain at least 5% of each class of issued securities.
- ▶ Horizontal – A sponsor could retain the most subordinate class of securities equal to at least 5% of the fair value of all securities issued.
- ▶ L-shaped – A sponsor could combine both the vertical and horizontal options as long as they total at least 5% of the fair value of all securities issued.

As an alternative to directly retaining the risk retention interest, sponsors of a CMBS offering may satisfy the risk retention requirement by selling to a qualified third-party purchaser (TPP) the most subordinate class of securities equal to at least 5% of the fair value of all securities issued (i.e., a horizontal interest). To the extent the TPP does not purchase enough of the horizontal interest to meet the full 5% fair value requirement, the transferor can utilize the L shaped structure to satisfy the requirement by itself retaining an incremental vertical interest to collectively meet the 5% requirement. A sponsor cannot satisfy the risk retention requirement by selling a vertical interest to a TPP.

If the sponsor sells the risk retention interest to a TPP, the TPP is subject to the same requirements that the sponsor would have been subject to, which includes a restriction on selling and pledging the risk retention interest on a non-recourse basis. A sponsor's sale of the risk retention interest (which generally occurs at the time of the securitization) has raised questions about whether the sponsor can derecognize the securitized financial assets. That's because ASC 860 permits sale accounting when a transferor has

continuing involvement with the transferred assets only if, among other things, each transferee (or if the transferee is a securitization vehicle (e.g., a CMBS issuer), each third-party holder (including the TPP) of its beneficial interests) has the right to freely sell or pledge those interests under ASC 860-10-40-5(b).

In 2017, the SEC staff responded to a preclearance submission²⁷ from the Securities Industry and Financial Markets Association requesting interpretive guidance on the application of the derecognition guidance in ASC 860 to the financial assets transferred in a CMBS issuance when the transferor sells the risk retention interest to a TPP. The SEC staff's response was based solely on the following facts and circumstances:

- ▶ The sponsor is not required to consolidate the CMBS issuer.
- ▶ The sponsor sells to a TPP either 1) a 5% horizontal interest representing the most subordinated class or classes in the securitization or 2) in an L-shaped structure, a horizontal interest while retaining a vertical interest, the combination of which makes up the 5% risk retention interest.
- ▶ The sponsor's ongoing involvement with the CMBS issuer is limited to the agreement between the sponsor and TPP in compliance with the rule and which may include holding a vertical risk retention interest.
- ▶ There are no other contracts between the sponsor and the securitization entity or beneficial interest holders.
- ▶ The conditions for legal isolation and effective control in ASC 860-10-40-5(a) and ASC 860-10-40-5(c), respectively, are met.

Based on the facts and circumstances presented in the submission, the SEC staff said it would not object to a conclusion that the conditions for sale accounting are met. The SEC staff said that its conclusion is based on the unique facts and circumstances described in the preclearance submission and the documented regulatory intent of the TPP Option. The SEC staff also said that entities should not apply sale accounting by analogy to other fact patterns.

²⁷ <https://www.sifma.org/wp-content/uploads/2017/12/SIFMA-on-SEC-Interpretive-Guidance.pdf>.

5 Criteria for a sale – Effective control

5.1 Introduction

This section focuses on the criterion outlined in ASC 860-10-40-5(c), which requires that for sale accounting to be achieved, the transferor cannot maintain effective control over the transferred financial assets.

5.2 Effective control criterion

Excerpt from Accounting Standards Codification

Transfers and Servicing – Overall

Derecognition

Conditions for a Sale of Financial Assets

860-10-40-5

A transfer of an entire financial asset, a group of entire financial assets, or a participating interest in an entire financial asset in which the transferor surrenders control over those financial assets shall be accounted for as a sale if and only if all of the following conditions are met:

- a. [EY note: Condition omitted; see section 3, *Criteria for a sale – Legal isolation*]
- b. [EY note: Condition omitted; see section 4, *Criteria for a sale – Right to pledge or exchange*]
- c. Effective control. The transferor, its consolidated affiliates included in the financial statements being presented, or its agents do not maintain effective control over the transferred financial assets or third-party beneficial interests related to those transferred assets (see paragraph 860-10-40-22A). A transferor's effective control over the transferred financial assets includes, but is not limited to, any of the following:
 1. An agreement that both entitles and obligates the transferor to repurchase or redeem the transferred financial assets before their maturity (see paragraphs 860-10-40-23 through 40-25)
 2. An agreement, other than through a **cleanup call** (see paragraphs 860-10-40-28 through 40-39), that provides the transferor with both of the following:
 - i. The **unilateral ability** to cause the holder to return specific financial assets
 - ii. A more-than-trivial benefit attributable to that ability.
 3. An agreement that permits the transferee to require the transferor to repurchase the transferred financial assets at a price that is so favorable to the transferee that it is probable that the transferee will require the transferor to repurchase them (see paragraph 860-10-55-42D).

The guidance in ASC 860-10-40-5(c) focuses on determining whether a transferor has relinquished effective control over transferred financial assets when certain arrangements exist that require or permit the transferor to reacquire such financial assets. When the transferee is a securitization entity that issues beneficial interests in the transferred financial assets, the evaluation of whether the transferor maintains effective control over the transferred financial assets should consider its control over the third-party beneficial interests. This concept is discussed further in section 5.4.1.1.

For the remainder of this section, when the terms “financial asset” and “transferee” are used, the same principles and guidance would apply to “beneficial interests” and “third-party holders of those beneficial interests” issued by an entity whose sole purpose is to facilitate securitizations or asset-backed financing activities whether or not specifically stated.

5.2.1 Use of judgment

Judgment is required to assess whether the transferor maintains effective control over transferred financial assets. As part of the assessment, the transferor should consider all arrangements made contemporaneously with, or in contemplation of, the transfer, even when such arrangements are not entered into concurrently with the transfer. The transferor should consider its continuing involvement as well as that of its consolidated affiliates included in the financial statements being presented and its agents in evaluating the derecognition criteria of ASC 860-10-40-5.

When assessing effective control, ASC 860-10-40-22A explains that the transferor considers the involvement of an agent only when the agent acts for and on behalf of the transferor. If the transferor and transferee have the same agent, the agent’s activities on behalf of the transferee should not be considered in the transferor’s evaluation of whether it has effective control over a transferred financial asset. For example, an investment manager may act as a fiduciary (agent) for both the transferor and the transferee; therefore, the transferor need only consider the involvement of the investment manager if it is acting on its behalf. This concept is discussed further in Question 5-4.

5.3 Agreements that both entitle and obligate the transferor to repurchase or redeem transferred financial assets

Under ASC 860-10-40-5(c)(1), the transferor is presumptively considered to maintain effective control over the transferred financial asset if there is an agreement that both entitles and obligates the transferor to repurchase the transferred financial asset before its maturity. Repurchase agreements (repos) and securities lending transactions are examples of typical arrangements containing such provisions. If effective control is maintained or the transaction qualifies for the repurchase-to-maturity transaction exception in ASC 860-10-40-24A, the transfer is accounted for as a secured borrowing.

Transfers that include only the right to reacquire, at the option of the transferor or upon certain conditions, or only the obligation to reacquire, at the option of the transferee or upon certain conditions, may not maintain the transferor’s control under ASC 860-10-40-5(c)(1), because the option might not be exercised or the conditions might not occur. Similarly, expectations of reacquiring the same securities without any contractual commitments (e.g., as in wash sales) provide no control over the transferred financial assets.²⁸

Not all arrangements that both entitle and obligate a transferor to repurchase the transferred financial assets result in the transferor maintaining effective control over the assets. For example, the transferor has not maintained effective control if:

- ▶ The arrangement does not require the repurchase of the same or “substantially the same” asset(s) as described in ASC 860-10-40-24 and ASC 860-10-55-35
- ▶ The arrangement does not require the transferor to repurchase the transferred financial assets before maturity at a fixed or determinable price
- ▶ The arrangement to reacquire the transferred financial assets is not entered into contemporaneously with, or in contemplation of, the transfer

²⁸ See ASC 860-10-40-25.

In these instances, assuming the other derecognition conditions of ASC 860-10-40-5(a) and 40-5(b) are met, the transfer would be accounted for as sale with a forward repurchase commitment.

Securities lending transactions and repurchase agreements, including the application of the effective control criteria to these arrangements, are discussed further in section 9.

5.4 Transferor's unilateral ability to cause the return of specific transferred financial assets

The second form of effective control described in ASC 860-10-40-5(c)(2) applies to a broader group of agreements whose terms provide the transferor (or any of its consolidated affiliates included in the financial statements being presented) both:

- ▶ The ability to unilaterally reclaim specific transferred financial assets
- ▶ A more-than-trivial benefit attributable to that ability

Examples of arrangements that could provide the transferor effective control include call options, including removal-of-accounts provisions, an ability to dissolve a securitization entity and regain control of the underlying financial assets and a freestanding forward purchase-sale contract between the transferor and transferee. ASC 860 also clarifies that all arrangements or agreements made contemporaneously with, or in contemplation of, the financial asset transfer should be considered to determine the accounting.

See Question 5-1 for additional interpretive guidance.

5.4.1 Call options and determination of more than a trivial benefit

Excerpt from Accounting Standards Codification

Transfers and Servicing – Overall

Derecognition

Effective Control through Unilateral Ability

860-10-40-28(a)

A call option or other right conveys more than a trivial benefit (that is, fails the condition in paragraph 860-10-40-5(c)(2)(ii)) if the price to be paid is fixed, determinable, or otherwise potentially advantageous, unless because that price is so far out of the money or for other reasons it is probable when the option is written that the transferor will not exercise it.

As used in ASC 860-10-40-28(a), we believe the phrase “potentially advantageous” should be interpreted as any ability to repurchase transferred financial assets at a price that is less than the financial assets’ fair value at the time of repurchase. For example, a call option held by the transferor that has a fixed exercise price based on the fair value of the financial assets on the day of the transfer is potentially advantageous because the market price for the underlying assets could increase after the initial transfer date. Such a call option provides the transferor with more than a trivial benefit and would preclude sale accounting pursuant to ASC 860-10-40-5(c).

All facts and circumstances should be considered in determining whether a call option or other right is potentially advantageous and thus, provides the transferor with more than a trivial benefit. Terms in transaction documents that are meant to approximate fair value should not necessarily be considered fair value for purposes of this evaluation.

5.4.1.1 Call options that preclude sale accounting

| Type of call option | Explanation |
|--|---|
| Fixed price call options | For the reasons noted in section 5.4.1, a call option on a specific transferred financial asset (i.e., a financial asset that is not readily obtainable in the market) at a price fixed at its principal amount maintains the transferor's effective control over the associated financial asset. |
| Freestanding fair value call options on non-readily obtainable assets | A freestanding call option that allows the transferor to reclaim transferred financial assets by paying their fair value when reclaimed may preclude sale accounting if the financial assets are not readily obtainable in the marketplace. The call option gives the transferor the unilateral ability to repurchase the assets and because the assets are not readily obtainable, that ability may provide the transferor with a more-than-trivial benefit (e.g., by knowing where the assets can be reclaimed or by preventing the transferee from further transferring the assets to a competitor). |

Effective control over transferred financial assets can be present even if the right to reclaim is indirect. The following implementation guidance from ASC 860-10-40-28(b) and 40-28A illustrates this point:

- ▶ If a call allows a transferor to buy back the beneficial interests at a fixed price, the transferor may maintain effective control of the financial assets underlying those beneficial interests. If the transferee is an entity whose sole purpose is to engage in securitization or asset-backed financing activities, that entity may be constrained from choosing to pledge or exchange the transferred financial assets. In that circumstance, any call held by the transferor on third-party beneficial interests is effectively an attached call on the transferred financial assets. Depending on the price and other terms of the call, the transferor may maintain effective control over the transferred financial assets.
- ▶ A transferor's unilateral ability to cause a securitization entity to return to the transferor or otherwise dispose of specific transferred financial assets, for example, in response to its decision to exit a market or a particular activity, has the characteristic in ASC 860-10-40-5(c)(2)(i) and, thus, would provide the transferor with effective control over the transferred financial assets if it also provides more than a trivial benefit to the transferor.

5.4.1.2 Call options that do not preclude sale accounting

ASC 860-10-40 provides examples of call options that do not preclude sale accounting:

| Type of call option | Explanation |
|---|---|
| Cash-settled call options (i.e., that cannot be physically settled in the underlying financial assets) | Do not constrain the transferee, nor do they result in the transferor maintaining effective control because they do not provide the transferor with an opportunity to reclaim the transferred financial assets (ASC 860-10-40-31). |
| Embedded call options in the underlying financial asset | Would not result in the transferor's maintaining effective control because it is the issuer rather than the transferor who holds the call option, and the call option does not provide more than a trivial benefit to the transferor. For example, a call embedded by the issuer of a callable bond or the borrower of a prepayable mortgage loan would not provide the transferor with effective control over the transferred financial asset (ASC 860-10-40-32). |
| Right to reclaim specific transferred financial assets by paying their fair value when reclaimed | Does not maintain effective control if it does not convey a more-than-trivial benefit to the transferor (ASC 860-10-40-35). For example, ASC 860-10-40-28(c) states that a call option on readily obtainable assets at fair value may not provide the transferor with more than a trivial benefit. However, a transferor has maintained effective control if it has such a right and also holds the residual interest in the transferred financial assets. Refer to section 5.4.4 for further guidance. |

| Type of call option | Explanation |
|--|---|
| Out-of-the-money fixed price call option that entitles the transferor to buy back the transferred financial assets or related beneficial interests | Would not maintain the transferor's effective control over the transferred financial asset if that price is so far out of the money or for other reasons it is probable when the call option is written that the transferor will not exercise it. ASC 860-10-40-28(a) clarifies that the probability of an option being exercised and its potential effect on the accounting for a related transfer of financial assets is assessed only at the time the option is written. |

The following are other examples of the application of the effective control principles:

Excerpt from Accounting Standards Codification

Transfers and Servicing – Overall

Implementation Guidance and Illustrations

Call Options

860-10-55-42

The following are other examples of the application of effective control principles:

- a. In a loan participation, the lead bank (that is also the transferor) allows the participating bank to resell but reserves the right to call at any time from whoever holds it and can enforce the call option by cutting off the flow of interest at the call date; such a call option precludes sale accounting.
- b. In a securitization, a call option permits the transferor to reclaim all of the transferred financial assets from the securitization entity at any time; such a call option precludes sale accounting unless both of the following conditions exist:
 1. The call option is an option to call, at fair value, a financial asset that is readily obtainable in the marketplace.
 2. The transferor does not hold a residual beneficial interest in the transferred financial assets (see paragraph 860-10-40-35).
- c. A transferor-servicer transfers a group of entire financial assets to a securitization entity and has the right to call all of the financial assets when the group amortizes to 20 percent of its value (determined at the date of transfer). The transferor-servicer determines that at that level of financial assets, its cost of servicing them would not be burdensome in relation to the benefits of servicing, and therefore that the call option is not a cleanup call. Such a call option precludes sale accounting for the entire group of transferred financial assets (see paragraph 860-10-55-70).
- d. If the third-party beneficial interests contain an embedded option and the transferor holds the residual interest in the securitization entity, the combination has the same kind of effective control as a scheduled auction provision if the transferor holds a residual beneficial interest. Sale accounting would be precluded for all of the transferred financial assets affected by the call option.^[29]
- e. If the third-party beneficial interests in a securitization entity pay off first (a so-called turbo structure, where principal payments and prepayments are allocated on a non-pro rata basis, as discussed in paragraph 860-10-05-13), the transferor may not maintain effective control over transferred financial assets (see paragraph 860-10-40-32). To some extent, these repayments are contractual cash flows of the underlying assets, but repayments also result from prepayments in the underlying assets (that is, the prepayment options in the underlying assets are mirrored in the

²⁹ EY note: See Question 5-6 for additional implementation guidance on a transferor retaining a residual interest in the transferred financial assets.

third-party beneficial interests). In this circumstance, call options embedded in the third-party beneficial interests result from the options embedded in the underlying assets (that is, they are held by the underlying borrowers rather than the transferor), and thus do not preclude sale accounting.

- f. A transferor's contractual right to repurchase, at any time, a loan that is not a readily obtainable financial asset would preclude sale accounting, because the transferor's contractual right to repurchase is effectively a call option of the type described in paragraph 860-10-40-17(c)(2).

5.4.2 Removal-of-accounts provision (ROAP)

ASC 860-10-40-36 explains that many transfers of financial assets that involve transfers of a group of entire financial assets to an entity whose sole purpose is to engage in securitization or asset-backed financing activities empower the transferor to reclaim assets subject to certain restrictions. Such a power is commonly referred to as a removal-of-accounts provision, or ROAP. Whether a ROAP precludes sale accounting depends on whether the ROAP results in the transferor maintaining effective control over transferred financial assets. If it is determined that a ROAP allows the transferor to unilaterally cause the return of specific assets, that provision must also be analyzed to determine whether it provides the transferor with more than a trivial benefit.

5.4.2.1 Examples of ROAPs that preclude sale accounting

The following examples of ROAPs typically cause a transfer of financial assets to be accounted for as a secured borrowing:

| ROAP | Description |
|--|---|
| Unconditional | An unconditional removal-of-accounts provision that allows the transferor to specify the financial assets that may be removed from a group of financial assets precludes sale accounting for all financial assets in the group that might be specified if such a provision allows the transferor unilaterally to remove specific financial assets and provides a more-than-trivial benefit to the transferor (see ASC 860-10-40-37(a)), even if the transferor's right to remove specific financial assets from a group of transferred financial assets is limited, for example, to 10 percent of the fair value of the financial assets transferred and all of the financial assets are smaller than that 10 percent. In that circumstance, none of the transferred financial assets would be derecognized at the time of transfer because no transferred financial asset is beyond the reach of the transferor. If the transferor reclaims all the financial assets it can, and thereby extinguishes its option, its control has expired and the rest of the financial assets will be considered sold at that time. ³⁰ |
| Transferor's decision to exit portion of a business | A removal-of-accounts provision conditioned on a transferor's decision to exit some portion of its business that provides a more-than-trivial benefit to the transferor precludes sale accounting because, whether it can be triggered by canceling an affinity relationship, spinning off a business segment, or accepting a third party's bid to purchase a specified (e.g., geographic) portion of the transferor's business, such a provision provides the transferor with a unilateral right to remove specific financial assets. ³¹ |

Both examples above would preclude sale accounting only when the right provides the transferor with a more-than-trivial benefit. The more-than-trivial benefit may be derived from the ROAP's exercise price (e.g., if the exercise price of the ROAP is below fair value at the date of transfer) or from providing the transferor the ability to keep access to its customers in the event of its own decision to exit a business. All facts and circumstances should be considered when determining whether the right to reacquire assets provides the transferor with a more-than-trivial benefit.

³⁰ Example adopted from ASC 860-10-55-41(a).

³¹ Example adopted from ASC 860-10-40-37(b) and ASC 860-10-55-41(c).

5.4.2.2

Examples of ROAPs that do not preclude sale accounting

The following examples of ROAPs typically do not preclude a transfer of financial assets from being accounted for as a sale:

Random removal of excess assets

- ▶ A removal-of-accounts provision for random removal of excess financial assets, if the provision is sufficiently limited so that the transferor cannot remove specific transferred financial assets (e.g., by limiting removals to the amount of the transferor's interests and to one removal per month (ASC 860-10-40-38(a))).
- ▶ A ROAP that permits the transferor to randomly select and reclaim excess assets (e.g., when the transferee's existing assets will more than adequately provide for cash flows necessary to meet its obligations) does not in and of itself preclude sale accounting if the ROAP is sufficiently limited so that the transferor cannot remove specific transferred financial assets. The determination of which assets being removed should not be in the control of the transferor.
- ▶ Consider the following implementation guidance from ASC 860-10-55-41(b):

A removal-of-accounts provision that provides the right to random removal of excess financial assets from a group of transferred financial assets up to 10 percent of the fair value of the financial assets transferred (all financial assets in the group are less than this 10 percent of the fair value of transferred financial assets) does not preclude sale accounting if the transferor has no other interest in the group. The transferor has, in essence, obtained a 10 percent beneficial interest in the group and should account for it as such. This treatment is permitted because the removal-of-accounts provision is sufficiently limited and the transferor cannot unilaterally remove specific transferred financial assets, because the timing of the removal (when the excess develops) and the assets being removed (which are randomly determined) are not under the control of the transferor.

Contingent ROAPs and calls

- ▶ A removal-of-accounts provision or call that can be exercised only in response to a third party's action (e.g., a contingent ROAP) that has not yet occurred does not maintain the transferor's effective control over financial assets as the transferor would not be able to unilaterally cause the return of assets subject to that ROAP. However, when a third party's action (e.g., borrower default) or inaction (e.g., option expires) occurs that allows removal of financial assets to be initiated solely by the transferor and that right provides a more-than-trivial benefit to the transferor, the transferor must recognize any financial assets subject to the ROAP, whether or not the ROAP is exercised.
- ▶ If the ROAP is exercised, the financial assets are recognized because the transferor has repurchased the financial assets. However, even if the ROAP is not exercised, the financial assets subject to the ROAP are recognized once the ROAP becomes exercisable because the transferor now has the unilateral ability to cause the transferee to return those specific financial assets, and therefore, the transferor once again has effective control over those transferred financial assets. Refer to section 6.6 for further guidance on the accounting requirements when a transferor regains control of a previously sold financial asset.

In addition to the general types of ROAPs discussed above, implementation guidance from ASC 860-10 (see below) provides specific examples of ROAPs that do not preclude sale accounting. These include a ROAP for defaulted assets and a ROAP conditioned on a third-party decision.

Excerpt from Accounting Standards Codification

Transfers and Servicing – Overall

Implementation Guidance and Illustrations

Removal-of-Accounts Provision

860-10-55-41(d)

A removal-of-accounts provision for defaulted receivables does not preclude sale accounting at the time of transfer, because the removal would be allowed only after a third party's action (default) and could not be caused unilaterally by the transferor (see paragraph 860-10-40-38(b)). However, once the default has occurred, the transferor would have the unilateral ability to remove those specific financial assets and would need to recognize the defaulted receivable if that ability provides a more-than-trivial benefit to the transferor.

860-10-55-41(e)

A removal-of-accounts provision conditioned on a third-party cancellation, or expiration without renewal, of an affinity or private-label arrangement does not preclude sale accounting at the time of transfer, because the removal would be allowed only after a third party's action (cancellation) or decision not to act (expiration) and could not be caused unilaterally by the transferor (see paragraph 860-10-40-38(c)). However, once the cancellation or expiration has occurred, the transferor would have the unilateral ability to remove specific financial assets and would need to recognize those financial assets if that ability provides a more-than-trivial benefit to the transferor.

860-10-55-41(f)

Because the transferor could not cause the reacquisition unilaterally a transferor does not maintain effective control through a removal-of-accounts provision that obligates the transferor to reacquire transferred financial assets from a securitization entity only after either:

1. A specified failure of the servicer to properly service the transferred financial assets that could result in the loss of a third-party guarantee
2. Third-party beneficial interest holders require a securitization entity to repurchase that beneficial interest.

5.4.3

Cleanup call option

Excerpt from Accounting Standards Codification

Glossary

860-10-20

Cleanup Call Option

An option held by the servicer or its affiliate, which may be the transferor, to purchase the remaining transferred financial assets, or the remaining beneficial interests not held by the transferor, its affiliates, or its agents in an entity (or in a series of beneficial interests in transferred financial assets within an entity) if the amount of outstanding financial assets or beneficial interests falls to a level at which the cost of servicing those assets or beneficial interests becomes burdensome in relation to the benefits of servicing.

As an exception to the effective control criteria, cleanup call options do not require re-recognition of the transferred financial assets until the option is exercised even though that right, once exercisable, provides the transferor with both the unilateral ability to cause the holder to return the remaining financial assets and a more-than-trivial benefit attributable to that ability.

Typically, the terms of the cleanup call are determined at the time of the financial asset transfer or servicing arrangement and, by definition, the call is not exercisable until the cost of servicing becomes burdensome. If the call is exercisable prior to the point when servicing becomes burdensome, it is not a cleanup call and sale accounting is generally precluded.

ASC 860 does not specify the level at which the cost of servicing would become burdensome. In practice, many arrangements identify the point of time when servicing becomes burdensome, and thus the cleanup call becomes contractually exercisable, as the point in time when a specified percentage of the financial assets being serviced remain outstanding. While this contractual percentage may vary, practice has accepted a level of 10% or less of the originally transferred financial assets. However, because there are no “safe-harbors,” an analysis of specific facts and circumstances is required to demonstrate the level at which the costs to the servicer become burdensome and the basis for that conclusion should be documented. The provisions of when a cleanup call is exercisable can consider either the transferred financial assets or related beneficial interests because the same servicing burden arises when the remaining financial assets or beneficial interests fall to a relatively small portion of the original balance.

5.4.3.1 Limits on ability to apply the cleanup call exception

It is important to note that ASC 860 allows the cleanup call exception only when the cleanup call is held by the servicer (which can be the transferor or an affiliate of the servicer). ASC 860-10-40-34 states that parties other than the servicer cannot hold the option, because only the servicer is burdened when the amount of outstanding financial assets falls to a level at which the cost of servicing the financial assets becomes burdensome – the defining condition of a cleanup call – and any other party would be motivated by some other incentive in exercising a call.³²

5.4.3.1.1 Cleanup call in which servicing is sub-contracted to another party

Excerpt from Accounting Standards Codification

Transfers and Servicing – Overall

Implementation Guidance and Illustrations

Call Options

860-10-55-42C

In a securitization transaction involving not-readily-obtainable financial assets, a transferor that is also the servicer may hold a cleanup call if it enters into a subservicing arrangement with a third party without precluding sale accounting. Under a subservicing arrangement, the transferor remains the servicer from the perspective of the securitization entity because the securitization entity does not have an agreement with the subservicer (that is, the transferor remains liable if the subservicer fails to perform under the subservicing arrangement). However, if the transferor sells the servicing rights to a third party (that is, the agreement for servicing is between the securitization entity and the third party after the sale of the servicing rights), then the transferor could not hold a cleanup call without precluding sale accounting.

³² See also ASC 860-10-55-42B.

5.4.4 Consideration of multiple arrangements and the involvement of affiliates and agents

ASC 860-10-40-5(c)'s effective control concept does not address all of the possible arrangements between two parties that may result in the transferor retaining effective control. Accordingly, when evaluating whether a transferor maintains effective control, it is important to consider all agreements and arrangements entered into concurrently with, or in contemplation of, the transfer.

In addition to ROAPs and call options, the transferor may hold other roles in a transaction that allow it to unilaterally take back specific financial assets at potentially advantageous terms. When assessing the ASC 860 control criteria, it is important to understand all of the roles the transferor has in the transaction, including those of its affiliates included in the consolidated financial statements and its agents. In certain transactions, the transferor could be the liquidity provider, remarketing agent, administrative agent or residual holder, among other roles. These roles individually or in combination could provide the transferor with rights that enable it to unilaterally gain control over the transferred financial assets.

Illustration 5-1: Transfer with liquidity provider

Assume the transferor transfers debt securities with an average maturity of five years to a securitization entity (trust). The trust issues 30-day commercial paper beneficial interests in the debt securities that continually roll over throughout the life of the trust. The transferor's wholly owned subsidiary is the designated liquidity provider. Contractually, the liquidity provider has the ability to periodically decide whether or not to renew the liquidity facility each time the 30-day beneficial interests mature. The transferor is obligated to purchase the beneficial interests issued by the trust if the liquidity provider is unable to provide liquidity to the beneficial interest holders or unwilling to renew its liquidity facility.

In this instance, the transferor has not met the criteria in ASC 860-10-40-5(c) and maintains effective control because the transferor could potentially direct its wholly owned subsidiary not to renew the liquidity facility, allowing the transferor to pay off the maturing beneficial interests and regain control of the underlying transferred financial assets.

All facts and circumstances must be considered in making this evaluation. For instance, if the beneficial interest holders in the example above had the substantive ability to replace the transferor's wholly owned subsidiary as liquidity provider and thus prevent the liquidation of the trust and the transferor from acquiring the underlying financial assets, then sale accounting may be appropriate.

ASC 860-10-55-42A provides an additional example of how a combination of rights held by one entity (or by multiple entities within a consolidated group) provides that entity (or consolidated group) with effective control over the transferred financial assets and therefore precludes sale accounting.

Excerpt from Accounting Standards Codification

Transfers and Servicing – Overall

Implementation Guidance and Illustrations

Call Options

860-10-55-42A

This guidance illustrates the concept in paragraph 860-10-40-35 that a transferor maintains effective control if it has a right to reclaim specific transferred assets by paying fair value and also holds the residual interest in the transferred financial assets. If a transferor holds the residual interest in securitized financial assets and can reclaim the transferred financial assets at termination of the securitization entity by purchasing them in an auction, and thus at what might appear to be fair value,

then sale accounting for the transfer of those financial assets it can reclaim would be precluded. Such circumstances provide the transferor with a more-than-trivial benefit and effective control over the financial assets, because it can pay any price it chooses in the auction and recover any excess paid over fair value through its residual interest in the transferred financial assets.^[33]

See Question 5-4 for additional interpretive guidance.

5.4.5 Differences in the assessment of the effect of call options to the “right to pledge or exchange” and “effective control” criteria for derecognition

The existence of an option may preclude sale accounting under the right to pledge or exchange criteria of ASC 860-10-40-5(b) or the effective control criteria of ASC 860-10-40-5(c), or possibly both. Consequently, each criterion should be evaluated because while the criteria are similar in some respects, each has a fundamentally different objective.

The discussion of the effect of options with regard to the ASC 860-10-40-5(c)(2) criterion relates to whether an option provides the transferor with the unilateral ability to cause the holder to return specific financial assets. However, the effect of options in the ASC 860-10-40-5(b) criterion relates to whether the option constrains the transferee from pledging or exchanging the transferred financial assets.

To illustrate the difference, consider a call option that:

- ▶ Is a freestanding option held by the transferor on non-readily obtainable assets
- ▶ Is contingent and exercisable only upon the transferee reaching an agreement to sell the transferred financial assets (i.e., a right of first refusal)
- ▶ Permits the transferor to reacquire the assets at the price paid plus a stated return
- ▶ Conveys more than a trivial benefit to the transferor

When evaluating the derecognition requirements of ASC 860-10-40-5(c)(2), the call option does not, at inception, preclude sale accounting because the transferor does not maintain the unilateral ability to cause return of the transferred financial assets. That is, the right of first refusal in and of itself does not provide the transferor a unilateral ability to reclaim the transferred assets.

However, when evaluating the derecognition requirements of ASC 860-10-40-5(b), sale accounting would be precluded because the transferee is effectively constrained from pledging or exchanging the transferred financial assets as they are not readily obtainable in the market. That is, the transferee, due to its inability to locate similar assets sufficient to satisfy the call option, would be constrained from pledging or exchanging the transferred financial assets to avoid the risk of default. See section 4, *Criteria for a sale – Right to pledge or exchange*, for a discussion of constraints on the transferee.

See Questions 5-5, 5-6 and 5-7 for additional interpretive guidance.

5.5 Transferee’s ability to require the transferor to repurchase the transferred financial assets

The third example provided in ASC 860-10-40-5(c) describes an agreement that permits the transferee to require the transferor to repurchase the transferred financial assets at a price that is so favorable to the transferee that it is probable that the transferee will require the transferor to repurchase the transferred financial assets. This type of condition also allows a transferor to maintain effective control over the transferred financial assets.

³³ EY note: See also section 5.4.1.1.

ASC 860-10-55-42D provides implementation guidance that addresses the application of the derecognition requirements described in ASC 860-10-40-5(c)(3).

Excerpt from Accounting Standards Codification

Transfers and Servicing – Overall

Implementation Guidance and Illustrations

Other Arrangements

860-10-55-42D

This implementation guidance addresses the application of paragraph 860-10-40-5(c)(3) through the following examples:

- a. A put option written to the transferee generally does not provide the transferor with effective control over the transferred financial asset under paragraph 860-10-40-5(c)(3).
- b. A put option that is sufficiently deep in the money when it is written would, under that paragraph, provide the transferor effective control over the transferred financial asset because it is probable that the transferee will exercise the option and the transferor will be required to repurchase the transferred financial asset.
- c. A sufficiently out-of-the-money put option held by the transferee would not provide the transferor with effective control over the transferred financial asset if it is probable when the option is written that the option will not be exercised.
- d. A put option held by the transferee at fair value would not provide the transferor with effective control over the transferred financial asset.

5.6

Questions and interpretive responses

Question 5-1

Unilateral ability to reclaim specific assets

Assume the transferor transfers debt securities that have an average maturity of five years to a trust. The trust issues 30-day commercial paper beneficial interests in the debt securities and the transferor retains the residual interest. The 30-day beneficial interests continually roll over throughout the life of the trust. The transferor is not precluded from bidding in the beneficial interests' remarketing process. If the transferor has the right to repurchase any transferred asset it chooses at a fixed price, but the right is limited to 20% of the transferred financial assets, does the transaction qualify for sale accounting?

No. Because the transferor still has the ability to repurchase any of the transferred financial assets up to a defined limit at a fixed price, sale accounting is precluded for all of the financial assets transferred until sufficient repurchases occur to reach the limit. In this circumstance, the fixed price arrangement provides the transferor with potentially advantageous pricing and, therefore, a more-than-trivial benefit associated with its right to unilaterally reclaim transferred financial assets. However, once the transferor has repurchased up to the 20% limit, the remaining financial assets transferred would be treated as a sale, assuming all other derecognition criteria are met. Additionally, if any single asset exceeds the limit such that it could not be repurchased, that asset would be considered sold for accounting purposes if the other derecognition criteria are met.

Question 5-2 Transferor retains a residual interest in the transferred financial assets

Assume the transferor transfers municipal bonds with an average life of 15 years to a trust. The trust issues two-year senior beneficial interests in the municipal bonds to investors with the transferor continuing to hold the residual interest. The trust terminates upon the maturity of the beneficial interests, and the transferor is not precluded from participating in an auction to purchase the underlying municipal bonds at the termination of the trust. Has the transferor met the criterion of ASC 860-10-40-5(c)(2) to have relinquished effective control?

No. The ability to unilaterally control the transferred assets is present if the transferor has the ability to participate in an auction and holds the residual interest. If the transferor holds the residual, it has the ability to control the bid process because any difference between its bid and market would be recovered through the residual interest it holds. See also ASC 860-10-55-42A. Accordingly, the requirements of ASC 860-10-40-5(c)(2) would not be met, and the transfer would be accounted for as a secured borrowing.

Question 5-3 Options on specified transferred financial assets

If the transferor has the unilateral right (call option) to repurchase a participating interest (as defined in ASC 860-10-40-6A) in an entire transferred financial asset at a fixed price, is sale accounting precluded for the other participating interests transferred?

No. If the transferor holds such a right, sale accounting is precluded only for the specific participating interests subject to that right. In this instance, assuming all other derecognition criteria specified in ASC 860-10-40-5 are met and all of the interests meet the definition of a participating interest, the transferor would recognize a sale for the transferred participating interests not subject to such a right and account for the transfer of the participating interest subject to the call option as a secured borrowing.

Question 5-4 Transferor's consideration of an agent's involvements with transferred financial assets

Does the mere presence of a common investment manager cause a transfer between affiliated investment companies to fail sale accounting?

No. The mere presence of a common investment manager does not cause the transferor to fail sale accounting, even though the investment manager could decide to resell the security to the original transferor.

For example, assume Investment Company X transfers a security to Investment Company Y in exchange for cash and an equity interest in Investment Company Y. Manager Z is the investment manager for both investment companies and as such, has full decision-making power over the assets under management. Investment Company X does not consolidate Investment Company Y and there is no written arrangement that explicitly entitles Investment Company X to reacquire the transferred assets (e.g., through a call option). Additionally, the purchase agreement contains no provision that prevents Investment Company Y from selling or pledging the security it received.

To assess whether the transferor maintains effective control over the transferred financial assets, ASC 860 clarifies that all continuing involvement by the transferor, its consolidated affiliates included in the financial statements being presented or its agents should be considered continuing involvement by the transferor. However, ASC 860-10-40-22A clarifies that when assessing effective control, the transferor should consider the involvement of an agent only when such agent is acting on its behalf. Accordingly, if the same investment manager acts as a fiduciary (agent) for both the transferor and transferee, only the involvement of the investment manager when acting on behalf of the transferor should be considered.

The investment manager has a fiduciary responsibility to perform the required duties in the best interests of the investors in the managed entities. In other words, when the investment manager executes a transfer of securities between funds under common management, the investment manager is a dual

agent, and its decisions are intended to be fair and equitable for both the transferor fund and the transferee fund. Therefore, absent an explicit arrangement that entitles the transferor fund to reacquire the transferred assets, the mere presence of a common investment manager with full investment discretion as described above does not cause the transferor to fail the requirements for sale accounting.

Question 5-5 Transferor's indirect ability to reclaim transferred financial assets

If a transferor has the ability to dissolve a securitization entity (e.g., through the beneficial interests that it holds) and reassume control of the transferred financial assets at any time, is the transferor precluded from accounting for the transfer as a sale?

Yes. ASC 860-10-55-67(b) states that the transferor's current ability to dissolve the securitization entity and reassume control of the transferred financial assets entitles it to unilaterally cause the return of the transferred financial assets, indicating that the transferor has maintained control over the transferred financial assets which precludes sale accounting under ASC 860-10-40-5(c).

Question 5-6 Transferor's ability to reclaim transferred financial assets only after the assets have paid down to a predefined level

In certain transactions, the transferor is entitled to repurchase a transferred amortizing, individual (specific) financial asset when its remaining principal balance reaches some specified amount, for example, 30 percent of the original balance. To exercise that call option, the transferor would pay the remaining principal balance. Under ASC 860, is such a transfer to be accounted for partially as a sale and partially as a secured borrowing?

A call that gives the transferor the ability to unilaterally cause whoever holds the transferred financial assets to return the remaining portion of an entire financial asset to the transferor and provides more than a trivial benefit to the transferor precludes sale accounting for the entire financial asset. ASC 860 requires that derecognition provisions be applied to a transfer of an entire financial asset, a group of entire financial assets or a participating interest in an entire financial asset. ASC 860-10-55-68A prohibits accounting for a transfer of an entire financial asset or a participating interest in an entire financial asset partially as a sale and partially as a secured borrowing.³⁴

ASC 860 provides the following additional implementation guidance:

Excerpt from Accounting Standards Codification

Transfers and Servicing – Overall

Implementation Guidance and Illustrations

Transferor Option to Repurchase Individual Financial Assets

860-10-55-70

If a transferor holds a call option to repurchase at any time a few specified, individual loans from an entire group of loans transferred in a securitization transaction, then sale accounting is precluded only for the specified loans subject to the call option, not the whole group of loans. In contrast, if the transferor holds a call option to repurchase from the group any loans it chooses, up to some specified limit, then sale accounting is precluded for the transfer of the entire group while that option remains outstanding. See paragraphs 860-10-55-39 through 55-42 for related guidance.

³⁴ The guidance in the response to Question 5-6 is based on question 50 of the FASB Staff's Special Report, *Questions and Answers Related to Implementation of FASB Statement No. 140*, as amended by Statement 166 and ASC 860-10-55-68 and 55-68A.

Question 5-7**Transfer of bad debt recovery rights**

A financial institution (transferor) transfers to a third-party transferee the right to an amount of future recoveries from loans previously written off by the transferor as uncollectible. The transferee is entitled to recoveries equal to the purchase price plus a market rate of interest on the unrecovered purchase price. There is no recourse to the transferor. The transferee can initiate its own collection efforts if dissatisfied with the transferor's recovery efforts. Is such a transfer eligible for sale accounting, or does it represent a secured borrowing?

ASC 860-10-55-73 states that the transaction is a secured borrowing (that is, a borrowing secured by the transferred rights). We believe this transaction does not meet the requirements for sale accounting because the transferred interest does not represent an entire financial asset or a participating interest in an entire financial asset (i.e., a unit of account eligible for derecognition as explained in ASC 860-10-40-4D).



6 Recognition and measurement

6.1 Introduction

This section primarily discusses the accounting for transfers that qualify as a sale, including the initial and subsequent measurement of assets obtained and liabilities incurred, and the calculation of any related gain or loss.

6.2 Transferee's accounting for transfers that qualify as sales (updated September 2025)

Excerpt from Accounting Standards Codification

Transfers and Servicing – Sales of Financial Assets

Recognition

860-20-25-3

The **transferee** shall recognize all assets obtained (including any **participating interest(s)** obtained) and any liabilities incurred.

Initial Measurement

860-20-30-2

The **transferee** shall initially measure, at fair value, any asset or liability recognized under paragraph 860-20-25-3, unless it is a purchased financial asset with credit deterioration or is a beneficial interest that meets the criteria in paragraph 325-40-30-1A, in which case the transferee shall apply the guidance in Topic 326 on measurement of credit losses to determine the initial amortized cost basis.

All assets obtained and liabilities incurred in a sale transaction are initially recognized by the transferee at fair value, unless the assets obtained meet the definition of “purchased financial assets with credit deterioration” (PCD) in ASC 326. If the transferee obtains beneficial interests in the scope of ASC 325-40, it would also need to apply the initial measurement guidance for purchased financial assets with credit deterioration if there is a significant difference between the contractual cash flows and expected cash flows from the beneficial interests at the date of recognition.

In these cases, the transferee applies the guidance in ASC 326 on purchased financial assets with credit deterioration to determine the initial amortized cost basis. Refer to our FRD, **Credit impairment under ASC 326**, for our interpretive guidance on determining whether financial assets, including beneficial interests, are subject to the guidance on purchased financial assets with credit deterioration.



FASB update

In June 2023, the FASB issued a proposed ASU that would expand the gross-up approach in ASC 326 to all financial assets acquired in a business combination and those acquired in an asset acquisition or recognized through the consolidation of a variable interest entity that is not a business, if they meet certain seasoning criteria, with limited exceptions. The approach is currently applied only to purchased financial assets with credit deterioration. The proposal would be applied on a modified retrospective basis. See our To the Point publication, [FASB proposes expanding the gross-up approach in ASC 326 to almost all acquired financial assets](#), for more information.

Refer to the [FASB website](#) for the tentative decisions reached by the Board during redeliberations on this project, which included removing non-PCD credit card receivables from the scope of the proposed amendments. The FASB directed the staff to draft a final ASU, which is expected to be issued in 2025.

6.3 Transferor's accounting for transfers that qualify as sales (updated May 2024)

The following paragraph from ASC 860 discusses the accounting for transfers of an entire financial asset or group of entire financial assets that qualify as sales:

Excerpt from Accounting Standards Codification

Transfers and Servicing – Sales of Financial Assets

Derecognition

Sale of an Entire Financial Asset or Group of Entire Financial Assets

860-20-40-1B

Upon completion^[35] of a transfer of an entire financial asset or a group of entire financial assets that satisfies the conditions in paragraph 860-10-40-5 to be accounted for as a sale, the transferor (seller) shall:

- Derecognize the **transferred financial assets**
- Apply the guidance in paragraphs 860-20-25-1^[36] and 860-20-30-1^[37] on recognition and measurement of assets obtained and liabilities incurred in the sale
- Recognize in earnings any gain or loss on the sale

If the transferred financial asset was accounted for under Topic 320 as available for sale before the transfer, item (a) requires that the amount in other comprehensive income be recognized in earnings at the date of transfer. If the transferred financial asset was included in a closed portfolio hedged in an existing portfolio layer method hedge in accordance with Topic 815 before the transfer, when applying the guidance in (a) through (c) an entity shall not include any portion of the hedge basis adjustment that is maintained on the closed portfolio basis in accordance with paragraphs 815-20-25-12A(b) and 815-25-35-1(c).

³⁵ EY note: ASC 860-20-25-2 explains that although a transfer of securities may not be considered to have reached completion until the settlement date, ASC 860 does not modify other US GAAP that requires accounting at the trade date for certain contracts to purchase or sell securities.

³⁶ EY note: ASC 860-20-25-1 explains that upon satisfying the conditions in ASC 860-10-40-5 for derecognition, the transferor (seller) shall recognize any assets obtained or liabilities incurred in the sale (e.g., cash, servicing contracts, beneficial interests).

³⁷ EY note: ASC 860-20-30-1 requires the transferor to initially measure any asset obtained (or liability incurred) at fair value.

ASC 860 is silent on the income statement “geography” of the gain or loss on a sale. Judgement is required. We generally believe that an entity should consider the nature of the asset transferred and its business operations in making the determination.

For example, when an entity sells a trade receivable arising from a contract with a customer accounted for under ASC 606, the entity may record the resulting gain or loss in operating profit or loss. However, if an entity sells a financial asset that is not part of its operating activities, the entity may need to consider whether presenting the resulting gain or loss outside of operating profit or loss is appropriate.

While the basic derecognition principles are similar, additional guidance for the derecognition of participating interests is provided because the carrying amount of the entire financial asset subject to participation must be allocated between the portion sold and the portion retained.

Excerpt from Accounting Standards Codification

Transfers and Servicing – Sales of Financial Assets

Derecognition

Sale of a Participating Interest

860-20-40-1A

Upon completion^[38] of a **transfer** of a **participating interest** that satisfies the conditions in paragraph 860-10-40-5 to be accounted for as a sale, the transferor (seller) shall:

- a. Allocate the previous carrying amount of the entire **financial asset** between both of the following on the basis of their relative fair values at the date of the transfer:
 1. The participating interest(s) sold
 2. The participating interest that continues to be held by the transferor.
- b. **Derecognize** the participating interest(s) sold
- c. Apply the guidance in paragraphs 860-20-25-1 and 860-20-30-1 on recognition and measurement of assets obtained and liabilities incurred in the sale
- d. Recognize in earnings any gain or loss on the sale
- e. Report any participating interest(s) that continue to be held by the transferor as the difference between the following amounts measured at the date of the transfer:
 1. The previous carrying amount of the entire financial asset
 2. The amount derecognized.

For the transfer of a participating interest in a financial asset included in a closed portfolio hedged in an existing portfolio layer method hedge in accordance with Topic 815 on derivatives and hedging, when applying the guidance in (a) through (e) an entity shall not include any portion of the hedge basis adjustment that is maintained on the closed portfolio basis in accordance with paragraphs 815-20-25-12A(b) and 815-25-35-1(c).

³⁸ EY note: ASC 860-20-25-2 explains that although a transfer of securities may not be considered to have reached completion until the settlement date, ASC 860 does not modify other US GAAP that requires accounting at the trade date for certain contracts to purchase or sell securities.

Upon completion of a transfer of an entire financial asset, group of entire financial assets or a participating interest³⁹ that qualifies as a sale,⁴⁰ the transferor performs each of the following steps:

| | Entire financial asset (or group of financial assets) | Participating interest in an entire financial asset |
|---|--|---|
| Step 1 – Derecognize the transferred financial asset(s) or participating interest(s) | Derecognize the entire carrying value of the financial asset(s) sold. The carrying value of a financial asset includes any related allowance for loan losses or credit losses, deferred costs and fees as determined under ASC 310-20, <i>Receivables – Nonrefundable Fees and Other Costs</i> , and unamortized premiums and discounts. ⁴¹ As a result, any amounts in other comprehensive income related to the transferred financial assets (e.g., available-for-sale debt securities) or any premiums (or discounts) that were not fully amortized (or accreted) will be recognized in earnings at the date of transfer. | Derecognize the carrying value (as defined for the entire financial asset) that relates to only the portion of the financial asset sold. The carrying value of the portion sold is based on the relative fair values of that portion and the entire financial asset on the transfer date. |
| Step 2 – Recognize proceeds received at fair value⁴² | Proceeds from sale collectively include any assets obtained and liabilities incurred. Examples include beneficial interests, servicing rights or guarantees. All proceeds should be initially measured at fair value on the transfer date. ⁴³ | |
| Step 3 – Recognize a gain or loss, as appropriate | Recognize a gain or loss based on the difference between (1) the net proceeds received in Step 2 and (2) the carrying value of the financial asset(s) sold in Step 1. A transferor cannot elect to defer any portion of a gain or loss resulting from the sale of financial assets or participating interests. See examples in sections 6.5.4.1 and 6.5.4.2. | |

When sales of financial assets are to one of the transferor's equity-method investees, the transferor may be required to eliminate some portion of the gain or loss on sale. Refer to section 6.2.1 of our FRD, ***Equity method investments and joint ventures***, for additional guidance on eliminating intra-entity profits on transactions between an investor and equity method investee.

³⁹ The criteria of a participating interest are outlined in ASC 860-10-40-6A and discussed further in section 2, *Unit of account*.

⁴⁰ The requirements for sale accounting are specified in ASC 860-10-40-5 and are discussed in section 3 through section 5.

⁴¹ There is diversity in practice with respect to the unit of account when a loan is made and a premium is paid for inseparable, concurrently entered into, third-party credit guarantees (e.g., guarantee premiums paid to the Small Business Administration (SBA) for loans that qualify under the SBA program). That is, some lenders account for the guarantee premium as a separate asset, while others include the premium for the guarantee in the carrying value of the loan. We believe either approach is acceptable as long as that accounting policy is applied consistently. If the reporting entity accounts for the third-party guarantee as a separate asset, all or a pro rata portion of the carrying value of that guarantee should be included in the transferor's calculation of gain or loss on sale when a transferor sells an entire financial asset, or a participating interest in an entire financial asset, that is guaranteed. Refer to Illustration 6-9 in section 6.5.4.2 for an example of the gain or loss calculation when the guarantee premium is included in the carrying value of the loan.

⁴² Participating interests retained by the transferor are not considered proceeds and thus is not re-measured at fair value. Instead, the carrying amount of the participating interest retained by the transferor is the difference between the previous carrying amount of the entire financial asset and the amount derecognized in Step 1.

⁴³ Refer to section 6.5.1 for further guidance on initial measurement.

6.3.1 Transaction costs

Excerpt from Accounting Standards Codification

Transfers and Servicing – Sales of Financial Assets

Subsequent Measurement

Transaction Costs

860-20-35-10

Transaction costs relating to a sale of the receivables may be recognized over the initial and reinvestment periods in a rational and systematic manner unless the transaction results in a loss. Transaction costs for a past sale are not an asset and thus are part of the gain or loss on sale. In a credit card **securitization**, however, some of the transaction costs incurred at the outset relate to the future sales that are to occur during the revolving period, and thus can qualify as an asset.

In many transfers of financial assets an entity incurs transaction costs, which must be considered in the gain or loss calculation when the transfer results in sale accounting, unless some of the costs incurred relate to future sales. To the extent the upfront transaction costs relate to future sales to occur during the revolving period of a securitization transaction (e.g., credit card securitizations), the cost should be deferred and expensed upon the earlier of (a) the completion of future related transactions or (b) the date the entity determines no future benefits can be derived from the deferred costs.⁴⁴ These costs may be significant when the transactions are complex and involve the assistance of external advisors, as is typical in securitization transactions. Such costs typically include:

- ▶ Lawyers' fees for drafting the prospectus and prospectus supplement
- ▶ Accountants' fees for attestation work on collateral
- ▶ Consultants' fees for loan file reviews
- ▶ Rating agencies' fees to rate the securities being offered
- ▶ Costs to print the prospectus, prospectus supplement and other documents
- ▶ Fees paid to the SEC to register the transaction
- ▶ Other administrative costs limited to direct incremental expenses

In transfers of financial assets that do not meet the conditions for sale accounting in ASC 860-10-40-5, the transactions are accounted for as secured borrowings (see section 6.4 for further information). ASC 835-30-45-1A states that "debt issuance costs related to a note shall be reported in the balance sheet as a direct deduction from the face amount of the note." Therefore, debt issuance costs, such as the costs described above, should be deferred and amortized using the interest method over the life of the debt to which they relate (i.e., the term of the secured borrowing).

⁴⁴ Because transfers involving non-interest-bearing financial assets (e.g., factoring arrangements involving sales of future trade receivables) will generally be sold at an accounting loss, transaction costs should be charged to expense as incurred.

6.4 Accounting for transfers that fail the conditions for sale accounting

Excerpt from Accounting Standards Codification

Transfers and Servicing – Secured Borrowing and Collateral

Recognition

General

860-30-25-2

The **transferor** and **transferee** shall account for a transfer as a secured borrowing with pledge of collateral in either of the following circumstances:

- a. If a transfer of an entire financial asset, a group of entire financial assets, or a **participating interest** in an entire financial asset does not meet the conditions for a sale in paragraph 860-10-40-5
- b. If a transfer of a portion of an entire financial asset does not meet the definition of a participating interest.

The transferor shall continue to report the transferred financial asset in its statement of financial position with no change in the asset's measurement (that is, basis of accounting).

Refer to section 8, *Secured borrowings and collateral*, for further guidance on accounting for failed sale transactions.

6.5 Proceeds from sales of financial assets (updated May 2024)

Excerpt from Accounting Standards Codification

Transfers and Servicing – Sales of Financial Assets

Recognition

General

860-20-25-1

Section 860-20-40 provides derecognition guidance a **transferor (seller)** applies upon completion of a **transfer of financial assets** that satisfies paragraph 860-10-40-5's conditions to be accounted for as a sale. Upon completion of such a transfer, the transferor (seller) shall also recognize any assets obtained or liabilities incurred in the sale, including, but not limited to, any of the following:

- a. Cash
- b. Servicing assets
- c. Servicing liabilities
- d. In a sale of an entire financial asset or a group of entire financial assets, any of the following:
 1. The transferor's beneficial interest in the **transferred financial assets**
 2. Put or call options held or written (for example, guarantee or recourse obligations)
 3. Forward commitments (for example, commitments to deliver additional receivables during the revolving periods of some **securitizations**)
 4. Swaps (for example, provisions that convert interest rates from fixed to variable).

See Examples 1, 2, and 5 (paragraphs 860-20-55-43 through 55-59) for illustration of this guidance.

An important step in accounting for transfers of financial assets (or participating interests in entire financial assets) that qualify as sales is identifying the resulting assets obtained and liabilities incurred (if any). These assets and liabilities are collectively referred to as proceeds, which the ASC Master Glossary defines as cash, beneficial interests, servicing assets, derivative instruments, or assets that are obtained in a transfer of financial assets, less any liabilities incurred. Proceeds include any separately recognized servicing liabilities and recourse obligations.

In some transactions, various elements of proceeds are bundled into a single retained interest. For example, an entity may sell a group of entire financial assets and obtain as part of the proceeds a single interest that includes characteristics of both an interest-only strip and a recourse agreement. In this case, we believe the transferor has a single beneficial interest whose value should be determined by considering all of its various elements. Refer to section 6.5.3.1 for further discussion on accounting for beneficial interests.

If the proceeds from a transfer of a participating interest in an entire financial asset includes a beneficial interest in the transferred financial asset, the participating interest rules are no longer met.

A participating interest requires that all the cash flows received from the entire financial asset be proportionately divided among the participating interest holders. ASC 860-20-25-1(d) indicates that a transferor's beneficial interest in transferred financial assets can only be recognized in a sale of an entire financial asset or a group of entire financial assets. Restricting the recognition of a beneficial interest in transferred financial assets only to transfers of an entire financial asset or a group of entire financial assets prevents such transfers from failing the requirement that a participating interest represent a proportionate ownership interest in the underlying financial asset.

For statement of cash flow presentation considerations that arise in transactions involving the sale or securitization of loans or trade receivables (e.g., factoring of trade receivables), refer to sections 5.2.1, *Loans and trade receivables*, and 5.2.2, *Securitized loans or trade receivables*, of our FRD, **Statement of cash flows**, for further discussions.

6.5.1 Initial measurement

Excerpt from Accounting Standards Codification

Transfers and Servicing – Sales of Financial Assets

Initial Measurement

General

860-20-30-1

The **transferor** shall initially measure at fair value any asset obtained (or liability incurred) and recognized under paragraph 860-20-25-1.

ASC 860-20-30-1 requires that all proceeds be initially measured at fair value in accordance with the principles of ASC 820, *Fair Value Measurement*. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date and, therefore, represents a market-based exit price. As such, the objective of the fair value measurement is to determine the price at which willing market participants would transact for the proceeds at the measurement date (considering the market conditions that exist at that date), irrespective of the transferor's actual intention or ability to dispose of the proceeds.

Many forms of proceeds associated with transfers of financial assets accounted for as sales will not be traded in active markets. Examples include certain beneficial interests representing subordinated or residual interests in non-readily obtainable assets and performance guarantees. ASC 820 provides a list of factors that may indicate when a market is not active and includes additional guidance for measuring fair value in these situations. The guidance indicates that all valuation techniques that are appropriate

and for which sufficient data is available should be used to measure fair value. Additionally, those techniques should maximize the use of observable inputs and minimize the use of unobservable inputs. For example, a market approach such as matrix pricing may be useful in measuring the fair value of certain proceeds (e.g., beneficial interests representing senior shares of interest in readily obtainable assets) when transaction data for comparable proceeds is available.

In many instances, the use of valuation techniques under an income approach, such as discounted cash flow models, option pricing models, or option-adjusted spread models, will be needed to measure the fair value of certain proceeds in markets that are not active. These valuation techniques should incorporate all of the factors and assumptions that market participants would consider in determining a current (i.e., as of the measurement date) exit price for the proceeds, including assumptions about risk and uncertainty. Depending on the complexity of the proceeds being measured, a valuation specialist may be needed. Refer to our FRD, *[Fair value measurement](#)*, for further guidance.

6.5.2 Subsequent measurement

ASC 860 provides limited guidance on the appropriate subsequent measurement of proceeds resulting from sales of financial assets. Accordingly, with the exception of certain financial assets subject to prepayment and servicing assets and servicing liabilities, the subsequent measurement of proceeds will be based on other applicable accounting guidance.

Financial assets subject to prepayment that are in the scope of ASC 860 are further discussed in section 6.5.3.1.2.3. Additionally, servicing assets and servicing liabilities are discussed in section 6.5.3.2, with further detail on subsequent measurement provided in section 7. Refer to section 6.5.3 for a brief description of common examples of proceeds resulting from transfers of financial assets that qualify as sales.

6.5.3 Examples of proceeds and subsequent measurement considerations

The following is a list of common types of proceeds resulting from transfers of financial assets that qualify as sales and a brief description of the subsequent accounting treatment.

6.5.3.1 Beneficial interests

Beneficial interests represent rights to receive specified cash inflows received by a trust or other entity. Transferors may receive beneficial interests as part of the proceeds from a sale of a financial asset or group of financial assets. Beneficial interests can be legally represented in various forms, including equity interests, debt instruments or as a provision within a financial asset transfer agreement (e.g., a deferred purchase price).

The ASC Master Glossary defines beneficial interests as 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:

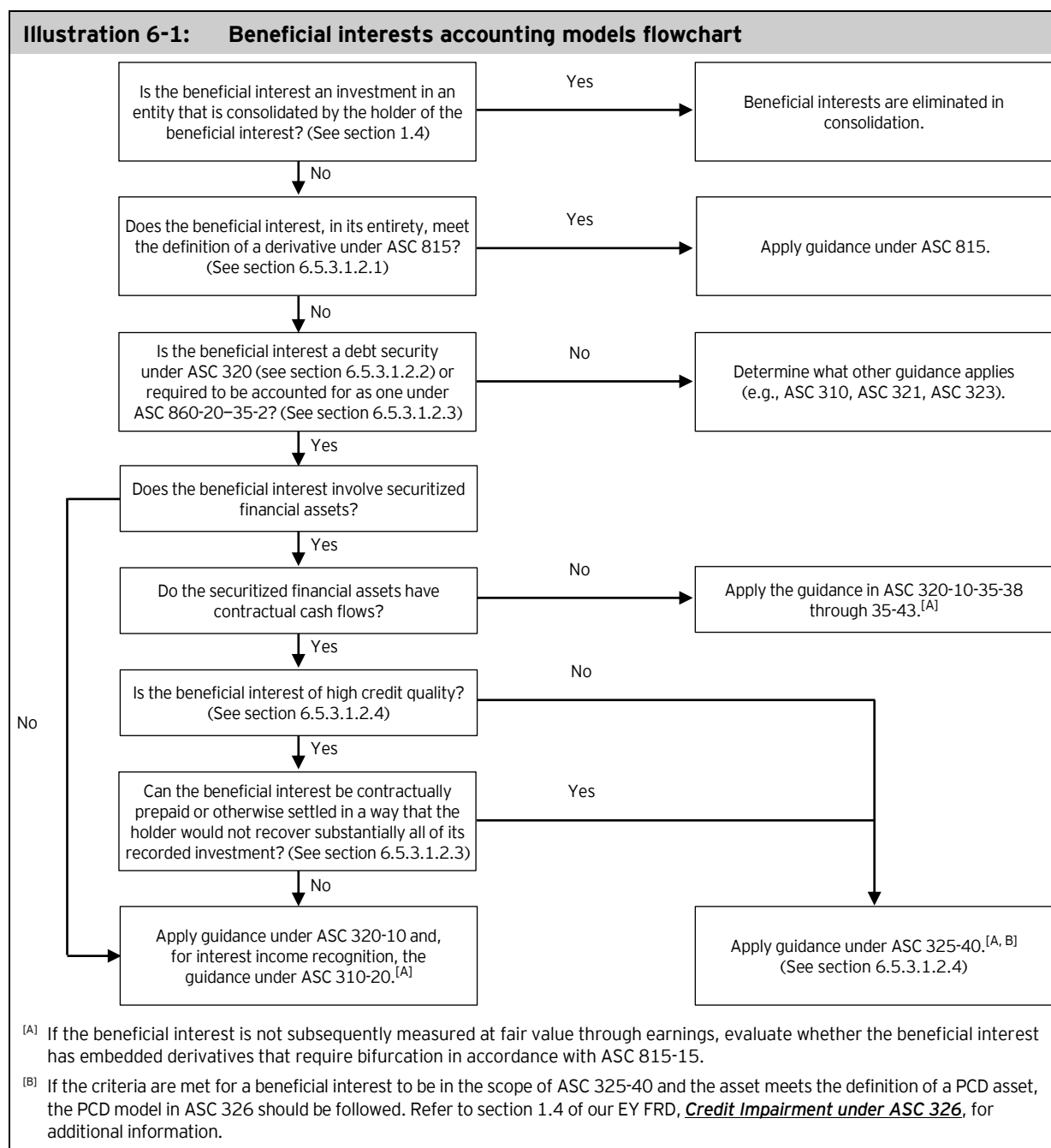
- a. Senior and subordinated shares of interest, principal, or other cash inflows to be passed-through or paid-through
- b. Premiums due to guarantors
- c. Commercial paper obligations
- d. Residual interests, whether in the form of debt or equity

Examples of beneficial interests include notes or investor certificates (commonly referred to as asset-backed securities), which represent claims to principal and interest collections on an underlying pool of assets. Another type of beneficial interest is an interest-only strip receivable, which is a contractual right to receive some or all of the interest due on a bond, mortgage loan, collateralized mortgage obligation or other interest-bearing financial asset. Generally, the interest-only strip is held by the transferor and arises because the transaction is designed to generate cash flows in excess of those cash flows actually

required to meet the minimum obligations of the senior asset-backed securities. Consequently, the interest-only strip represents a return of this excess cash flow. It is important to note that beneficial interests frequently arise from securitization transactions but may also be received when there is no securitization (e.g., deferred purchase price when factoring trade receivables).

Refer to section 10, *Securitizations*, for additional information regarding securitizations and the types of beneficial interests that commonly result from such transactions.

Beneficial interests received by a transferor as proceeds from a sale transaction may be accounted for under several accounting models (e.g., ASC 815, ASC 310, ASC 321, ASC 320). The following flowchart provides a framework for determining the appropriate accounting model for beneficial interests, including whether ASC 325-40 applies:



Beneficial interests may result in the transferor consolidating the entity issuing the interests in accordance with ASC 810. As discussed in section 1.4, this is particularly relevant for transfers related to securitization transactions. Refer to section 10 for a detailed discussion on determining the accounting for securitization transactions.

6.5.3.1.1

Initial measurement

Beneficial interests received by a transferor as proceeds from a sale transaction should initially be measured at fair value in accordance with ASC 860-20-30-1. Determining the fair value of beneficial interests obtained as proceeds in transfers of financial assets accounted for as sales will most likely be based on a discounted cash flow analysis. The timing and amount of future cash flows for beneficial interests in securitizations are often uncertain, especially if those interests are subordinate to more senior beneficial interests and involve assets that are subject to prepayment or credit losses. Applying the discounted cash flow approach depends heavily on the performance assumptions of the underlying assets securitized.

Estimates should consider current expectations based on market conditions. The prepayment, credit loss, discount and other rates used to arrive at an estimate of fair value should represent the rate that a market participant would use to determine the value of the beneficial interest in an orderly transaction. If possible, an entity should use a probability-weighted discounted cash flow approach. Under that approach, the entity would assign a probability of occurrence to each identified possible assumption (e.g., select several different possible prepayment speeds and assign a probability to each prepayment speed). It would then derive the fair value using the resulting probability-weighted cash flows. The use of probability-weighted cash flows is illustrated in ASC 820-10-55-13 through 55-20. Refer to section 21 of our FRD, ***Fair value measurement***, for further discussion on expected present-value techniques that use probability-weighted cash flows.

The estimated cash flows should be modeled in conformity with the design of the specific securitization structure such that they consider both the amount and timing of cash payments to the beneficial interest holder. An example of a feature of securitizations that would require tailoring of the valuation model is a cash retention trigger upon reaching certain levels of delinquency or default in the underlying portfolio. Such a trigger typically provides for the retention of additional cash within the securitization vehicle for a longer period of time, thereby slowing the payment of cash to the holders of subordinated beneficial interests.

Prepayment and net loss assumptions should consider all available information and should be tailored for the characteristics of the underlying portfolio and current market conditions. The mix of contract interest rates, loan-to-value ratios, the mix of fixed versus floating interest rate instruments and credit scores all affect fair value. Prepayment assumptions should be based on forward yield curves rather than spot rates and loss assumptions should consider, among other things, the servicing and underwriting history of the issuer.

Valuation assumptions should be “forward-looking” and generally should not be based solely on historical performance. Forward-looking assumptions should reflect any known trends or economic conditions that may differ from historical trends.

Illustration 6-2: Prepayment rates

If prepayment rates typically vary during certain months of the year, this variance should be considered in determining the appropriate prepayment assumption to use in valuation models. For example, credit card balances typically increase during the fourth quarter of the calendar year due to holiday spending and then decrease during the first quarter as customers pay down their balances. As a result, it is generally not appropriate to use an average of the fourth-quarter prepayment rates as the prepayment assumption in a 31 December valuation of credit card interests obtained by the transferor in a sale. That prepayment rate would not reflect the prepayment rate expected in the first quarter of the following year.

Additional factors that should be considered when deriving net credit loss assumptions for measuring fair value include trends in the amount and timing of recoveries and collectability of interest on defaulted receivables.

The valuation considerations discussed above are not meant to be all inclusive but are provided to highlight some of the common issues encountered when performing the valuation of beneficial interests created through the securitization process.

6.5.3.1.2 *Subsequent measurement*

6.5.3.1.2.1 *Beneficial interests that are derivatives under ASC 815*

If consolidation of the issuer of the beneficial interests is not required, the beneficial interests should be evaluated to determine whether they meet the definition of a derivative in ASC 815 and if so, whether they meet a scope exception from derivative accounting. Under ASC 815 a derivative instrument (1) must have a notional amount or payment provision, (2) must have an underlying, (3) requires little or no initial net investment and (4) may be net settled. ASC 815 provides an exception from derivative accounting for certain interest-only strips (IOs) and principal-only strips (POs) that represent only the simplest separations of interest payments and principal payments.

ASC 815-10-15-72 and 15-73 clarify that to be exempt from derivative accounting, the IO or PO (1) must represent the right to receive only a specified proportion of the contractual interest cash flows of a specific debt instrument (IO) or a specified proportion of the contractual principal repayment cash flows (PO) of that debt instrument and (2) does not incorporate any terms not present in the original debt instrument. An allocation of a portion of the interest and principal cash flows of a debt instrument to compensate another entity for servicing the instrument would meet this scope exception if the servicing fee was not greater than adequate compensation as defined by ASC 860.⁴⁵ However, an allocation of a portion of the interest or principal cash flows to provide for servicing in an amount greater than adequate compensation or for any other purpose would not meet the scope exception.

If a beneficial interest is required to be accounted for as a derivative it should be subsequently measured at fair value through earnings. This accounting would also apply if the beneficial interest is not accounted for as a derivative but the holder of the interest elects the fair value option (i.e., ASC 825-10-15-4).

Beneficial interests that are not considered freestanding derivatives, or not otherwise subsequently measured at fair value through earnings, should be analyzed for embedded features that must be separated from a host contract and accounted for as a derivative instrument.

Refer to sections 2 and 3 of our FRD, *Derivatives and hedging*, for further guidance on evaluating whether beneficial interests meet the definition of a derivative in their entirety or contain embedded derivatives that should be accounted for separately.

6.5.3.1.2.2 *Beneficial interests that are debt securities under ASC 320*

If a beneficial interest does not meet the definition of a derivative, it is typically accounted for under ASC 320, Investments – Debt Securities. Entities will need to evaluate the scope of ASC 320 and determine whether the beneficial interests held meet the definition of a “debt security,” including the definition of a “security,” in accordance with ASC 320.

If an entity determines that the beneficial interests it holds are in the scope of ASC 320, or are required to be accounted for like debt securities under ASC 860-20-35-2 (see section 6.5.3.1.2.3 below), it must evaluate whether the beneficial interests are also in the scope of ASC 325-40, Investments – Other – Beneficial Interests in Securitized Financial Assets. Refer to section 6.5.3.1.2.4 for additional discussion

⁴⁵ Refer to section 7.3 for additional guidance on determining adequate compensation.

on applying ASC 325-40. Refer to our FRD, *Certain investments in debt and equity securities*, for our interpretive guidance on applying ASC 320. Beneficial interests that are not in the scope of ASC 320 or are not required to be accounted for like debt securities under ASC 860-20-35-2 (as discussed in section 6.5.3.1.2.3 below), should be evaluated under other US GAAP (e.g., ASC 310, ASC 321, ASC 323) to determine the appropriate subsequent accounting.

6.5.3.1.2.3

Beneficial interests that are financial assets subject to prepayment

Even if a beneficial interest is not in the scope of ASC 320, ASC 860 requires financial assets that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment to be subsequently measured like investments in debt securities classified as available for sale or trading under ASC 320 (e.g., certain interest-only strips that are not securities).

Excerpt from Accounting Standards Codification

Transfers and Servicing – Sales of Financial Assets

Subsequent Measurement

Financial Assets Subject to Prepayment

860-20-35-2

Financial assets, except for instruments that are within the scope of Subtopic 815-10, that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment shall be subsequently measured like investments in debt securities classified as available for sale or trading under Topic 320. Examples of such financial assets include, but are not limited to, **interest-only strips**, other beneficial interests, loans, or other receivables. Interest-only strips and similar interests that meet the definition of **securities** are included in the scope of that Topic. Therefore, all relevant provisions of that Topic (including the disclosure requirements) shall be applied. See related implementation guidance beginning in paragraph 860-20-55-33.

Certain prepayment features embedded in financial assets such as interest-only strips may expose their holders to the possibility of not recovering substantially all of their recorded investments. While the term “substantially all” is not defined in ASC 860, it has been referenced elsewhere in US GAAP (e.g., ASC 842, ASC 815). As a result of its use in other US GAAP, “substantially all” is generally interpreted in practice to mean 90% of the recorded investment.

Further, while it is important to determine whether “substantially all” of the initial recorded investment will be recovered, ASC 860-20-35-5 clarifies that the probability of prepayment or other forms of settlement that result in the holder not recovering substantially all of its recorded investment is not relevant. That means that there only needs to be one possible scenario in which the financial asset can be contractually prepaid or otherwise settled in such a way that substantially all of the initial recorded investment will not be recovered.

ASC 860-20-35-4 clarifies that the evaluation in ASC 860-20-35-2 of whether the financial asset can be prepaid or otherwise settled such that the holder does not recover substantially all of its recorded investment should only consider its contractual provisions. That is, scenarios that are not the result of contractual provisions (e.g., borrower default) should not be considered when determining whether an asset can be contractually settled in such a way that the holder does not recover substantially all of its recorded investment.

Illustration 6-3: Functional currency investment

Consider an investment denominated in euros that is held by an entity with a US dollar functional currency. This investment would not be subject to the requirements of ASC 860-20-35-2 unless the asset can be contractually settled in such a way that substantially all of the invested euros would not be repaid. That is, the currency denomination of the investment itself does not result in a financial asset being accounted for under ASC 860-20-35-2.

Illustration 6-4: Credit-indexed note receivable

Consider a note receivable for which the repayment amount is indexed to the creditworthiness of a party other than the issuer. This note receivable is subject to the provisions of ASC 860-20-35-2 because the event that might cause the holder to receive less than substantially all of its recorded investment is based on a contractual provision, rather than a default by the borrower (i.e., the issuer of the note). That contractual provision indexes the payment terms of the note to a default by a third party unrelated to the issuer of the note. Unless that note is within the scope of ASC 815-10, the guidance of ASC 860-20-35-2 would apply.

Excerpt from Accounting Standards Codification**Transfers and Servicing – Sales of Financial Assets*****Subsequent Measurement******Financial Assets Subject to Prepayment*****860-20-35-3**

Interest-only strips and similar interests that are not in the form of securities are not within the scope of Topic 320 but shall be measured like investments in debt securities classified as available for sale or trading. In that circumstance, all of the measurement provisions of that Topic, as well as the provisions of Topic 326 on measurement of credit losses, shall be followed. However, other provisions of Topics 320 and 326, such as those addressing disclosures, are not required to be applied. Paragraph 320-10-15-9 explains that, for debt securities within its scope, Subtopic 325-40 provides incremental guidance on accounting for and reporting discount and credit losses.

Financial assets in the scope of ASC 860-20-35-2 are subsequently remeasured at fair value with changes recognized either in the statement of operations (if classified as trading) or other comprehensive income (if classified as available for sale). ASC 860-20-35-5 prohibits these assets from being classified as held to maturity (i.e., measured at amortized cost). Refer to Question 6-10 for further discussion on measuring these beneficial interests.

If an entity determines that the beneficial interests it holds are required to be accounted for like debt securities under ASC 860-20-35-2, or are otherwise in the scope of ASC 320 (see section 6.5.3.1.2.2 above), it must evaluate whether the beneficial interests are also in the scope of ASC 325-40. Refer to section 6.5.3.1.2.4 for additional discussion on applying ASC 325-40. Refer to our FRD, ***Certain investments in debt and equity securities***, for our interpretive guidance on applying ASC 320. Beneficial interests that are not in the scope of ASC 320 or are not required to be accounted for like debt securities under ASC 860-20-35-2 should be evaluated under other US GAAP (e.g., ASC 310, ASC 321, ASC 323) to determine the appropriate subsequent accounting.

6.5.3.1.2.4

Subsequent measurement under ASC 325-40 for certain beneficial interests (updated September 2025)

Beneficial interests that are in the scope of ASC 320 (see section 6.5.3.1.2.2) or are required to be accounted for like debt securities under ASC 860-20-35-2 (see section 6.5.3.1.2.3) must be evaluated to determine whether they are also in the scope of ASC 325-40. ASC 325-40 provides income recognition and impairment guidance for certain beneficial interests that are supported by securitized financial assets with contractual cash flows. However, ASC 325-40 does not apply to these beneficial interests if they both (1) are of high credit quality and (2) cannot be contractually prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment. The following table provides examples of how the guidance may be applied to certain securities based on the scoping criteria noted above.

| Security type | AAA-rated senior security | Agency ⁴⁶ interest-only strip | BBB-rated subordinated interest | Residual interest |
|--|---------------------------|--|---------------------------------|-------------------|
| High credit quality | Yes | Yes | No | No |
| Cannot be contractually prepaid or otherwise settled in a way that the holder would not recover substantially all of its recorded investment | Yes | No | No | No |
| In the scope of ASC 325-40 | No | Yes | Yes | Yes |

ASC 325-40 states that beneficial interests guaranteed by the US government, its agencies or other creditworthy guarantors and loans or securities that are sufficiently collateralized to make sure that the possibility of credit loss is remote are considered to be of high credit quality.

Although ASC 325-40 does not specify a minimum credit rating, the SEC staff believes that only beneficial interests rated AA or higher should be considered of “high credit quality.”⁴⁷

A beneficial interest may have a so-called split rating in which one credit rating agency has rated the instrument as AA or higher, but another credit rating agency has rated it below AA. In these situations, we understand the SEC staff would not consider the beneficial instrument to be of high credit quality for purposes of applying ASC 325-40 (i.e., the instrument would be in the scope of ASC 325-40).

How we see it

ASC 325-40 does not address whether an entity should reevaluate the scope criteria, including the evaluation of whether a beneficial interest is of high credit quality, after the acquisition date of the beneficial interest. Some entities evaluate the scope criteria in ASC 325-40 at acquisition, while others perform a continual reassessment that considers the cumulative increase in the allowance for credit losses on the asset. An entity should apply its elected accounting policy consistently.

⁴⁶ Refers to US government agencies and government-sponsored enterprises, including Government National Mortgage Association (Ginnie Mae), Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac).

⁴⁷ Remarks by John M. James, SEC staff, before the 31st AICPA National Conference on Current SEC Developments, 11 December 2003.

Applying the ASC 325-40 model

ASC 325-40 requires an entity to recognize accretable yield as interest income over the life of the beneficial interests held.

At the acquisition or transaction date, for beneficial interests that do not apply the accounting for purchased financial assets with credit deterioration, the accretable yield should be measured as the excess of cash flows expected to be collected over the initial investment. For beneficial interests that apply the accounting for purchased financial assets with credit deterioration, the entity shall measure accretable yield initially as the excess of all contractual cash flows attributable to the beneficial interest at the transaction date over the amortized cost basis (the purchase price plus the initial allowance for credit losses).⁴⁸ Estimated expected cash flows should consider both the amount and timing of estimated future cash flows, which were used in determining the purchase price or the holder's fair value determination for purposes of determining a gain or loss under ASC 860. The accretable yield should not be presented on the balance sheet.

In accordance with ASC 325-40-35-1, an entity must prospectively adjust the yield used to recognize interest income for changes in estimated future cash flows since the last evaluation date (typically at each financial reporting date). As such, excess future cash flows are recognized using the effective yield method.

For income recognition purposes, beneficial interests in the scope of ASC 325-40 classified as trading are included in the scope of ASC 325-40-15-7 because certain industries (such as banks and investment companies) report interest income as a separate line item in their income statements, even though the investments are accounted for at fair value.

Changes in expected cash flows can arise due to prepayments, credit concerns, changes in interest rates or other reasons. After the transaction date, cash flows expected to be collected are defined as the holder's estimate of the amount and timing of estimated principal and interest cash flows based on the holder's best estimate of current conditions and reasonable and supportable forecasts.

If upon evaluation, there is a favorable (or an adverse) change in cash flows expected to be collected from the cash flows previously projected, the holder of the beneficial interest shall first apply the credit impairment guidance in ASC 326 to account for that change (whether favorable or adverse). If after application of the credit impairment guidance in ASC 326, the amount of the change in cash flows expected to be collected (whether favorable or adverse) is not reflected in the allowance for credit losses, ASC 325-40 requires a holder of a beneficial interest to recalculate the amount of accretable yield on the date of evaluation. The amount of the accretable yield is the excess of cash flows expected to be collected over the beneficial interest's reference amount.⁴⁹

⁴⁸ The FASB is expected to issue a final ASU that would expand the gross-up approach in ASC 326 to all loan receivables, excluding credit cards, acquired in a business combination and in an asset acquisition or recognized through the consolidation of a variable interest entity that is not a business, if they meet certain seasoning criteria. Refer to the [FASB website](#) for the tentative decisions reached by the Board during redeliberations on this project.

⁴⁹ In January 2025, the FASB issued a proposed ASU as part of its Codification Improvements project. Issue 6 in the Exposure Draft, "Clarify calculation of the reference amount for beneficial interests," would amend ASC 325-40 to clarify the description of the calculation of the reference amount for beneficial interests in ASC 325-40-35-4B to state that the reference amount is reduced by the amount of the allowance for credit losses. The reference amount affects the calculation of the accretable yield and, therefore, the recognition of interest income over the life of the beneficial interest. The FASB has been redeliberating based on comments received and is expected to issue a final ASU in the fourth quarter of 2025. Readers should monitor developments.

6.5.3.1.3 **Cash flow presentation considerations for beneficial interests from sales of loans or trade receivables**

Transferors may securitize or factor loans or trade receivables by transferring them to a trust, commercial paper conduit, bank or other entity. The transferor in these transactions typically receives partial cash consideration and a note receivable (i.e., a beneficial interest) for the remainder of the purchase price. Payment on the beneficial interest is generally linked to the performance of the loans or receivables transferred. This beneficial interest is commonly referred to as a holdback, deferred purchase price (DPP) or deferred purchase payment. The beneficial interest typically is neither considered a security nor a certificated interest under the Uniform Commercial Code (i.e., a separate financial instrument contract is not received related to the DPP). Instead, payments are made on the beneficial interest as amounts are collected by the transferee from the transferred loans or receivables, but only to the extent that the cash collected by the transferee exceeds the original cash paid by the transferee for those loans or receivables, less the transferee's carrying and servicing costs.

ASC 230, *Statement of Cash Flows*, requires transferors to disclose the receipt of beneficial interests, such as a DPP, in transferred loans or trade receivables as a noncash investing activity. Similarly, the guidance also requires cash receipts that are related to beneficial interests in previously transferred loans or trade receivables to be classified as cash inflows from investing activities. Refer to section 5.2.2, *Securitized loans or trade receivables*, of our FRD, ***Statement of cash flows***, for additional discussion regarding the cash flow presentation considerations related to beneficial interests.

6.5.3.2 **Servicing assets and servicing liabilities**

A servicing asset or servicing liability represents the servicing fees in excess (i.e., asset) or below (i.e., liability) adequate compensation. Adequate compensation represents the amount of benefits of servicing that would fairly compensate a substitute servicer should one be required, including the profit that would be demanded in the marketplace. Any servicing asset or servicing liability recognized as part of the sale must initially be measured at fair value.

Subsequent measurement

For subsequent measurement purposes, each identified class of servicing assets and liabilities is measured using either the amortization method or fair value measurement method. ASC 860-50-35 and section 7, *Servicing of financial assets*, discuss the initial and subsequent measurement of servicing assets and servicing liabilities in further detail.

6.5.3.3 **Derivatives**

Securitizations often involve derivatives when the interest rate on the transferred financial assets is different than that of the asset-backed securities issued in the transaction (e.g., if the transferred assets pay a fixed interest rate and the asset-backed securities pay a floating rate). Often, the rating agencies will require that any interest rate mismatch be mitigated through an interest rate swap or other derivative instrument to obtain a favorable rating. Derivatives in a securitization transaction may be discrete (i.e., purchased separately) or embedded within the residual interest (e.g., subordinated interest or interest-only strip).

Examples of derivative financial instruments (either held or written) entered into concurrently with a transfer of financial assets include:

| Example | Description |
|---------------------------|---|
| Swaps | Arrangements in which two parties agree to exchange periodic payments for the mutual benefit of the exchangers (e.g., interest rate swaps – provisions that convert interest rates from fixed to variable; currency swaps – the exchange of principal and interest in one currency for principal and interest in another currency). |
| Put options | Contracts that allow the holder to sell a specified quantity of an underlying instrument (e.g., stock) to the writer of the contract at a fixed price during a given period. Put options may be in the form of guarantee or recourse obligations that are further discussed in sections 6.5.3.4 and 6.5.3.5, respectively. |
| Call options | Contracts that allow the holder to buy a specified quantity of an underlying instrument (e.g., stock) from the writer of the contract at a fixed price for a given period (e.g., provisions that allow the transferor to repurchase the transferred financial assets). |
| Credit derivatives | Derivative instruments that have both of the following characteristics: ⁵⁰ <ol style="list-style-type: none"> One or more of its underlyings are related to any of the following: <ol style="list-style-type: none"> The credit risk of a specified entity (or a group of entities) An index based on the credit risk of a group of entities It exposes the seller to potential loss from credit-risk-related events specified in the contract <p>Examples of credit derivatives include, but are not limited to, credit default swaps, credit spread options, and credit index products.</p> |
| Forwards | Agreements between two parties to buy or sell an asset at a certain future time for a certain price agreed today. |

Additionally, ASC 860-20-55-29 through 55-31 provide implementation guidance on commitments to deliver additional receivables during revolving periods of some securitizations.

Excerpt from Accounting Standards Codification

Transfers and Servicing – Sales of Financial Assets

Implementation Guidance and Illustrations

Forward Contracts in Revolving-Period Securitizations

860-20-55-29

The requirement that all financial assets obtained and liabilities incurred by the transferor of a securitization that qualifies as a sale shall be recognized and measured as provided in this Subtopic includes the implicit forward contract to sell additional financial assets during a revolving period. Such a forward contract may become valuable or onerous to the transferor as interest rates and other market conditions change.

⁵⁰ As defined in the ASC Master Glossary.

860-20-55-30

The value of the forward contract implicit in a revolving-period securitization arises from the difference between the agreed-upon rate of return to investors on their beneficial interests in the trust and current market rates of return on similar investments. For example, if the agreed-upon annual rate of return to investors in a trust is 6 percent, and later market rates of return for those investments increased to 7 percent, the forward contract's value to the transferor (and burden to the investors) would approximate the present value of 1 percent of the amount of the investment for each year remaining in the revolving structure after the receivables already transferred have been collected. If a forward contract to sell receivables is entered into at the market rate, its value at inception may be zero. Changes in the fair value of the forward contract are likely to be greater if the investors receive a fixed rate than if the investors receive a rate that varies based on changes in market rates.

860-20-55-31

Gain or loss recognition for revolving-period receivables sold to a securitization trust is limited to receivables that exist and have been sold.

As a reminder, entities should carefully evaluate rights or obligations to reacquire transferred financial assets or beneficial interests to evaluate whether these rights or obligations preclude sale accounting (refer to sections 4 and 5 for further information).

Subsequent measurement

Under the guidance of ASC 815, *Derivatives and Hedging*, all discrete and embedded derivatives that require bifurcation and separate accounting are subsequently measured at fair value. Embedded derivatives should be separated from the host contract (e.g., beneficial interest) and accounted for as derivative instruments only if certain criteria are met (ASC 815-15-25-1). These criteria are:

- ▶ The economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the host contract.
- ▶ The hybrid instrument is not remeasured at fair value through earnings under otherwise applicable US GAAP.
- ▶ A separate instrument with the same terms as the embedded derivative would, pursuant to ASC 815-10-15, be a derivative instrument subject to the requirements of ASC 815-10.

Further, an entity that initially recognizes a hybrid financial instrument that is required to be separated into a host contract and a derivative instrument under ASC 815-15-25-1 may irrevocably elect to subsequently measure that hybrid financial instrument in its entirety at fair value (with changes in fair value recognized in earnings). A hybrid financial instrument where the embedded derivative is not required to be separated from the host contract because it does not meet the criteria listed above will continue to follow the appropriate accounting for the hybrid instrument (e.g., investment accounting as an available-for-sale security).

Refer to sections 2 and 3 of our FRD, *Derivatives and hedging*, for further information.

6.5.3.4 Guarantees (updated September 2025)

To provide enhanced credit protection, a transferor or third party may guarantee collection of the scheduled cash flows of the transferred asset(s). Because the accounting for credit enhancement(s) may vary depending on how the specific arrangement is structured, it is necessary to understand the terms of the contractual arrangements. While ASC 460, *Guarantees*, generally applies to financial guarantees, certain arrangements referred to as “financial guarantees” and “insurance contracts” that relate to an underlying borrower’s credit event may need to be accounted for as derivatives if they do not qualify for the financial guarantee scope exception in ASC 815-10-15-58. If the arrangement is accounted for as a derivative it may still be subject to the disclosure requirements of ASC 460.

Subsequent measurement

ASC 460-10-35 does not provide detailed guidance on how the guarantor’s liability for its obligations under the guarantee should be measured after its initial recognition. A guarantee obligation should not be subsequently measured at fair value unless the use of that method is permitted under other US GAAP. For example, if the guarantee is a derivative (or the entity elects the fair value option), the obligation should be remeasured at fair value at each reporting date with changes in fair value reported through earnings. Conversely, if the guarantee meets the scope exception in ASC 815 and the entity does not elect the fair value option, other accounting guidance should be considered.

When subsequent measurement at fair value is not permitted for a guarantee, the liability initially recognized by the guarantor is typically reduced (by a credit to earnings) in subsequent periods as the guarantor is released from risk under the guarantee. Depending on the nature of the guarantee, the guarantor’s release from risk is typically recognized over the term of the guarantee using various methods described in ASC 460-10-35-2 (i.e., upon either expiration or settlement of the guarantee, a systematic and rational amortization method, or as the fair value of the guarantee changes if it can be justified under other US GAAP). Any subsequent evidence that indicates the initial fair value measurement was understated should generally follow loss contingency accounting under ASC 450-20 and be recognized when such increased liability is probable and reasonably estimable.

Entities that issue guarantees in the scope of ASC 460 must evaluate whether the guarantees are also in the scope of ASC 326, Credit Losses. Not all guarantees that are in the scope of ASC 460 are also in the scope of ASC 326. For guarantees that are in the scope of ASC 326, the noncontingent aspect of the guarantee (i.e., standing ready to perform) and the contingent aspect (i.e., making payments if a triggering event or condition occurs) are accounted for separately. In these cases, the expected credit losses (the contingent aspect) would be measured and accounted for using the expected credit loss model in ASC 326 in addition to and separately from the noncontingent aspect, which should be accounted for pursuant to ASC 460. Refer to our FRD, ***Credit impairment under ASC 326***, for our interpretive guidance on applying the credit losses standard in ASC 326.

6.5.3.5 Recourse obligations (updated September 2025)

Recourse is the right of a transferee (e.g., purchaser) to receive payment from the transferor (e.g., seller) for (a) failure of underlying borrowers to make payments when due, (b) the effects of prepayments or (c) adjustments resulting from defects in the eligibility of the underlying transferred financial assets or breach of standard representations and warranties.⁵¹ For example, the transferor may be required to:

- ▶ Make full or partial payment to the transferee if the underlying borrowers fail to pay when payment is due for a specified period of time (e.g., for the first three scheduled payments after the transfer date)
- ▶ Refund the premium paid by the transferee if a prepayment or default occurs within a specified period
- ▶ Make payments to the transferee if underwriting defects are determined to exist

In accordance with ASC 860-20-55-24, a transferor should initially measure at fair value any recourse obligations resulting from a sale of financial assets. In many instances, observable market prices or model inputs may not exist to estimate the fair value of these obligations. Accordingly, this may require the transferor to make its own assumptions about the assumptions that market participants would use in pricing the obligation. A starting point for these assumptions could be historical experience, adjusted to reflect expectations of future losses based on current market conditions. However, if relevant observable market data exists indicating that market participants would use different assumptions, the transferor should adjust its assumptions to incorporate that market information.⁵²

Subsequent measurement

An entity that issues a recourse obligation is required to evaluate whether it meets the definition of a derivative (and is therefore measured at fair value through earnings), or is otherwise in the scope of ASC 326. If it is in the scope of ASC 326, the contingent aspect of the recourse obligation should be measured and accounted for pursuant to ASC 326-20. Refer to our FRD, [Credit impairment under ASC 326](#), for our interpretive guidance on applying the credit losses standard in ASC 326.

Recourse obligations that do not meet the definition of a derivative in ASC 815 and are not in the scope of ASC 326 should be subsequently measured according to accounting pronouncements for measuring similar liabilities. We generally believe ASC 450-20, *Contingencies – Loss Contingencies*, would apply. ASC 450-20 requires that a loss should be recorded only when it is probable and reasonably estimable. Once the obligation is measured, entities should regularly reassess credit enhancement agreements to determine the need to increase the recognized obligation (e.g., in the case of a recourse arrangement) or recognize an impairment (e.g., in the case of an investment in a subordinated beneficial interest issued by a securitization entity).

⁵¹ Standard representations and warranties are defined in the ASC Master Glossary as representations and warranties that assert the financial asset being transferred is what it is purported to be at the transfer date. Examples include representations and warranties about (a) the characteristics, nature, and quality of the underlying financial asset, including characteristics of the underlying borrower and the type and nature of the collateral securing the underlying financial asset, (b) the quality, accuracy, and delivery of documentation relating to the transfer and the underlying financial asset, and (c) the accuracy of the transferor's representations in relation to the underlying financial asset. Representations and warranties generally are applicable for the life of the transferred financial assets and thus create an ongoing exposure for a transferor that must be considered in the initial and subsequent measurement of any liability.

⁵² Refer to our FRD, [Fair value measurement](#), for further guidance on measuring fair value.

6.5.4 Examples that illustrate the calculation of gain or loss

The transactions described below are assumed to meet all of the conditions for sale accounting in ASC 860-10-40-5, and portions retained by the transferor meet the requirements of a participating interest as defined in ASC 860-10-40-6A. It is also assumed that the transferor is not required to consolidate the transferee under the guidance of ASC 810. There is no assurance or presumption that such transactions would actually meet the conditions for derecognition and nonconsolidation.

6.5.4.1 Transfers of an entire financial asset or groups of entire financial assets

Illustration 6-5: Factoring of trade receivables

Company C, an auto supplier, needs to raise cash to fund its operations and improve its credit position with its lenders. Company C decides to sell \$1 million in short-term (30 to 45 days) trade receivables (in their entirety) to Finance Entity H through a factoring arrangement. Because the trade receivables are non-interest-bearing, Company C sells them at a discount to face value. The discount rate, which in this instance is 5%, reflects the market return expected for investments of similar duration and credit quality. The factoring arrangement allows Company C to transfer the receivables on a nonrecourse basis. In other words, the receivables are sold outright to Finance Entity H, which assumes the full risk of collection, without recourse to Company C in the event of a loss. Company C's debtors are directed to send payments to Finance Entity H.

Additional assumptions:

At the date of transfer, Company C has no allowance for credit losses⁵³ established for the receivables, as its history suggests credit losses on accounts receivable have been immaterial.

Loss on sale calculation

| | |
|--|--------------------|
| Cash proceeds from factoring arrangement | \$ 950,000 |
| Less: Carrying amount of receivable sold | 1,000,000 |
| Loss on sale | <u>\$ (50,000)</u> |

Balance sheet comparison

| | Before | After |
|-------------------------------------|---------------------|---------------------|
| Assets | | |
| Cash | \$ 100,000 | \$ 1,050,000 |
| Trade receivables | 1,000,000 | - |
| Total assets | <u>\$ 1,100,000</u> | <u>\$ 1,050,000</u> |
| Liabilities | | |
| Bank loans | \$ 650,000 | \$ 650,000 |
| Accounts payable | 300,000 | 300,000 |
| Total liabilities | 950,000 | 950,000 |
| Equity | 150,000 | 100,000 |
| Total liabilities and equity | <u>\$ 1,100,000</u> | <u>\$ 1,050,000</u> |

Other financial reporting consideration:

The loss on the sale would be recorded on the date of sale and included in the statement of operations.

⁵³ For simplicity, the example does not include an allowance for credit losses, although most assets measured at amortized cost carry an allowance for credit losses. Refer to our FRD, [Credit impairment under ASC 326](#), for our interpretive guidance on applying ASC 326, *Credit Losses*.

Illustration 6-6: Transfers with proceeds of cash, beneficial interests and a recourse obligation

ABC Bank transfers a group of loans in their entirety with a carrying amount of \$1,000,000 to a trust (ABC 2010-6 Trust, or the transferee). The transferee is an entity whose sole purpose is to engage in securitization or asset-backed financing activities. For tax and credit rating purposes, among other reasons, the transferee is constrained from selling or pledging the transferred loans. To finance the acquisition, ABC 2010-6 Trust issues three different classes of beneficial interests in the transferred loans:

- ▶ Senior certificates with an aggregate fair value of \$880,000
- ▶ Mezzanine certificates with an aggregate fair value of \$165,000
- ▶ Residual interests with an aggregate fair value of \$55,000

Investors in the beneficial interests issued by ABC 2010-6 Trust are not constrained from selling or pledging their beneficial interests. In exchange for the transferred loans, ABC Bank obtains 20% of the senior certificates issued by the trust and \$924,000 in cash. ABC Bank undertakes no servicing responsibilities and assumes a limited recourse obligation to repurchase delinquent loans.⁵⁴ The initial fair value of the limited recourse obligation is \$30,000.

| | Fair value amount | |
|--|--------------------------|---------------|
| Net proceeds received by ABC Bank | | |
| Cash | \$ | 924,000 |
| Plus: Senior certificates ⁵⁵ | | 176,000 |
| Less: Assumed recourse obligation ⁵⁶ | | (30,000) |
| Net proceeds | \$ | 1,070,000 |
| Gain on sale calculation | | |
| Net proceeds | \$ | 1,070,000 |
| Carrying amount of loans sold | | 1,000,000 |
| Gain on sale | \$ | 70,000 |
| Journal entry recorded by ABC Bank | | |
| | Debit | Credit |
| Cash | \$ 924,000 | |
| Senior certificates | 176,000 | |
| Loans | | \$ 1,000,000 |
| Recourse obligation | | 30,000 |
| Gain on sale | | 70,000 |
| Note: To record transfer of loans accounted for as a sale | | |

⁵⁴ The option held by ABC 2010-6 Trust that entitles it to put back delinquent loans to ABC Bank does not preclude ABC Bank from derecognizing the transferred loans because exercise of the put option is conditional and beyond ABC Bank's control. Additionally, it is assumed that the extent of the guarantee does not prevent the transferor from meeting the legal isolation requirements for sale accounting.

⁵⁵ ASC 860-20-30-1 requires that all proceeds, including beneficial interests obtained, and reductions from proceeds, including guarantees or recourse obligations, be initially measured at fair value.

⁵⁶ Represents the initial fair value of the recourse obligation ABC Bank is required to recognize under ASC 860 and ASC 460, *Guarantees*.

Illustration 6-7: Transfers with proceeds of cash, derivatives and other liabilities

The following example is adopted from ASC 860-20-55-43 through 55-45, *Recording Transfers with Proceeds of Cash, Derivative Instruments, and Other Liabilities*:

Entity A transfers entire loans with a carrying amount of \$1,000 to an unconsolidated securitization entity and receives proceeds with a fair value of \$1,030, and the transfer is accounted for as a sale. Entity A undertakes no obligation to service and assumes a limited recourse obligation to repurchase delinquent loans. Entity A agrees to provide the transferee a return at a variable rate of interest even though the contractual terms of the loan are fixed rate in nature (that provision is effectively an interest rate swap).

This example has the following assumptions.

Fair Value

| | | |
|--------------------------|----|-------|
| Cash proceeds | \$ | 1,050 |
| Interest rate swap asset | | 40 |
| Recourse obligation | | 60 |

Net proceeds

| | | |
|--------------------------------|----|--------------|
| Cash received | \$ | 1,050 |
| Plus: Interest rate swap asset | | 40 |
| Less: Recourse obligation | | <u>(60)</u> |
| Net proceeds | \$ | <u>1,030</u> |

Gain on sale

| | | |
|-------------------------------------|----|----------------|
| Net proceeds | \$ | 1,030 |
| Less: Carrying amount of loans sold | | <u>(1,000)</u> |
| Gain on sale | \$ | <u>30</u> |

Journal entry recorded by Entity A

| | Debit | Credit |
|--------------------------|--------------|---------------|
| Cash | \$ 1,050 | |
| Interest rate swap asset | 40 | |
| Loans | | \$ 1,000 |
| Recourse obligation | | 60 |
| Gain on sale | | 30 |

Note: To record transfer of loans accounted for as a sale

Illustration 6-8: Banker's acceptance transaction

Banker's acceptances provide a way for a bank to finance a customer's purchase of goods from a vendor for periods usually not exceeding six months. Under an agreement between the bank, the customer, and the vendor, the bank agrees to pay the customer's liability to the vendor upon presentation of specified documents that provide evidence of delivery and acceptance of the purchased goods. The bank recognizes a receivable from the customer and a liability for the acceptance it has issued to the vendor. The vendor typically sells the accepted draft at a discount either to the accepting bank or in the marketplace.

In accordance with ASC 860-10-55-65, an accepting bank that obtains a risk participation from another bank should not derecognize the liability for the banker's acceptance because the accepting bank is still primarily liable to the holder of the banker's acceptance even though it benefits from a guarantee of reimbursement by a participating bank. The accepting bank should not derecognize the receivable from the customer because it has not transferred the receivable. Rather, it controls the benefits inherent in that receivable and it is still entitled to receive payment from the customer. The accepting bank should, however, record the guarantee purchased, and the participating bank should record a liability for the guarantee issued. Consider the following example.

An accepting bank assumes a liability to pay a customer's vendor and obtains a risk participation from another bank. The face value of the draft provided to the vendor is \$1,000 for 90 days. The Bank charges commission of \$25 (assumed at an annual rate of 10%). The Bank also pays fees of \$10 for obtaining the risk participation.

The banks would make the following journal entries:

Journal Entries for Accepting Bank

| | Debit | Credit |
|---|----------|----------|
| At issuance of acceptance: | | |
| Receivable from customer | \$ 1,000 | |
| Cash | 25 | |
| Time draft payable to vendor | | \$ 1,000 |
| Deferred acceptance commission revenue | | 25 |
| At purchase of risk participation from a participating bank: | | |
| Guarantee purchased | 10 | |
| Cash | | 10 |
| Upon presentation of the accepted time draft: | | |
| Time draft payable to vendor | 1,000 | |
| Deferred acceptance commission revenue | 25 | |
| Cash | | 1,000 |
| Acceptance commission revenue | | 25 |
| Upon collection from the customer (or the participating bank, if the customer defaults): | | |
| Cash | 1,000 | |
| Guarantee expense | 10 | |
| Receivable from customer | | 1,000 |
| Guarantee purchased | | 10 |

| Journal Entries for Participating Bank | | |
|--|-------|--------|
| | Debit | Credit |
| Upon issuing the risk participation: | | |
| Cash | \$ 10 | |
| Guarantee liability | | \$ 10 |
| Upon payment by the customer to the accepting bank: | | |
| Guarantee liability | 10 | |
| Guarantee revenue | | 10 |
| Or: | | |
| In the event of total default by the customer: | | |
| Guarantee loss | 990 | |
| Guarantee liability | 10 | |
| Cash (paid to accepting bank) | | 1,000 |

6.5.4.2

Transfers of participating interests

Illustration 6-9: Recording transfers of participating interests

Bank X originates a loan to Company ABC on 1 February 2010. The loan is for \$200,000, has a stipulated interest rate of 6.5%, becomes due on 31 January 2020 and is collateralized by Company ABC's property, plant and equipment. Principal and interest are paid monthly. Fees earned by Bank X in connection with originating this loan, net of costs incurred, totaled \$1,500. In accordance with ASC 310-20-25-2, net origination fees are deferred and reported as part of the carrying value of the loan (i.e., carrying value at inception equals \$198,500 (\$200,000 loan – \$1,500 net origination fees)). The net origination fees will be amortized over the life of the loan.

During December 2010, Bank X decides to sell a portion of its loan to increase its cash position. On 31 December 2010, Bank X reaches an agreement with Investment Group to sell a 40% participating interest in the Company ABC loan.

Additional assumptions:

- ▶ At the time of sale, the carrying value and fair value of the entire loan recorded on Bank X's balance sheet are \$185,290 and \$192,592, respectively. The fair value of the Company ABC loan is higher than the carrying amount because market interest rates for comparable loans (e.g., comparable credit quality and duration) have fallen to 5.9%.
- ▶ The amount paid by Investment Group for the 40% participating interest is \$77,037 and represents fair value.
- ▶ Bank X retains servicing rights and in exchange is entitled to a fee of 35 basis points.
- ▶ The transaction is assumed to qualify for sale accounting. No servicing asset or servicing liability is initially recognized because Bank X estimates that the servicing fee is just adequate to compensate it for its servicing responsibilities.

To calculate the gain or loss on sale, Bank X allocates the carrying amount between the participating interest sold to Investment Group and the participating interest that it continues to hold. This allocation is based on the relative fair values at the date of transfer. The participating interest that Bank X continues to hold is recognized as the difference between the previous carrying amount and the amount derecognized. That is, the portion of the loan retained continues to be recognized on Bank X's balance sheet at its allocated book value because control has not been surrendered.

The allocation of the participating interests sold and retained, the calculation of the gain recorded on sale and related journal entries are outlined in the tables below:

Allocated carrying amount based on relative fair values

| | Fair value | Percentage of total fair value | Allocated carrying amount |
|---|-------------------|--------------------------------|---------------------------|
| Four-tenths participating interest sold | \$ 77,037 | 40% | \$ 74,116 ^(A) |
| Six-tenths participating interest that continues to be held by Bank X | 115,555 | 60 | 111,174 ^(B) |
| Total | <u>\$ 192,592</u> | <u>100%</u> | <u>\$ 185,290</u> |

Notes:

- (A) Represents the carrying value of the loan at the time of sale multiplied by the ratio of the fair value of the participating interest (PI) sold relative to the sum of the PI sold and the PI retained (i.e., $\$185,290 \times [\$77,037 / (\$77,037 + \$115,555)]$ or $\$185,290 \times 40\%$).
- (B) Represents the carrying value of the loan at the time of sale multiplied by the ratio of the fair value of the participating interest (PI) retained relative to the sum of the PI retained and the PI sold (or $\$185,290 \times [\$115,555 / (\$115,555 + \$77,037)]$ or $\$185,290 \times 60\%$).

Gain on sale calculation

| | |
|--|-----------------|
| Proceeds | \$ 77,037 |
| Allocated carrying amount of loan sold | <u>74,116</u> |
| Gain on sale | <u>\$ 2,921</u> |

Journal entry recorded by Bank X

| | Debit | Credit |
|--------------|-----------|-----------|
| Cash | \$ 77,037 | |
| Loan | | \$ 74,116 |
| Gain on sale | | 2,921 |

Note: To record transfer of a portion of a loan accounted for as a sale

Illustration 6-10: Transfers of participating interests involving third-party guaranties

On 1 January 2010, Bank A originates a ten-year loan to Company B (the Borrower) with a contractual principal amount and interest rate of \$300,000 and 7%, respectively. Fees earned by Bank A in connection with originating this loan, net of costs incurred, totaled \$2,000. Bank A obtains a third-party guarantee from the Small Business Administration (SBA) for 75% of the loan's contractual payments in the event the borrower defaults. The guarantee is attached to the loan, and the loan with the attached guarantee is transferable. Bank A accounts for the guarantee as part of the loan basis, consistent with its accounting policy. A one-time guarantee fee equal to 3% of the total amount guaranteed (i.e., 3% of \$225,000, or \$6,750) is assessed by and paid to the SBA at the loan's origination.

Shortly after its origination, Bank A transfers the guaranteed portion (i.e., 75% of the loan) to Bank C and retains servicing rights.

Additional assumptions:

- ▶ The transaction meets all of the criteria to qualify as a participating interest⁵⁷ and each of the derecognition criteria of ASC 860 to be accounted for as a sale.
- ▶ A servicing asset of \$3,161 is initially recognized because Bank A estimates that the servicing fee (100 basis points⁵⁸) is more than adequate compensation, but not significantly above an amount that would fairly compensate a substitute service provider, should one be required.
- ▶ Except for standard representations and warranties, Bank A provides no recourse to Bank C.
- ▶ Market interest rates have not changed from the time of origination to the time of sale.
- ▶ The price paid by Bank C for its participating interest is \$230,839, which is assumed to be fair value.
- ▶ The estimated fair value of the participating interest retained by Bank A is \$75,000.

To calculate the gain or loss on sale, Bank A allocates the carrying amount of the loan between the participating interest sold to Bank C and the participating interest that it continues to hold. This allocation is based on the relative fair values at the date of transfer. In this example, the premium that Bank C pays to Bank A primarily relates to the SBA guarantee. Excluding the guarantee, the relative fair values of the portion of the loan sold and the portion retained would also differ because the portion of the loan sold is subject to a servicing fee, which is considered to be above adequate compensation, but not significantly above.⁵⁹

The allocation of the participating interests sold and retained, the calculation of the gain recorded on sale and related journal entries are outlined in the tables below:

| | Fair value | Percentage of total fair value | Allocated carrying amount |
|--|-------------------|---------------------------------------|----------------------------------|
| 75% Participating interest sold | \$ 230,839 | 75.48% | \$ 230,025 ^(A) |
| 25% Participating interest that continues to be held by Bank A | 75,000 | 24.52 | 74,725 ^(B) |
| Total | \$ 305,839 | 100.00% | \$ 304,750 |

Notes:

(A) Represents the carrying value of the loan (\$300,000 [loan amount] – \$2,000 [net origination fees] + \$6,750 [guarantee fee]) = \$304,750 x 75.48% [percentage of fair value] or \$230,025.

(B) Represents the carrying value of the loan (\$300,000 [loan amount] – \$2,000 [net origination fees] + \$6,750 [guarantee fee]) = \$304,750 x 24.52% [percentage of fair value] or \$74,725.

Gain on sale calculation

Proceeds:

| | |
|---|-----------------|
| Cash received on sale of participating interest | \$ 230,839 |
| Servicing asset | 3,161 |
| Total proceeds | 234,000 |
| Less: Allocated carrying amount of loan sold | (230,025) |
| Gain on sale | \$ 3,975 |

⁵⁷ ASC 860-10-55-17M clarifies that third-party guarantees are excluded from the determination of what constitutes a participating interest.

⁵⁸ Terms may vary based on the specific SBA program.

⁵⁹ The example assumes that the 100-basis-point servicing fee does not entitle a servicer to an amount that would be significantly above adequate compensation. There is no assurance or presumption that such a fee would actually meet the requirements of a participating interest. Any evaluation of the adequacy of servicing fees should be based on the specific facts and circumstances.

Journal entry recorded by Bank A

| | Debit | Credit |
|-----------------|------------|------------|
| Cash | \$ 230,839 | |
| Servicing asset | 3,161 | |
| Loans | | \$ 230,025 |
| Gain on sale | | 3,975 |

Note: To record transfer of a portion of a loan accounted for as a sale and recognize an asset for servicing rights retained

Other financial reporting consideration:

The 25% of the original loan that remains on Bank A's statement of financial position has an allocated carrying amount of \$74,725. This amount, assuming all payments are made as agreed, will be accreted to \$75,000, which represents the 25% of the contractual payments due from Company B.

Illustration 6-11: Transfers of participating interests in sales-type lease receivables

Company A manufactures equipment with an estimated economic life of 5 years and leases equipment to Company B for a period of 4 years at \$250,000 per year. Company A subsequently sells an 80% participating interest in the lease receivables to Investor X for \$650,000. Company A retains servicing rights and receives a servicing fee from Investor X. Company A retains a 100% interest in the unguaranteed residual value of the leased equipment. Because the unguaranteed residual value is not a financial asset, it is excluded from the analysis of whether the transfer of the 80% participating interest in the lease receivables meets the definition of a participating interest.⁶⁰

Additional assumptions:

- ▶ The lease represents a sales-type lease.
- ▶ The transaction meets all of the criteria to qualify as a participating interest and each of the derecognition criteria of ASC 860 to be accounted for as a sale.
- ▶ No servicing asset or servicing liability is initially recognized because Company A estimates that the servicing fee is just adequate to compensate it for its servicing responsibilities.
- ▶ Market interest rates for comparable leases (e.g., comparable credit quality and duration) have decreased since commencement of the lease.

⁶⁰ This transaction would also meet the definition of a participating interest if Company A, at lease commencement, obtained a third-party guarantee on the estimated residual value of the equipment. Because the residual value would be guaranteed by a third-party, the guarantee would be excluded from the determination of whether a portion of the gross investment in lease receivables meets the definition of a participating interest. See section 2.3.3 for additional information regarding the effect of recourse provisions on participating interests and questions 2-1 and 2-2 in section 2, *Unit of account*, for further discussion of the unit of account related to investments in lease receivables.

The allocation of the participating interests sold and retained, the calculation of the gain recorded on sale and related journal entries are outlined in the tables below:

Carrying amounts

| | | |
|--|------------|----------------------------|
| Lease receivables | | \$ 800,000 |
| Unearned income related to lease receivables | | 200,000 |
| Gross investment in lease receivables | | <u>\$ 1,000,000</u> |
| Unguaranteed residual value | \$ 100,000 | |
| Unearned income related to unguaranteed residual value | 40,000 | |
| Gross investment in unguaranteed residual value | | <u>140,000</u> |
| Total gross investment in lease | | <u><u>\$ 1,140,000</u></u> |

Gain on sale calculation

| | | |
|--|------------|-------------------------|
| Proceeds – cash received | | \$ 650,000 |
| Less: | | |
| 80% of carrying amount of gross investment in lease receivables | \$ 800,000 | |
| 80% of carrying amount of unearned income related to lease receivables | (160,000) | |
| Net carrying amount of lease receivables sold | | <u>640,000</u> |
| Gain on sale | | <u><u>\$ 10,000</u></u> |

Journal entry recorded by Company A

| | Debit | Credit |
|------------------|--------------|---------------|
| Cash | \$ 650,000 | |
| Unearned income | 160,000 | |
| Lease receivable | | \$ 800,000 |
| Gain on sale | | 10,000 |

Note: To record sale of 80% of the lease receivables

6.6 Regaining control of financial assets sold (updated September 2025)

Under ASC 860, a transferred financial asset is considered to be repurchased if the transfer no longer qualifies for sale accounting. In general, the sale accounting criteria must continue to be met after the transfer to be accounted for as a sale. For example, a contingent call held by a transferor on previously sold financial assets may potentially become exercisable at a later date if the contingency is resolved and provides the transferor the unilateral right to reclaim the underlying asset. In that circumstance, obtaining control of the financial asset or group of financial assets is accounted for as if the assets were purchased new.

Regaining control of previously derecognized financial assets raises several accounting issues, including:

- ▶ How the transferor should account for the previously sold assets for which control has been regained
- ▶ How the accounting differs if such assets are actually repurchased
- ▶ How the transferor should account for interests that continue to be held by the transferor when the underlying assets are re-recognized
- ▶ Whether any gain or loss should be recognized by the transferor when an event occurs that requires re-recognition of the previously sold assets
- ▶ Whether under any circumstances an allowance for credit losses should initially be recorded for loans that do not meet the definition of a security when they are re-recognized
- ▶ How re-recognition of previously sold assets affects the accounting for the related servicing asset or servicing liability

- ▶ After the transferor has regained control of assets previously derecognized, whether the transferor should continue to separately account for interests that continue to be held in the original transaction

ASC 860-20-25 clarifies how the guidance in ASC 860-10-40-41 relates to those issues.

Excerpt from Accounting Standards Codification

Transfers and Servicing – Sales of Financial Assets

Recognition

Regaining Control of Financial Assets Sold

860-20-25-8

Paragraph 860-10-40-41 explains that a change in law or other circumstance may result in a transferred portion of an entire financial asset no longer meeting the conditions of a participating interest (see paragraph 860-10-40-6A) or the transferor's regaining control of transferred financial assets after a transfer that was previously accounted for as a sale, because one or more of the conditions in paragraph 860-10-40-5 are no longer met.

860-20-25-9

Such changes shall be accounted for in the same manner as a purchase of the transferred financial assets from the former transferee(s) in exchange for liabilities assumed unless they arise solely from either:

- Consolidation of an entity involved in the transfer at a subsequent date (see paragraph 860-20-25-10)
- A change in market prices (for example, an increase in price that moves into the money a **freestanding call option** on a non-readily-obtainable, transferred financial asset that was originally sufficiently out of the money that it was judged not to constrain the transferee).

See the related guidance beginning in paragraph 860-20-25-1.

860-20-25-10

After that change,^[61] the transferor shall do all of the following:

- Recognize in its financial statements those transferred financial assets together with liabilities to the former transferee(s) or beneficial interest holders of the former transferee(s).^[62]
- Not change the accounting for the servicing asset related to the previously sold financial assets. That is, even though the transferor has regained control over the previously sold assets, the cash flows from those assets will contractually be paid to the special-purpose entity, which will then distribute the proceeds to satisfy its contractual obligations (including obligations to the beneficial interest holders). Because the transferor, as servicer, is still contractually required to collect the asset's cash flows for the benefit of the special-purpose entity and otherwise service the assets, it shall continue to recognize the servicing asset and assess the asset for impairment if subsequently measured using the amortization method, as required by paragraph 860-50-35-9. Once a servicing asset is recognized it shall not be added back to the underlying asset. Even when the transferor has regained control over the underlying assets through an event that triggers a transferor to rerecognize previously transferred assets that were accounted for as having been sold, the related servicing asset shall continue to be separately recognized.

⁶¹ EY note: That is, a change in circumstance that results in the transferor regaining control of assets previously accounted for as a sale (see ASC 860-20-25-8), unless the change results solely from circumstances described in ASC 860-20-25-9.

⁶² EY note: ASC 860-20-40-3 indicates that the transferee would derecognize the transferred financial assets, as if it had sold the financial assets in exchange for a receivable from the transferor.

The accounting for the servicing asset or servicing liability related to previously sold financial assets does not change when the transferor regains control over those assets. However, if the previously derecognized financial assets are repurchased from the transferee (i.e., the transferee no longer owns the asset being serviced and receives no cash flows from the asset being serviced), the original servicing arrangement would cease to exist and the servicing asset or servicing liability would be derecognized. In other words, the servicing asset or servicing liability would be recombined with the underlying assets. The accounting is similar if the transferee is subsequently consolidated by the transferor (i.e., the related servicing asset or servicing liability is no longer separately recognized in the transferor's consolidated financial statements). Although the servicing contract may still exist, we believe the effects of ASC 860-20-25-10 would be eliminated through the normal elimination of intercompany transactions in consolidation.

Excerpt from Accounting Standards Codification

Transfers and Servicing – Sales of Financial Assets

Recognition

Regaining Control of Financial Assets Sold

860-20-25-10

- c. Continue to account for the transferor's interests in those underlying financial assets apart from any rerecognized financial assets. That is, the transferor's interests shall not be combined with and accounted for with the rerecognized financial assets. Example 10 (see paragraph 860-20-55-83) illustrates this guidance. However, a subsequent event that results in the transferor reclaiming those financial assets from the transferee, for example, the exercise of a removal-of-accounts provision or the consolidation by the transferor of the securitization entity in accordance with applicable GAAP, including the Variable Interest Entities Subsections of Subtopic 810-10, would result in a recombination of the transferor's interests with the underlying financial assets.

For guidance on consolidation, which is relevant to determining whether a transferor must consolidate an entity involved in a transfer that was accounted for as a sale, see Topic 810.

When control is regained over previously sold assets, the transferor should recognize such assets at fair value with a corresponding payable to the transferee or the transferee's beneficial interest holders. Additionally, in accordance with ASC 860-20-35-9, beneficial interests that the transferor continues to hold should be periodically evaluated for possible impairment, including at the time control is regained over the underlying financial assets.

Excerpt from Accounting Standards Codification

Transfers and Servicing – Sales of Financial Assets

Recognition

Regaining Control of Financial Assets Sold

860-20-25-12

Upon application of paragraph 860-20-25-10, no gain or loss shall be recognized in earnings with respect to any of the transferor's **beneficial interests**. A gain or loss may be recognized upon the exercise of a removal-of-accounts provision or similar contingent right with respect to the repurchased transferred financial assets that were sold if the removal-of-accounts provision or similar contingent right held by the transferor is not accounted for as a derivative instrument under Subtopic 815-10 and is not at the money, resulting in the fair value of those repurchased financial assets being greater or less than the related obligation to the transferee.

860-20-25-13

For financial assets rerecognized in accordance with paragraph 860-20-25-10, an entity shall initially recognize a financial asset at fair value. An entity shall then apply relevant guidance, including this Topic, Topic 310 on receivables, Topic 320 on investments—debt securities, Topic 321 on investments—equity securities, Topic 323 on investments—equity method and joint ventures, and Topic 325 on investments—other. In addition, an entity shall measure an allowance for credit losses in accordance with Topic 326, if applicable.

- a. For those financial assets that are not purchased financial assets with credit deterioration within the scope of Topic 326, an entity shall recognize an allowance for credit losses with a corresponding charge to credit loss expense as of the reporting date.
- b. For those financial assets that are **purchased financial assets with credit deterioration** (which includes beneficial interest that meets the criteria in paragraph 325-40-30-1A) within the scope of Topic 326, an entity shall recognize an allowance for credit losses in accordance with Topic 326 with a corresponding increase to the amortized cost basis of the financial asset(s) as of the recognition date.

Re-recognized financial assets will continue to be initially recognized at fair value. For assets that are determined to be PCD⁶³ pursuant to ASC 326 (which includes beneficial interest that meets the criteria in paragraph 325-40-30-1A), an entity will recognize an allowance for credit losses in accordance with ASC 326 with a corresponding increase to the amortized cost basis of the financial asset(s) as of the recognition date. For non-PCD assets, an allowance for credit losses is recognized in accordance with ASC 326 with a corresponding charge to credit loss expense. Refer to our FRD, ***Credit impairment under ASC 326***, for our interpretive guidance on applying ASC 326 including PCD accounting.

Initial measurement of financial assets upon regaining control

Excerpt from Accounting Standards Codification

Transfers and Servicing – Sales of Financial Assets

Initial Measurement

Regaining Control of Financial Assets Sold

860-20-30-3

The transferor shall initially measure **transferred financial assets** and liabilities that are rerecognized under paragraph 860-20-25-10(a) as a result of regaining control of the **financial assets** sold at fair value on the date of the change as if the transferor purchased the transferred financial assets and assumed the liabilities on that date.

⁶³ The FASB is expected to issue a final ASU that would expand the gross-up approach in ASC 326 to all loan receivables, excluding credit cards, acquired in a business combination and in an asset acquisition or recognized through the consolidation of a variable interest entity that is not a business, if they meet certain seasoning criteria. Refer to the [FASB website](#) for the tentative decisions reached by the Board during redeliberations on this project.

6.6.1 Removal-of-accounts provision (ROAP)

Excerpt from Accounting Standards Codification

Transfers and Servicing – Sales of Financial Assets

Recognition

Regaining Control of Financial Assets Sold

860-20-25-11

Whether the removal-of-accounts provision is exercised or not, the transferor shall recognize any financial assets subject to the removal-of-accounts provision if all of the following conditions are met:

- a. A third party's action (such as default or cancellation) or decision not to act (expiration) occurs.
- b. The occurrence allows removal of assets to be initiated solely by the transferor.
- c. The provision provides a more-than-trivial benefit to the transferor.

For example, once a contingency is met (such as when a given loan goes into default), the call option on that asset (loan) is no longer contingent.

Many transfers of financial assets that involve transfers of a group of entire financial assets to an entity whose sole purpose is to engage in securitization or asset-backed financing activities empower the transferor to reclaim assets subject to certain restrictions (e.g., right to specify the assets to be removed from a credit card master trust). Such a power is commonly referred to as a "removal-of-accounts provision" or "ROAP." Whether a ROAP precludes sale accounting depends on whether the ROAP results in the transferor maintaining effective control over transferred financial assets. If it is determined that a ROAP provision allows the transferor to unilaterally cause the return of specific assets, it must also be analyzed to determine whether it provides the transferor with more than a trivial benefit.

One class of contingent rights does not preclude sale accounting because it does not include unilateral rights. The most common type of removal-of-accounts provision is a default ROAP, which gives the holder the right but not the obligation to purchase (call) a loan that is in default (the meaning of default typically is specifically defined in each transaction). Such rights are common in credit card securitizations and in securitizations sponsored by the Government National Mortgage Association (GNMA)⁶⁴ and other governmental or quasi-governmental agencies.

Once the contingency is met (in this case, when a given loan goes into default), the call option on that asset is no longer contingent. At that point, the transfer fails the criterion in ASC 860-10-40-5(c) because the transferor has the unilateral right to purchase a specific transferred financial asset (assuming that right also provides more-than-a-trivial benefit to the transferor). Under the requirements of ASC 860-20-25-11, when a contingency related to a transferor's contingent right has been met, the transferor generally must account for the specific subset of the financial assets transferred to and held by the entity as if it had been repurchased. As noted in ASC 860-20-55-41, the transferor must do so regardless of whether it intends to exercise its call option.

⁶⁴ The provisions of ASC 860 apply to the ROAP when the servicer is also the transferor. See section 6.6.1.1 for additional guidance regarding GNMA securitization programs that include buyback options.

6.6.1.1 GNMA buyback option

GNMA mortgage-backed securities are backed by residential mortgage loans that are insured or guaranteed by the Federal Housing Administration, the US Department of Veterans Affairs, or the Farmers Home Administration. GNMA securitization programs allow servicers (which often are also the transferors/originators of the underlying loans) to buy back individual delinquent mortgage loans from the securitized loan pool once certain conditions are met. If a borrower makes no payment for three consecutive months, the servicer has the option to repurchase the delinquent loan for an amount equal to 100% of the loan's remaining principal balance. Under ASC 860, this buy-back option is considered a conditional option until the delinquency criteria are met, at which time the option becomes unconditional.

When the loans backing a GNMA security are initially securitized, ASC 860 does not preclude the transferor of the loans from treating the transaction as a sale for accounting purposes, because the conditional nature of the buyback option means that the transferor does not maintain effective control over the loans. See section 5.4.2.2, *Examples of ROAPs that do not preclude sale accounting*, for additional guidance. If the transfer meets all the criteria for sales accounting, the loans are removed from the transferor's balance sheet. When individual loans later meet GNMA's specified delinquency criteria and are eligible for repurchase, the transferor (provided the transferor is also the servicer) must account for loans as if they had been repurchased, provided the buyback option provides the transferor with a "more-than-trivial benefit."⁶⁵ In other words, the delinquent GNMA loans must be brought back onto the transferor-servicer's books as assets and initially recorded at fair value, regardless of whether the transferor-servicer intends to exercise the buyback option. An offsetting liability also would be recorded.

6.6.2 Examples that illustrate the requirements of ASC 860-20-25-8 through 25-13 (regaining control)

Illustration 6-12: Rerecognition of transferred assets and subsequent accounting for transferor's interest and a servicing asset

ASC 860-20-55-84 through 55-92 provides the following example that illustrates the accounting for a sale of loans in their entirety by a transferor to an unconsolidated entity and the subsequent accounting for the transferor's interest and a servicing asset. In this example, the transferor's interest is an interest-only strip that is accounted for at fair value in the same manner as an available-for-sale security under ASC 860-20-35-2.

On 2 January 20X1, Entity I (the transferor) originates \$1,000 of loans, yielding 10.5 percent interest income for their estimated life of 9 years. Entity I later transfers the loans in their entirety to an unconsolidated entity and accounts for the transfer as a sale. Entity I receives as proceeds \$1,000 cash plus a beneficial interest that entitles it to receive 1 percent of the contractual interest (an interest-only strip receivable). Entity I will continue to service the loans for a fee of 100 basis points. The guarantor, a third party, receives 50 basis points as a guarantee fee.

⁶⁵ Determining whether the GNMA buyback option provides a transferor-servicer with a "more-than-trivial benefit" requires judgment and the assessment may not always be readily quantifiable. For example, a buyback option may provide a transferor-servicer with a more-than-trivial benefit by preserving an entity's reputation in the securitization market. That is, by repurchasing defaulted loans, the transferor-servicer preserves the credit quality of beneficial interests held by third-party investors and increases the likelihood that it would be able to utilize the securitization market in the future to meet its funding requirements. We generally believe that preserving an entity's reputational risk would meet the more-than-trivial benefit criterion even if the borrowing costs incurred by the entity to reacquire the loans are greater than the interest that can be earned by holding the reacquired loans. Refer to section 5, *Criteria for a sale – Effective control*, for further discussion of rights that provide the transferor a unilateral ability to cause the return of specific transferred financial assets and the concept of more-than-trivial benefit.

At the date of transfer, the following facts are assumed:

- The fair value of the servicing asset is \$40.
- The total fair value of the loans including servicing is \$1,040.
- The fair value of the interest-income strip receivable is \$60.

On 1 December 20X1, an event occurs that results in the transfer no longer meeting the conditions for sale accounting. The fair value of the assets at 1 December 20X1 are as follows:

- The fair value of the servicing asset on that date is \$38.
- The fair value of the originally transferred financial assets that remain outstanding in the entity on that date is \$929.
- The fair value of Entity I's interest (in the form of an interest-only strip) on that date is \$58.

The guarantee that was entered into by the entity does not trade with the underlying financial assets. The fees on this guarantee will be paid as part of the cash waterfall.

All cash flows from the financial assets transferred to the trust are initially sent directly to the trust and then distributed in order of priority. The priority of payments in the cash waterfall is as follows: servicing fees, guarantees, amounts due to outside beneficial interest holders, and amounts due to Entity I's beneficial interest.

The following journal entries would be made.

| | Debit | Credit |
|--|----------|----------|
| 2 January 20X1 | | |
| Cash | \$ 1,000 | |
| Entity I's interest (available-for-sale) | 60 | |
| Servicing asset | 40 | |
| Loans | | \$ 1,000 |
| Gain on sale | | 100 |

Note: To record the sale of the assets and to recognize Entity I's interest and a servicing asset at fair value

| | | |
|--|------|------|
| 1 December 20X1 | | |
| Other comprehensive income | \$ 2 | |
| Entity I's interest (available-for-sale) | | \$ 2 |

Note: To subsequently measure Entity I's interest in the same manner as an available-for-sale security

The following illustrates the accounting entry to be made after the event occurs that results in the transfer not meeting the conditions for sale accounting.

| | | |
|------------------------------|--------|--------|
| Loans | \$ 929 | |
| Due to securitization entity | | \$ 929 |

Note: To recognize the previously sold loans on Entity I's books along with the obligation to pass the cash flows associated with those loans to Securitization Entity

Entity I would account for the re-recognized financial assets and transferor's interests as follows:

- Entity I would continue to account for transferor's interests (in accordance with ASC 320-10-35-1) at fair value with changes in fair value recognized in other comprehensive income.
- Entity I would account for the loans at cost plus accrued interest in accordance with ASC 310-20.

How we see it

Although Entity I has regained control over the loans that were previously sold, Entity I would continue to separately recognize a servicing asset. ASC 860-20-25-10(b) requires that once a servicing asset is recognized it should not be added back to the underlying financial asset. In the FASB's example, the cash flows from loans will contractually be paid to the unconsolidated entity, which will then distribute the proceeds to satisfy its contractual obligations (including obligations to the beneficial interest holders). Because Entity I, as servicer, is still contractually required to collect the loan's cash flows for the benefit of the unconsolidated entity and otherwise service the assets, it continues to recognize the servicing asset and assess the asset for impairment if subsequently measured using the amortization method, as required by ASC 860-50-35-9.

6.7 Questions and interpretive responses

Question 6-1 Classification of transferred debt securities

If a transferee is required to sell the transferred securities and liquidate at a pre-determined time, does the transferor have the option to classify beneficial interests received in the form of debt securities as trading at the time of the transfer?

To illustrate this question, assume the following facts that are based on the FASB's implementation guidance in ASC 860-10-55-75.

An entity may transfer debt securities to an unconsolidated entity that has a predetermined life in exchange for cash and the right to receive proceeds from the eventual sale of the securities. For example, a third party holds a beneficial interest that is initially worth 25% of the fair value of the assets of the entity at the date of transfer. The entity is required to sell the transferred securities at a predetermined date and liquidate the entity at that time. Assume the facts in that example and the following additional facts:

- a. The beneficial interests are issued in the form of debt securities.
- b. Before the transfer, the debt securities were accounted for as available-for-sale securities in accordance with ASC 320, *Investments – Debt Securities*.

In this example, the initial classification by the transferor would depend on whether the transfer is accounted for as a sale or as a secured borrowing:

- a. The transfer would be accounted for as a sale if a transfer of a group of entire financial assets satisfies the conditions to be accounted for as a sale. ASC 860-20 requires that any assets obtained or liabilities incurred in the transfer be recognized (see ASC 860-20-25-1) and initially measured at fair value (see ASC 860-20-30-1). In this case, the transferor would account for the debt securities received as new assets and would have the option to classify the debt securities received as trading securities.
- b. If the transfer is accounted for as a secured borrowing, ASC 860-30-25-2 requires the transferor to continue to report the transferred debt securities in its statement of financial position with no change in their measurement (that is, basis of accounting). ASC 320-10-35-12, which explains that transfers into or from the trading category should be rare, would continue to apply.

If the transferred financial assets were not securities subject to the guidance in Topic 320 before the transfer that was accounted for as a sale but the beneficial interests were issued in the form of debt securities, then the transferor would have the opportunity to decide the appropriate classification of the beneficial interests received as proceeds from the sale.

Question 6-2 **Amounts in OCI for AFS securities transferred⁶⁶**

In certain transfers that are accounted for as sales, the transferor obtains an interest that should be subsequently accounted for under ASC 325-40, *Beneficial Interests in Securitized Financial Assets [Investments-Other]*. If the transferred financial asset was accounted for as available-for-sale under ASC 320 prior to the transfer, how should the transferor account for amounts in other comprehensive income at the date of transfer?

ASC 860-20-25-1 requires a transferor to derecognize a transferred financial asset upon completion of a transfer of an entire financial asset that satisfies the conditions to be accounted for as a sale. As a result, the amount in other comprehensive income will be recognized in earnings at the date of transfer.

Question 6-3 **Transfer of a bond purchased at a premium**

Would an existing premium or discount continue to be amortized or accreted after an entity transfers a bond to an unconsolidated entity for cash and beneficial interests?

The answer depends on whether the transfer is accounted for as a secured borrowing or a sale (i.e., the transfer meets the conditions in ASC 860-10-40-5 for derecognition).

- ▶ If the transfer of the bond is accounted for as a secured borrowing, the transferor would continue to amortize (or accrete) the premium (or discount) because ASC 860-30-25-2 requires that the transferor continue to report the transferred financial assets in its statement of financial position with no change in their measurement (that is, basis of accounting).
- ▶ If the transfer of the bond satisfies the conditions to be accounted for as a sale, any beneficial interests received as proceeds would be initially recognized at fair value. As a result, the previously existing premium (or discount) would not continue to be amortized (or accreted); rather, the unamortized (or nonaccreted) amount would be included in the calculation of the gain (or loss) as of the transfer date.

Question 6-4 **Transfers of receivables with recourse**

Can the method used by the transferor for providing “recourse” affect the accounting for a transfer to an unconsolidated entity?

The effect of a recourse provision on the application of ASC 860-10-40-5 may vary by jurisdiction. In some jurisdictions, transfers with full recourse may not place transferred financial assets beyond the reach of the transferor, its consolidated affiliates and its creditors, but transfers with limited recourse may.

- ▶ Transfer consists of an entire financial asset or a group of entire financial assets

Before the method of recourse can be evaluated to determine the appropriate accounting treatment, the entity shall first determine whether a sale has occurred because in some jurisdictions recourse might mean that the transferred financial assets have not been isolated beyond the reach of the transferor, its consolidated affiliates (that are not entities designed to make remote the possibility that it would enter bankruptcy or other receivership) included in the financial statements being presented, and its creditors. A transfer of receivables in their entirety with recourse should be accounted for as a sale, with the proceeds of the sale reduced by the fair value of the recourse obligation, if the conditions in ASC 860-10-40-5 are met. Otherwise, a transfer of receivables with recourse should be accounted for as a secured borrowing.

⁶⁶ Reproduced from question 62 of the FASB Staff’s Special Report, *Questions and Answers Related to Implementation of FASB Statement No. 140*, as amended by Statement 166. This question and answer was not codified.

- ▶ Transfer does not consist of an entire financial asset or a group of entire financial assets

The transferred financial asset must meet the definition of a participating interest. A transfer of a portion of a receivable with recourse, other than that permitted in ASC 860-10-40-6A(c)(4), does not meet the requirements of a participating interest and should be accounted for as a secured borrowing.

Question 6-5

Distinguishing new interests obtained from part of a beneficial interest obtained

What should the transferor consider when determining whether credit risk is a separate liability or part of a beneficial interest that has been obtained by the transferor?

In determining whether credit risk is a separate liability or part of a beneficial interest that has been obtained by the transferor, ASC 860-20-25-6 clarifies that the transferor should focus on the source of cash flows in the event of a claim by the transferee. If the transferee can only look to cash flows from the underlying financial assets, the transferor has obtained a portion of the credit risk only through the interest it obtained and a separate obligation should not be recognized. Credit losses from the underlying assets would affect the measurement of the interest that the transferor obtained.

In contrast, if the transferor could be obligated for more than the cash flows provided by the interest it obtained and, therefore, could be required to reimburse the transferee for credit-related losses on the underlying assets, the transferor should record a separate liability. It is not appropriate for the transferor to defer any portion of a resulting gain or loss (or to eliminate gain on sale accounting, as it is sometimes described in practice).

Question 6-6

Credit enhancements

How should a transferor initially and subsequently measure credit enhancements (e.g., cash reserve accounts) provided in a transfer of an entire financial asset or a group of entire financial assets to an unconsolidated entity that is accounted for as a sale if the balance that is not needed to make up for credit losses is ultimately to be paid to the transferor?

ASC 860-20-30-1 clarifies that the transferor should initially measure any asset obtained (or liability incurred) and recognized under ASC 860-20-25-1 at fair value. While ASC 860 does not specifically address the subsequent measurement of credit enhancements there are some factors to consider. Factors such as how much cash the transferor will receive from, for example, a cash reserve account, and when it will receive cash inflows depend on the performance of the transferred financial assets. Entities should regularly review those assets for impairment because of their nature. Entities should look to other guidance for subsequent measurement including guidance for impairment based on the nature of the credit enhancement.

Question 6-7

Estimating the fair value of beneficial interests with “turbo” or “bullet” provisions

What effects do “turbo” and “bullet” provisions in securitization structures have on the accounting for the transfers of financial assets?

Many securitization structures provide for a disproportionate distribution of cash flows to various classes of investors during the amortization period, which is referred to as a “turbo” provision. For example, a turbo provision might require the first \$100 million of cash received during the amortization period of the securitization structure to be paid to one class of investors before any cash is available for repayment to other investors. Similarly, certain revolving-period securitizations use what is referred to as a “bullet” provision as a method of distributing cash to their investors. Under a bullet provision, during a specified period preceding liquidating distributions to investors, cash proceeds from the underlying assets are reinvested in short-term investments other than the underlying revolving-period receivables. Those investments mature or are otherwise liquidated to make a single bullet payment to certain classes of investors.

ASC 860-20-55-16 clarifies that trust liquidation methods that allocate receipts of principal or interest between beneficial interest holders and transferors in proportions different from their stated percentage of ownership interests do not affect whether the transferor should obtain sale accounting and derecognize

those transferred assets, assuming the trust is not required to be consolidated by the transferor. However, both turbo and bullet provisions in securitization structures should be taken into consideration in determining the fair values of assets obtained by the transferor and transferee.

Question 6-8

Accrued interest receivable

How should an entity account for the accrued interest receivable related to securitized and sold credit card receivables?

The receivables for accrued fee and finance charge income on an investor's portion of the transferred credit card receivables, whether billed but uncollected or accrued but unbilled, are commonly referred to as accrued interest receivable.

ASC 860-20-55-18 clarifies that generally, if a securitization transaction meets the criteria for sale treatment and the accrued interest receivable is subordinated either because the asset has been isolated from the transferor or because of the operation of the cash flow distribution (or "waterfall") through the securitization trust, the total accrued interest receivable should be considered to be one of the components of the sale transaction. Therefore, under the circumstances described, the accrued interest receivable asset should be accounted for as a transferor's interest. It is inappropriate to report the accrued interest receivable related to securitized and sold receivables as "loans receivable." Terminology implying that the accrued interest receivable has not been subordinated to the senior interests in the securitization should not be used.

ASC 860-20-55-19 also clarifies that in such circumstance, the accrued interest receivable (i.e., a transferor's interest) is not required to be subsequently measured like an investment in debt securities classified as available for sale or trading under ASC 320 because the accrued interest receivable cannot be contractually prepaid or settled in such a way that the owner would not recover substantially all of its recorded investment. In such cases, entities should follow existing applicable accounting standards, including ASC 326 on measurement of credit loss, for subsequently accounting for the accrued interest receivable.

The same conclusion applies to other types of securitization transactions.

Question 6-9

Options embedded in transferred securities

Assume a transaction involves the sale of a marketable security to a third-party buyer, with the buyer having an option to put the security back to the seller at a specified future date or dates for a fixed price. Because of the put option, the seller generally receives a premium price for the security. Should an entity account for the put option as a derivative or a guarantee?

ASC 860-20-55-21 through 55-23 clarifies that if the transfer is accounted for as a sale, a put option that enables the holder to require the writer of the option to reacquire for cash or other assets a marketable security or an equity instrument issued by a third party should be accounted for as a derivative by both the holder and the writer, provided the put option meets the definition of a derivative in ASC 815-10-15-83 (including meeting the net settlement requirement, which may be met if the option can be net settled in cash or other assets or if the asset required to be delivered is readily convertible to cash). If multiple put options exist, recognition of the multiple put options as liabilities, and initial measurement at fair value, are required.

A put option that is issued as part of a transfer being accounted for as a sale that is not accounted for as a derivative under ASC 815-10 would be considered a guarantee under ASC 460-10-55-2(b) and would be subject to the initial recognition, measurement, and disclosure requirements of ASC 460. If the written put option is accounted for as a derivative under ASC 815-10 by the seller-transferor, then the put option would be subject to only the disclosure requirements of ASC 460.

If the transaction is accounted for as a secured borrowing under ASC 860-30, any difference between the sale proceeds and the put price should be accrued as interest expense, and any impairment of the underlying security would generally not be recognized. The difference between the original sale price and

the put price should be amortized over the period to the first date the securities are eligible to be put back. If the transfer is accounted for as a secured borrowing, the put option is not subject to ASC 460 or ASC 815, as both standards provide a scope exception for features (such as the put option) that serves as an impediment to sale accounting under ASC 860-10.⁶⁷

Question 6-10 Beneficial interests subject to prepayment

Can a financial asset, such as a beneficial interest, subject to prepayment that is in the scope of ASC 860-20-35-2 (see section 6.5.3.1.2.3) be measured at amortized cost?

ASC 860-20-35-5 prohibits a financial asset that can be contractually prepaid or otherwise settled in a way that the holder would not recover substantially all of its recorded investment from being classified as held-to-maturity (i.e., measured at amortized cost) even if the investor concludes that prepayment or other forms of settlement are remote.⁶⁸

ASC 860-20-35-2 requires certain financial instruments (e.g., loans) that are not debt securities (i.e., not in the scope of ASC 320), that when initially purchased could be contractually prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment, to be accounted for like available-for-sale or trading debt securities, even if these financial instruments do not meet the definition of a debt security. ASC 860-20-55-38 provides that these financial instruments may be reclassified as held for investment later in its life, if the investor would recover substantially all of its recorded investment even if the investment was repaid. Specifically, these financial instruments would no longer be required to be measured in accordance with the guidance in ASC 860-20-35-2 if both of the following conditions are met:

- ▶ It would no longer be possible for the holder not to recover substantially all of its recorded investment upon contractual prepayment or settlement
- ▶ The conditions for amortized cost accounting are met (e.g., ASC 310-10-35-47 and ASC 948-310-25-1)

However, upon reclassification from available-for-sale to held-for-investment, any pre-existing unrealized gains or losses would continue to be reported in other comprehensive income and should be amortized over the remaining life of the financial instrument as an adjustment of its yield. The financial instrument would not be classified as held to maturity because only debt securities under ASC 320 may be classified as held to maturity.

Question 6-11 Reassessment of a previously failed transfer

Assume a transferor previously transferred financial assets and maintained effective control over those financial assets, thus requiring the transfer to be accounted for as a secured borrowing. If facts and circumstances have changed where the transferor has subsequently lost effective control over those financial assets, can the transferor now account for the transfer as a sale?

It depends. A transferor should reassess the accounting for transfers that previously failed the conditions for sale accounting and were accounted for as secured borrowings when certain events occur. Such events can include changes to the terms of contractual arrangements or the expiration of derivative instruments, such as a call option or put option. Careful consideration is necessary in determining whether such events are considered substantive in nature, because we believe that non-substantive events or transactions would not warrant a change in the accounting treatment of a transfer that was previously accounted for as a secured borrowing.

⁶⁷ See ASC 460-10-15-7(g) and ASC 815-10-15-63, respectively.

⁶⁸ ASC 860-20-55-39 discusses whether a residual tranche debt security in a securitization of a financial asset can be classified as held-to-maturity.

7 Servicing of financial assets

7.1 Introduction

A servicing right is a contract to perform specific administration functions for an asset or groups of assets. Determining when to recognize a servicing asset or servicing liability (collectively referred to as servicing rights) depends on how the servicing contract was obtained. Servicing rights are initially measured at fair value and subsequently measured at fair value or under an amortization methodology (subject to impairment). This section provides an overview of servicing rights and discusses the guidance in ASC 860 on the initial recognition and measurement, subsequent measurement, as well as derecognition of servicing and subservicing rights.

Questions have arisen about whether servicing and subservicing contracts on financial assets are in the scope of ASC 860 or ASC 606. FASB Transition Resource Group for Revenue Recognition (TRG)⁶⁹ generally agreed that income from servicing and subservicing financial assets is not in the scope of ASC 606. Entities generally should apply the guidance in ASC 860 to contracts for servicing and subservicing financial assets. Refer to Question 7-10 for additional discussion.

7.2 Overview of servicing rights and responsibilities

Excerpt from Accounting Standards Codification

Transfers and Servicing – Servicing Assets and Liabilities

Overview and Background

General

860-50-05-2

Servicing is inherent in all **financial assets**; it becomes a distinct asset or liability for accounting purposes only in the circumstances described in paragraph 860-50-25-1.

860-50-05-3

Servicing of mortgage loans, credit card receivables, or other financial assets commonly includes, but is not limited to, the following activities:

- a. Collecting principal, interest, and escrow payments from borrowers
- b. Paying taxes and insurance from escrowed funds
- c. Monitoring delinquencies
- d. Executing foreclosure if necessary
- e. Temporarily investing funds pending distribution
- f. Remitting fees to guarantors, trustees, and others providing services
- g. Accounting for and remitting principal and interest payments to the holders of **beneficial interests** or **participating interests** in the financial assets.

⁶⁹ 18 April 2016 FASB TRG meeting; agenda paper no. 52.

860-50-05-4

A servicer of financial assets commonly receives the following **benefits of servicing**:

- a. Revenues from **contractually specified servicing fees**
- b. A portion of the interest from the financial assets
- c. Late charges
- d. Other ancillary sources, including float.

A servicer is entitled to receive all of those benefits of servicing only if it performs the servicing and incurs the costs of servicing the financial assets.

The pooling and servicing agreement specifies the servicer's responsibilities including how to allocate and distribute cash flows to beneficial or participating interest holders. It also describes how the assets are to be serviced and the requirements for special circumstances.

The complexity of servicing activities can vary based on the type of asset being serviced. For example, servicing conventional mortgage loans is less complex than subprime mortgage loans, which have a higher probability of default and may require some form of remediation (e.g., loan modification or foreclosure). The servicer's relative strengths and capabilities is one of the factors considered by rating agencies because servicing adds an element of operational risk to the transaction, failure of which can have a negative effect on the ultimate cash flows of a securitization transaction.

Structures may require the use of multiple servicers, including master servicers, primary or sub-servicers or special servicers. In general, a master servicer is primarily responsible for the servicing activities of the trust or securitization vehicle. The master servicer collects payments, redistributes those cash collections and performs other administrative and record keeping responsibilities.

Often, a primary or sub-servicer is an affiliate of the asset originator who maintains direct contact with the borrower. Due to this relationship, the master servicer often sub-contracts certain responsibilities (e.g., monthly cash remittance handling) to the primary servicer, and the parties enter into a sub-servicing agreement. This agreement typically mirrors the provisions under the servicing agreement (i.e., the agreement between the master servicer and the trust), thereby limiting the primary servicer's discretion and subjecting it to the same servicing standard as the master servicer.

A special servicer typically manages distressed or defaulted assets or other specified events (e.g., legal settlements). Special servicers generally specialize in certain types of distressed financial assets (e.g., commercial properties, residential real estate), many of which require a unique level of expertise.

While all servicers are generally responsible to mitigate the risk of default, a special servicer may specifically manage a default or foreclosure process, considering various options to maximize the recovery from the borrower (e.g., loan modifications, deed in lieu, negotiated payoff, foreclosure).

The compensation received for servicing generally is commensurate with the required level of involvement and, therefore, is typically different for the master servicer, primary or sub-servicer and the special servicer.

7.3 Initial recognition and measurement requirements

7.3.1 Initial recognition

Excerpt from Accounting Standards Codification

Transfers and Servicing – Servicing Assets and Liabilities

Recognition

General

860-50-25-1

An entity shall recognize a **servicing asset** or **servicing liability** each time it undertakes an obligation to service a **financial asset** by entering into a servicing contract in any of the following situations:

- a. A servicer's **transfer** of any of the following, if that transfer meets the requirements for sale accounting:
 1. An entire financial asset
 2. A group of entire financial assets
 3. A participating interest in an entire financial asset, in which circumstance the transferor shall recognize a servicing asset or a servicing liability only related to the participating interest sold.
- b. [Subparagraph superseded by Accounting Standards Update No. 2009-16]
- c. An acquisition or assumption of a servicing obligation that does not relate to financial assets of the servicer or its **consolidated affiliates** included in the financial statements being presented.

Example 1 (see paragraph 860-50-55-20) illustrates accounting for a sale of receivables with servicing obtained by the transferor.

860-50-25-3

A servicer that recognizes a servicing asset or servicing liability shall account for the contract to service financial assets separately from those financial assets.

While servicing is inherent in all financial assets, servicing assets and servicing liabilities are not themselves financial instruments; rather, they represent executory contracts. Separate recognition is required under ASC 860-50-25-1 and 25-3 when the servicing asset or servicing liability is contractually separated from the underlying financial assets and the underlying financial assets are excluded from the servicer's and its consolidated affiliates' financial statements.

7.3.1.1 Exception to the separate recognition of a servicing right principle

ASC 860-50-25-4 provides an exception to the general principle regarding when a servicing right should be recognized and states that in a transfer that qualifies as a sale in which the transferor obtains the resulting securities and classifies them as debt securities held to maturity in accordance with ASC 320, the servicing asset/liability may be either separately recognized or reported together with the asset being serviced. We believe that this exception may be applied only if the transferor takes back all of the resulting securities.

7.3.1.2 Transactions that prohibit the separate recognition of a servicing asset or servicing liability

Under ASC 860-50-25-2, no servicing asset or servicing liability should be recognized when a servicer transfers financial assets in a transaction that does not meet the requirements for sale accounting (i.e., the transfer is accounted for as a secured borrowing with the underlying financial assets remaining on the transferor's balance sheet).

7.3.2 Initial measurement

Excerpt from Accounting Standards Codification

Transfers and Servicing – Servicing Assets and Liabilities

Initial Measurement

General

860-50-30-1

An entity shall initially measure at fair value, a **servicing asset** or **servicing liability** that qualifies for separate recognition regardless of whether explicit consideration was exchanged.

860-50-30-2

Typically, the **benefits of servicing** are expected to be more than **adequate compensation** to a servicer for performing the servicing, and the contract results in a servicing asset. However, if the benefits of servicing are not expected to adequately compensate a servicer for performing the servicing, the contract results in a servicing liability. Paragraph 860-50-35-1A states that a servicing asset may become a servicing liability, or vice versa, if circumstances change. The initial measure for servicing may be zero if the benefits of servicing are just adequate to compensate the servicer for its servicing responsibilities. A servicing contract that entitles the servicer to receive benefits of servicing just equal to adequate compensation, regardless of the servicer's own servicing costs, does not result in recognizing a servicing asset or a servicing liability. A purchaser would neither pay nor receive payment to obtain the right to service for a rate just equal to adequate compensation.

860-50-30-3

The determination of whether the servicer is adequately compensated for servicing specified assets is based on the amount demanded by the marketplace, not the contractual amount to be paid to a replacement servicer. However, that contractual provision would be relevant for determining the amount of **contractually specified servicing fees**. Therefore, the amount that would be paid to a replacement servicer under the terms of the servicing contract can be more or less than adequate compensation.

860-50-30-4

Whether a servicing asset or servicing liability is recorded is a function of the marketplace, not the servicer's cost of servicing. For example, a loss shall not be recognized if a servicing fee that is equal to or greater than adequate compensation is to be received but the servicer's anticipated cost of servicing would exceed the fee.

In determining fair value, a servicer should evaluate whether the benefits of servicing obtained from the contract are greater or less than adequate compensation for performing the servicing. The benefits of servicing include the revenues from contractually specified servicing fees (e.g., a portion of the interest from the financial assets being serviced), late charges, and other ancillary sources of income to be received for performing servicing. Such other sources of income include rights to short-term investment proceeds earned from investing excess cash payments prior to their required distribution to investors or third-party beneficial interest holders – commonly known as “float.”

Excerpt from Accounting Standards Codification

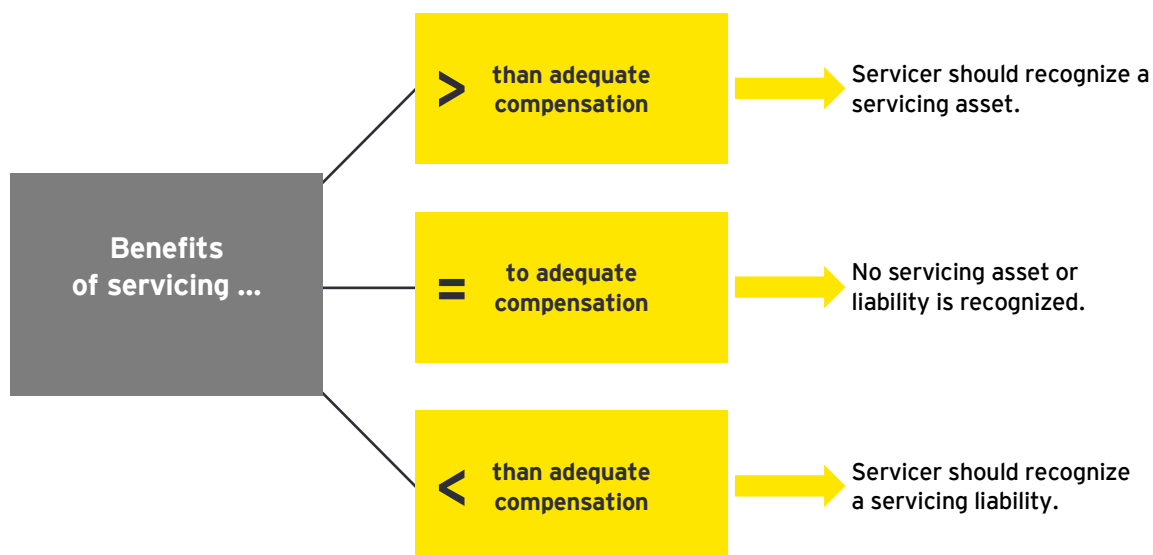
Glossary

860-50-20

Adequate Compensation

The amount of benefits of servicing that would fairly compensate a substitute servicer should one be required, which includes the profit that would be demanded in the marketplace. It is the amount demanded by the marketplace to perform the specific type of servicing. Adequate compensation is determined by the marketplace; it does not vary according to the specific servicing costs of the servicer.

If the benefits of servicing are greater than adequate compensation, the servicer should recognize a servicing asset and a servicing liability when the benefits are less than adequate compensation, even if no explicit consideration is exchanged for the servicing contract. If the benefits of servicing are equal to adequate compensation, no servicing asset or liability is recognized.



The determination of adequate compensation is a market notion and should be made independent of the entity's cost structure. A servicing asset or servicing liability is based upon the fair value of servicing, which is the amount that a servicer would pay to acquire (or transfer) in the market the rights to service. As a result, an inefficient servicer may recognize a servicing asset, even if its actual costs to service are higher than its level of compensation. Likewise, an efficient servicer may recognize a servicing liability, even if it can profitably perform the servicing below the contractually specified fee or adequate compensation, as defined.

The basis for determining adequate compensation should be well documented, and entities should ensure that their calculations of estimated fair value for their servicing assets and liabilities consider only the difference between the benefits of servicing and adequate compensation as determined by the marketplace. Considerations for estimating the value of servicing rights are discussed further in section 7.4.

7.3.3

Illustrations of initial recognition and measurement of servicing rights

To illustrate the initial recognition and measurement requirements for servicing contracts, consider the following examples.

Illustration 7-1: Initial recognition and measurement of a servicing asset

Assumptions: A servicer receives a 50 basis point fee for servicing transferred financial assets (which qualified for sale accounting) in accordance with the pooling and servicing agreement. The servicer has an internal servicing cost of 35 basis points. The market expectation to service this type financial asset is 30 basis points for the cost and 6 basis points of profit. (Note: For simplicity, in this example, the fair value of income from float and other ancillary income is considered to be nominal.)

Computation: The servicing asset would be calculated based on an excess of 14 basis points over adequate compensation. This amount represents the 50 basis point contractual servicing fee, less the sum of (a) the market expectation of the cost of servicing of 30 basis points and (b) the market expectation of profit for servicing this particular type of financial asset of 6 basis points. The servicer's internal servicing cost is irrelevant to determining the existence of a servicing asset or liability.

Illustration 7-1(a): Initial recognition and measurement of a servicing liability

Assumption: Same as Illustration 7-1 above, except the market expectation of the cost of servicing is 40 basis points and the market expectation of profit for servicing is 12 basis points.

Computation: A servicing liability based on 2 basis points under adequate compensation would be recognized, even though the transferor's internal cost of servicing is only 35 basis points. This amount represents the 50 basis point contractual servicing fee, less the sum of (a) the market expectation of the cost of servicing of 40 basis points and (b) the market expectation of profit for servicing this particular type of financial asset of 12 basis points.

Illustration 7-1(b): Servicing contracts that result in the initial recognition of an asset, even if considered burdensome to the servicer

Assumption: Same as Illustration 7-1 above, except the internal cost of servicing is higher than the contractual servicing fees, but the market expectation for the cost of servicing and profit are lower.

Computation: While the transferor would experience negative cash flows under the servicing agreement, it still would recognize a servicing asset. Fair value represents what the market would pay or charge to assume servicing. As such, any difference between the servicer's internal costs and the costs assumed by the marketplace are not considered in the fair value of the asset or liability but instead recognized over time as the financial assets are serviced, whether they represent relative efficiencies or inefficiencies. That is, the actual costs of servicing and the fees earned including changes in the fair value (or amortized cost) of the servicing asset or liability are recognized as they occur through the income statement.

7.3.4

Distinguishing servicing from an interest-only strip**Excerpt from Accounting Standards Codification****Transfers and Servicing – Servicing Assets and Liabilities****Recognition*****Distinguishing Servicing from an Interest-Only Strip*****860-50-25-6**

A servicer shall account separately for rights to future interest income from the serviced assets that exceed **contractually specified servicing fees**. Those rights are not servicing assets; they are financial assets, effectively interest-only strips to be accounted for in accordance with paragraph 860-20-35-2.

860-50-25-7

Whether a right to future interest income from serviced assets should be accounted for as an interest-only strip, a servicing asset, or a combination thereof, depends on whether a servicer would continue to receive that amount (that is, the value of the right to future interest income) if a substitute servicer began servicing the assets. Therefore, any portion of the right to future interest income from the serviced assets that would continue to be received even if the servicing were shifted to another servicer would be reported separately as a financial asset in accordance with paragraph 860-20-35-2. For guidance on why an interest-only strip precludes a portion of a financial asset from meeting the definition of a participating interest, see paragraph 860-10-55-17K.

860-50-25-8

The value of the right to receive future cash flows from ancillary sources such as late fees shall be included in the measurement of the servicing asset, not the interest-only strip, if retention of the right to receive the cash flows from those fees depends on servicing being performed satisfactorily, as is generally the case.

In all cases, an entity should differentiate the contractual benefits of servicing (i.e., the amounts that will be received specifically for servicing activities) from other forms of consideration retained after the transfer. In other words, any rights to future income from the transferred financial asset that are not dependent on the transferor performing servicing activities are beneficial interests. In many cases, they will represent interest-only strips that are recognized and measured in accordance with ASC 815, *Derivatives and Hedging*, or ASC 320-10, *Investments – Debt Securities – Overall*. Interest-only strips obtained in securitizations, which do not depend on servicing, may be subsequently measured differently from the related contractual servicing rights. For example, the transferor may elect to subsequently measure a servicing right under the amortization method while the related interest-only strip will be remeasured at fair value.

7.3.5 “Adequate” versus “excess” servicing and their effect on transfers of financial assets

Any portion of a servicing benefit that is significantly higher than adequate compensation is referred to as “excess” servicing and could affect the accounting for transfers involving portions of an entire financial asset. Refer to section 2.3.1 for additional guidance.

For transfers involving an entire financial asset or groups of entire financial assets, the existence of an excess servicing benefit does not alter the initial or subsequent measurement requirements of the contractual servicing asset because the “excessive” portion of a servicing right, which comes from a single contract, generally cannot be separately sold after the sale or securitization of the underlying financial assets. The excess servicing portion, like normal servicing, will be collected only if the servicing work is performed satisfactorily. While excess servicing economically resembles an interest-only strip in some respects, the FASB concluded that accounting based on that distinction is unduly complex and would often result in several assets and liabilities being recognized for one servicing contract.

7.4 Fair value considerations

7.4.1 Observable and non-observable inputs and assumptions

When determining the fair value of a servicing contract, the servicer must consider all relevant valuation assumptions and inputs. Quoted prices in active markets are the best evidence of fair value and they should be used as the basis of measurement, if available. However, quoted market prices typically are not available for servicing contracts. In these instances, use of a valuation technique, such as a discounted cash flow model or an option-pricing model (which incorporates present value techniques), will be required in estimating the fair value.⁷⁰ To the extent possible, observable inputs should be used in the valuation model. However, certain inputs, such as prepayment risk and industry or third-party costs to service, may be unobservable and therefore need to be estimated.

The valuation of a servicing contract should consider the estimated timing and amount of contractual benefits the servicer will receive during the life of the servicing arrangement. This valuation should also consider the market expectation of the cost of servicing and the market expectation of profit for servicing the particular type of financial asset, all discounted at an appropriate rate. Essentially, the fair value of a servicing contract represents the period over which market participants expect to earn a return which is in excess of or below adequate compensation. Because the timing and amount of future cash flows are in most cases uncertain, the fair value measurement should include a risk premium reflecting the amount market participants would demand as compensation for bearing the uncertainty in the cash flows. This risk premium could be included in either the expected cash flows directly or captured through the use of a risk-adjusted discount rate.

⁷⁰ Refer to our FRD, *Fair value measurement*, for further discussion on the valuation techniques utilized for fair value measurement purposes.

Any valuation technique should incorporate market participant expectations about future cash flows and costs associated with servicing the financial assets, including the required profit margin. For example, it would not be appropriate for a servicer to estimate the fair value of a servicing asset based on the present value of the projected difference between the contractual servicing cash flows and the servicer's own costs plus a market-based profit margin over the life of the financial assets being serviced. However, that approach would be acceptable if the servicer also supports that its cost assumption is consistent with the cost assumption that would be used by other market participants. Servicers may want to consider obtaining a third-party valuation of their servicing assets and liabilities to support their fair value measurements, particularly when limited market participant data is available. The valuation technique used to estimate the fair value of servicing rights would also incorporate market participant assumptions about interest rates, default rates and prepayment speeds, among other considerations. Estimates of the expected cash inflows that will be received by the servicer may also be affected by other provisions such as ancillary fees (ancillary fees are discussed below).

The following table identifies and discusses specific examples of common valuation inputs used in estimating the fair value of a servicing contract:

| Input considerations | Potential effect on fair value |
|-------------------------|---|
| Servicing fee | All contractual amounts that are due to the servicer in exchange for servicing the financial asset that would no longer be received by a servicer if the beneficial owners of the serviced assets (or their trustees or agents) were to exercise their actual or potential authority under the contract to shift the servicing to another servicer. |
| Prepayment speed | Prepayment speed represents the rate at which underlying asset prepayments are expected to occur. Estimating prepayment speed is highly subjective and requires consideration of various factors, including geographical characteristics, average loan balances, credit quality of the portfolio, and interest rates (i.e., fixed or floating), among other considerations. Changes in estimated prepayment speeds have a direct and inverse effect on the fair value of servicing contracts. That is, an increase in expected prepayment speed (that might result from an expected decrease in interest rates) decreases the future cash flows and fair value, while a decrease in expected prepayment speed (that might result from an expected increase in interest rates) would increase the future cash flows and fair value of the servicing asset. |
| Discount rates | Discount rates are used for discounting future cash inflows and outflows associated with the servicing contract. Assuming that the cash flows capture the effect of uncertainty associated with prepayment speeds, interest rates and other elements of risk, the discount rates are generally comprised of two components – a risk-free rate and a risk premium. The risk-free rate varies with changes in interest rates irrespective of changes in risks associated with the underlying assets or service contract. The risk premium contemplates the underlying risks of a servicing contract. For example, a greater expected variability of prepayment speeds would result in a market participant demanding a higher risk premium as compensation for the increased uncertainty regarding the period of time over which they will earn compensation. Conversely, lower expected variability of prepayment speeds would result in a market participant demanding a lower risk premium. Other factors that affect the risk premium include, but are not limited to, the nature and uncertainties associated with the underlying assets, geography and availability of recourse. |

| Input considerations | Potential effect on fair value |
|--|--|
| Cost of servicing | <p>While not entity specific, a market participant's expected cost to service the underlying financial assets is a factor in determining the fair value of a servicing contract. If market participants view the operational costs of servicing (e.g., postage, labor, data management, computing costs) have risen or fallen such expectations would be included in the determination of fair value.</p> <p>The type of financial assets serviced is an important consideration when estimating fair value. The types of assets being serviced affect the amount required to adequately compensate the servicer. For example, the amount of effort required to service a home equity loan likely would be different from the amount of effort required to service a credit card receivable or a small business administration loan.</p> |
| Delinquency and default rates | <p>Default rate assumption represents the rate at which underlying financial assets are expected to default. Assumptions regarding default rate should reflect a market participant expectation of defaults associated with a given type of financial asset.</p> |
| Float income | <p>The rights to short-term investment proceeds earned from investing excess cash payments prior to their required distribution to investors or third-party beneficial interest holders. The benefit of the float accrues to the servicer through interest earned or a reduction of its cost of funds. The value of a right to potential future cash flows derived from the float should be factored into the estimated fair value of a servicing contract because such benefits directly affect the fair value of the servicing rights. However, like all other inputs and assumptions, such factors should be based on a market participant's expectations.</p> |
| Ancillary income | <p>Examples of items that generate ancillary income for servicers include earnings resulting from temporarily investing cash received from underlying loan holders (e.g., principal and interest payments) before the cash is paid to the eventual recipients (e.g., beneficial interest holders), late fee income, telephone payment fees and returned check fees. Therefore, the expected amount of these cash flows directly impacts the fair value of the servicing contract.</p> |
| Transfer and cancellation of servicing contract | <p>Consider whether the servicing contract is transferable and any cancellation and expiration provisions, including whether the contract may be cancelled at will or expires prior to the maturity or expected prepayment date of the underlying portfolio of assets. These types of contractual provisions may significantly affect the fair value of a servicing contract.</p> |

7.4.2

Consistent use of fair value measurement techniques

Valuation techniques should be consistently applied from period to period. However, if a change in the valuation technique (or a change in the relative importance of one technique versus another) results in a more representative fair value measurement estimate, such changes should be implemented, and the effect of such a change should be accounted for as a change in accounting estimate in accordance with ASC 250, *Accounting Changes and Error Corrections*. When multiple valuation techniques are used, the merits of each valuation technique and the underlying assumptions embedded in each of the techniques should be considered in evaluating and assessing the results.

Servicers often use cash flow models to estimate the fair value of servicing assets and liabilities because quoted market prices, or observable market inputs for the valuation model, may not be available. While this is common practice, it is important to consider whether the approach and assumptions used in such models and valuation techniques are appropriate and consistent with those that a market participant would use.

Some servicers may consider obtaining the assistance of a third-party valuation specialist to estimate the fair value of its servicing rights. The use of a third-party valuation specialist does not reduce management's ultimate responsibility for the fair value measurements (and related disclosures) in the entity's financial statements. Management must understand the assumptions used in the valuations, including those performed in accordance with the USPAP,⁷¹ and determine whether the assumptions are consistent with ASC 820, *Fair Value Measurement*. That is, management may determine that an adjustment to the third-party specialist's valuation may be necessary to comply with the provisions of ASC 820. Entities must also ensure that the appraisal process and report are consistent with the requirements of ASC 820. This may require consideration of, but is not limited to, each of the following:

- ▶ Whether the principal or most advantageous market has been appropriately considered
- ▶ Whether appropriate market participants (or characteristics of market participants) have been identified
- ▶ Whether the assumptions market participants would utilize in pricing the asset have been used
- ▶ Whether adjustments to market data are based on observable or unobservable inputs and whether such adjustments are significant to the overall fair value measure
- ▶ Whether appropriate valuation approaches and techniques have been utilized

In the absence of an independent third-party appraisal, an entity may corroborate the reasonableness of its servicing assets' and servicing liabilities' fair value estimates and related processes, by periodically performing each of the following:

- ▶ Analyzing and comparing its own fair value estimates, including model inputs (e.g., discount rates, default rates, prepayment speeds, servicing costs), to market data which may be available through external surveys, broker quotes or trading/acquisition activity in the marketplace
- ▶ Reconciling actual monthly cash flows to the cash flow projections made by the valuation model to validate and calibrate the model

Refer to our FRD, *Fair value measurement*, for further guidance.

See Question 7-6 for additional interpretive guidance.

7.5

Subsequent measurement election

Excerpt from Accounting Standards Codification

Transfers and Servicing – Servicing Assets and Liabilities

Subsequent Measurement

General

860-50-35-1

An entity shall subsequently measure each class of **servicing assets** and **servicing liabilities** using either of the following methods:

- a. Amortization method. Amortize servicing assets or servicing liabilities in proportion to and over the period of estimated net servicing income (if servicing revenues exceed servicing costs) or net servicing loss (if servicing costs exceed servicing revenues), and assess servicing assets or servicing liabilities for impairment or increased obligation based on fair value at each reporting date.

⁷¹ The Uniform Standards of Professional Appraisal Practice (USPAP) are the generally accepted standards for professional appraisal practice in North America in valuing real estate, personal property and businesses. An assessment of the appraisal should be performed to determine that the appraised value is an appropriate measure of fair value for financial reporting purposes (i.e., the appraisal has been performed in accordance with the principles of ASC 820).

- b. Fair value measurement method. Measure servicing assets or servicing liabilities at fair value at each reporting date and report changes in fair value of servicing assets and servicing liabilities in earnings in the period in which the changes occur.

860-50-35-2

The election described in paragraphs 860-50-35-1 through 35-5 shall be made separately for each class of servicing assets and servicing liabilities.

860-50-35-3

The following guidance applies to the election of a method for subsequent measurement of servicing assets and servicing liabilities:

- a. Once an entity elects the fair value measurement method for a class of servicing assets and servicing liabilities, that election shall not be reversed.
- b. Different elections can be made for different classes of servicing assets and servicing liabilities.
- c. Once a servicing asset or a servicing liability is reported in a class of servicing assets and servicing liabilities that an entity elects to subsequently measure at fair value, that servicing asset or servicing liability shall not be placed in a class of servicing assets and servicing liabilities that is subsequently measured using the amortization method.
- d. An entity may make an irrevocable decision to subsequently measure a class of servicing assets and servicing liabilities at fair value at the beginning of any fiscal year.
- e. Transferring servicing assets and servicing liabilities from a class subsequently measured using the amortization method to a class subsequently measured at fair value is permitted as of the beginning of any fiscal year. If an entity makes such a **transfer**, subsequent measurement of servicing assets and servicing liabilities at fair value shall be applied prospectively with a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year to reflect the difference between the fair value and the carrying amount, net of any related valuation allowance, of the servicing assets and servicing liabilities that exist at the beginning of the fiscal year in which the entity makes the fair value election.
- f. If an entity recognizes a new class of servicing assets and servicing liabilities, and no servicing assets and servicing liabilities that would belong to this class had previously been recognized by the entity, the entity may elect to subsequently measure that new class of servicing assets and servicing liabilities at fair value at the date of initial recognition of those servicing assets and servicing liabilities.

860-50-35-4

An entity shall apply the same subsequent measurement method to each servicing asset and servicing liability in a class.

Identifying classes of servicing assets and servicing liabilities

Excerpt from Accounting Standards Codification

Transfers and Servicing – Servicing Assets and Liabilities

Subsequent Measurement

General

860-50-35-5

Classes of servicing assets and servicing liabilities shall be identified based on any of the following:

- a. The availability of market inputs used in determining the fair value of servicing assets or servicing liabilities
- b. An entity's method for managing the risks of its servicing assets or servicing liabilities.

860-50-35-6

Under the approach in the preceding paragraph, a servicer may or may not consider the major asset type of the underlying **financial asset** being serviced when identifying its classes of separately recognized servicing assets and servicing liabilities. Further, this approach for defining classes of servicing assets and servicing liabilities is not analogous to the stratification guidance for determining impairment of servicing assets or servicing liabilities that are subsequently measured using the amortization method.

7.5.1

Fair value measurement method

Under the fair value measurement method, classes of servicing assets or servicing liabilities are subsequently measured at fair value each reporting date with changes in fair value recognized in earnings. The fair value measurement method simplifies the accounting because the fair value of derivatives used to economically hedge the servicing assets and servicing liabilities can be currently recognized in earnings without having to apply hedge accounting.

At the beginning of any fiscal year, an entity may make an irrevocable decision to subsequently measure a specific class of servicing assets or servicing liabilities at fair value with changes in fair value reported in earnings. That decision does not affect the subsequent accounting measurement decisions of other classes of servicing assets and servicing liabilities. That is, the fair value election may be made on a class-by-class basis. If an entity elects to subsequently measure a class at fair value, that subsequent measurement policy may not change. That is, a servicer may elect to change from the amortization method to the fair value method, but it may not change from the fair value method to the amortization method.

Illustration 7-2: Measurement policy

An entity may have identified two different classes of recognized servicing assets and servicing liabilities (Class A and Class B) for which it previously applied the amortization policy for subsequent measurement. On the first day of its fiscal year, the entity can elect to subsequently measure Class A at fair value. Class B can continue to be measured using the amortization method. The fair value election for Class A is now irrevocable. The entity can still change its subsequent measurement policy for Class B to fair value as of the first day of any subsequent fiscal year. However, if and when that election is made, it would also be irrevocable.

7.5.2 Amortization method

Under the amortization method, classes of servicing assets or servicing liabilities are amortized through earnings in proportion to, and over the period of, estimated net servicing income for servicing assets or the period of estimated net servicing loss for servicing liabilities. In addition, under this method, each class of servicing assets or servicing liabilities is evaluated for impairment or increased obligation based on fair value at each reporting date.

7.5.2.1 Impairment analysis

Excerpt from Accounting Standards Codification

Transfers and Servicing – Servicing Assets and Liabilities

Subsequent Measurement

General

860-50-35-7

An entity shall first identify its classes of separately recognized servicing assets and servicing liabilities under the approach in paragraph 860-50-35-5. For any class subsequently measured using the amortization method, an entity shall then stratify that class to determine if impairment has occurred, as discussed in paragraph 860-50-35-9(a).

860-50-35-9

An entity shall evaluate and measure impairment of each class of separately recognized servicing assets that are subsequently measured using the amortization method described in paragraph 860-50-35-1(a) as follows:

- a. Stratify servicing assets within a class based on one or more of the predominant risk characteristics of the underlying financial assets. Those characteristics may include financial asset type, size, interest rate, date of origination, term, and geographic location. For mortgage loans, financial asset type refers to the various conventional or government guaranteed or insured mortgage loans and adjustable-rate or fixed-rate mortgage loans.
- b. Recognize impairment through a valuation allowance for an individual stratum. The amount of impairment recognized separately shall be the amount by which the carrying amount of servicing assets for a stratum exceeds their fair value. The fair value of servicing assets that have not been recognized shall not be used in the evaluation of impairment.
- c. Adjust the valuation allowance to reflect changes in the measurement of impairment after the initial measurement of impairment. Fair value in excess of the carrying amount of servicing assets for that stratum, however, shall not be recognized.

860-50-35-10

This Subtopic does not address when an entity should record a direct write-down of recognized servicing assets.

860-50-35-11

For servicing liabilities subsequently measured using the amortization method, if subsequent events have increased the fair value of the liability above the carrying amount, for example, because of significant changes in the amount or timing of actual or expected future cash flows relative to the cash flows previously projected, the servicer shall revise its earlier estimates and recognize the increased obligation as a loss in earnings. That is, if subsequent events increase the fair value of a stratum of servicing liabilities within a class that an entity has elected to subsequently measure using the amortization method, that increase shall be recognized in earnings as a loss. Similar to the accounting for changes in a valuation allowance for an impaired asset, increases in the servicing obligation may be recovered, but the obligation shall not be reduced below the amortized measurement of the initially recognized servicing liability.

860-50-35-12

The impairment provisions of paragraphs 860-50-35-9 and 860-50-35-11 for classes of servicing assets and servicing liabilities subsequently measured using the amortization method are based on the fair value of the contract rather than the gain or loss from subsequently carrying out the terms of the contract.

860-50-35-13

An entity is not required to use either the most predominant risk characteristic or more than one predominant risk characteristic to stratify the servicing assets for purposes of evaluating and measuring impairment. An entity must exercise judgment when determining how to stratify servicing assets (that is, when selecting the most appropriate characteristic[s] for stratification). An entity may use different stratification criteria for the purposes of impairment testing under this Subtopic and for the purposes of grouping similar assets to be designated as a hedged portfolio in a fair value hedge under Subtopic 815-20. If an entity chooses not to restratify servicing assets for impairment testing under this Subtopic consistent with any restratification done for compliance with hedging criteria under Subtopic 815-20, the entity shall record any adjustments resulting from a fair value hedge to the risk strata used for impairment testing under paragraph 860-50-35-9.

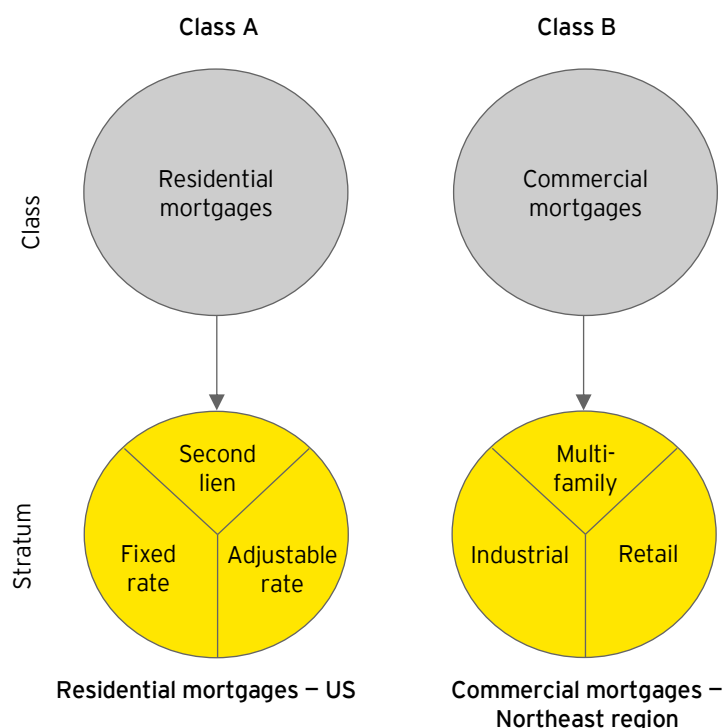
860-50-35-14

Once an entity has determined the predominant risk characteristics to be used in identifying the resulting strata within each class of servicing assets subsequently measured using the amortization method, that decision shall be applied consistently unless significant changes in economic facts and circumstances clearly indicate that the predominant risk characteristics and resulting strata should be changed. If a significant change in economic facts and circumstances occurs, that change shall be accounted for prospectively as a change in accounting estimate in accordance with paragraphs 250-10-45-17 through 45-19 and 250-10-50-4.

Any impairment or increased servicing obligation (when applicable) should be recognized through a valuation allowance (or an increase in the servicing liability) for each individual stratum identified and analyzed. The amount of impairment recognized should be the amount by which the carrying amount of servicing assets for a stratum exceeds the fair value of that stratum. For servicing liabilities, the amount by which the estimated fair value of that stratum exceeds the corresponding carrying value would result in an increase to the existing liability.

The fair value of servicing assets not eligible for separate recognition should not be used in the evaluation of impairment. Stated another way, when evaluating each stratum for impairment (or increased obligation), similar but unrecognized servicing assets (or servicing liabilities) are not considered in the analysis of each recognized stratum of servicing asset or servicing liabilities. Similarly, it would not be appropriate to defer recognition of impairment in one recognized stratum by considering the unrealized appreciation in other recognized strata. The impairment analysis should be performed on an individual stratum basis with consideration only of recognized servicing assets and liabilities, with no offsetting of gains and losses across strata.

The relationship between a class of servicing assets and a related stratum(s) can be illustrated as follows:



ASC 860 does not prescribe specific guidance on how a class of servicing assets or servicing liabilities or related stratum(s) should be identified, but it does provide general guidelines (see ASC 860-50-35-5 and 35-9). In practice, we observe that stratum(s) generally are segregated and separately identified beyond the levels illustrated above.

For example, assume an entity originates residential mortgage loans all over the United States, with both fixed and floating interest rates. The entity securitizes its loan originations every six months and typically retains servicing contracts that provide more than adequate compensation. After the initial recognition of servicing assets, the entity elects the amortization method for subsequent accounting.

In this example, the servicing class may be broadly defined as all residential mortgages originated in the United States. One possible stratum within that class of servicing contracts may be for fixed mortgages originated in a specific region during a particular period (e.g., all residential mortgages originated in California in June 2010).

7.5.2.2

Valuation allowance versus write-downs

Recognized impairments of servicing assets should be recorded in a valuation allowance and adjusted for subsequent impairments. As noted in ASC 860-50-35-10, US GAAP does not address when a direct write-down (rather than through a valuation allowance) of impaired servicing assets should be recognized. Therefore, we believe, a direct write-down of the servicing asset is a matter of accounting policy that should be disclosed in the reporting entity's significant accounting policies disclosures. An example of such a policy follows:

"As noted above, the Company elects to subsequently measure certain mortgage servicing rights under the amortization method. These servicing rights are assessed for impairment on a quarterly basis with any impairment recorded in a related mortgage servicing asset valuation account. The Company also quarterly reviews such impaired mortgage servicing rights to determine if a further impairment is necessary. Any subsequent impairments are also recorded to the valuation account. However, if circumstances indicate that the likelihood of future recovery of the impaired assets is remote, the Company will directly write-down such assets and relieve the valuation account."

7.5.2.3

Examples illustrating servicing assets subsequently measured under the amortization method and tested for impairment**Illustration 7-3: Application of the amortization requirement**

Company ABC holds a portfolio of acquired residential mortgage servicing rights, which the company has elected to subsequently measure under the amortization method in accordance with ASC 860-50-35-1(a).

A portion of the servicing portfolio consists of adjustable rate subprime residential mortgages that have the following specifications:

- ▶ Total undiscounted net servicing income is estimated to be \$52,000.
- ▶ The initial fair value recorded for the servicing asset is \$45,000.

The undiscounted net servicing income to be received in years one through four is estimated at \$2,000, \$1,980, \$1,920 and \$1,800, respectively. For simplicity, only the first four years are shown; the total net undiscounted income of \$52,000 includes all years comprising the weighted-average term of the loan pool.

The amortization amounts to be recorded in years one through four would be as follows:

| | (I) | (II) | (III) | (IV) | (V) | (VI) | (VII) |
|--|-----------------------------------|--|---|--------------------------------------|--|------------------------------------|-------------------------------------|
| Year | Undiscounted net servicing income | Cumulative undiscounted net servicing income | Current period amortization expense percentage* | Cumulative amortization percentage* | Current period amortization expense | Cumulative amortization expense | Servicing asset carrying value |
| | | (II) prior year + (I) current year | (I)/\$52,000 ^A | (IV) prior year + (III) current year | (III) current year * (VII) initial value | (VI) prior year + (V) current year | (VII) prior year – (V) current year |
| Initial value (Period ending 31 December 2010) | | | | | | | \$ 45,000 |
| 2011 | \$ 2,000 | \$ 2,000 | 3.85% | 3.85% | \$ 1,731 | \$ 1,731 | 43,269 |
| 2012 | 1,980 | 3,980 | 3.81% | 7.65% | 1,713 | 3,444 | 41,556 |
| 2013 | 1,920 | 5,900 | 3.69% | 11.35% | 1,662 | 5,106 | 39,894 |
| 2014 | 1,800 | 7,700 | 3.46% | 14.81% | 1,558 | 6,663 | 38,337 |

^A Total estimated undiscounted net servicing income

* Differences due to rounding

Note: Companies often determine the amount of the servicing asset (liability) to be amortized during a given period by calculating the undiscounted net servicing income (loss) for the period, divided by the total estimated undiscounted net servicing income (loss). The resulting percentage represents the amount of the originally recorded servicing asset (liability) to be amortized during the period. For this purpose, the same estimated undiscounted cash flows used in the fair value calculation should be used. The aforementioned methodology is only one example of an amortization method. Other methods may be appropriate.

Importantly, a company would need to update its net undiscounted servicing revenues every reporting period and test for impairment.

Illustration 7-3(a): Application of the impairment provisions to servicing assets (liabilities) measured at amortized cost

This example builds on the assumptions in Illustration 7-3.

For purposes of measuring impairment (the excess of amortized cost of an individual stratum over its estimated fair value), Company ABC stratifies its mortgage servicing rights (MSR) based on the predominant risk characteristics of the underlying serviced loans, as follows:

- ▶ **Stratum A** – Fixed rate conventional residential mortgage loans originated in the mid-Atlantic region of the US with an average expected life of 11 years.
- ▶ **Stratum B** – Adjustable rate subprime residential mortgage loans originated in the southwest region of the US with an average expected life of 9 years.
- ▶ **Stratum C** – Hybrid-adjustable rate residential mortgage loans originated in the northeast region of the US with an average expected life of 7 years.

At 31 December 2012, Company ABC determines the MSR impairment to be \$3,556, calculated as follows:

| | Stratum A | Stratum B | Stratum C | Total |
|---|-----------|------------------------|------------|------------|
| Amortized carrying value | \$ 63,912 | \$ 41,556 ¹ | \$ 176,253 | \$ 281,721 |
| Estimated fair value | 65,300 | 38,000 | 180,700 | 284,000 |
| Fair value in excess (below) amortized carrying value | 1,388 | (3,556) | 4,447 | 2,279 |
| Required valuation allowance (or write-off) | 0 | (3,556) | 0 | (3,556) |

¹ Amortized carrying value as shown in Illustration 7-3

A valuation allowance (or write-off) is required for Stratum B because the fair value of the servicing asset is below its amortized carrying value. Importantly, even though the aggregate fair value of all MSRs exceeds their aggregate amortized carrying value, the unrecognized excess of fair value over carrying value attributed to Stratum A and C cannot be used to offset the deficit (impairment) in Stratum B (see ASC 860-50-35-9(b)).

If Company ABC believes that the likelihood of future recovery of Stratum B's amortized carrying value is more than remote, it will establish a valuation allowance of \$3,556 and continue to recognize amortization expense based on the computations shown in the table in Illustration 7-3. However, if Company ABC determines the likelihood for recovery is remote, they would directly write down the servicing asset and recalculate the amortization schedule for the stratum's adjusted carrying value based on the revised estimated undiscounted net servicing income.

| | (I) | (II) | (III) | (IV) | (V) | (VI) | (VII) |
|--|-----------------------------------|--|---|--------------------------------------|--|------------------------------------|-------------------------------------|
| Year | Undiscounted net servicing income | Cumulative undiscounted net servicing income | Current period amortization expense percentage* | Cumulative amortization percentage* | Current period amortization expense | Cumulative amortization expense | Servicing asset carrying value |
| | | (II) prior year + (I) current year | (I)/\$47,600 ^A | (IV) prior year + (III) current year | (III) current year * (VII) adjusted carrying value | (VI) prior year + (V) current year | (VII) prior year – (V) current year |
| Adjusted carrying value (at 31 December 2012) | | | | | | | \$ 38,000 |
| 2013 | \$ 1,757 | \$ 1,757 | 3.69% | 3.69% | \$ 1,403 | \$ 1,403 | 36,597 |
| 2014 | 1,647 | 3,404 | 3.46% | 7.15% | 1,315 | 2,717 | 35,283 |

^A Revised total estimated undiscounted net servicing income

* Differences due to rounding

The following entry would be recorded by Company ABC if the likelihood of recovery of the amortized carrying value of the MSR is considered more than remote:

| | Debit | Credit |
|----------------------------|----------|----------|
| 31 December 2012 | | |
| Provision for impaired MSR | \$ 3,556 | |
| Valuation allowance | | \$ 3,556 |

Note: To establish a valuation allowance for impaired MSRs for which likelihood of recovery is more than remote

Additionally, the following amortization expense would be recorded by Company ABC if the likelihood of recovery of the amortized carrying value of the MSR is considered more than remote:

| | Debit | Credit |
|------------------------------------|----------|----------|
| Year ended 31 December 2013 | | |
| Amortization expense | \$ 1,662 | |
| Accumulated amortization | | \$ 1,662 |

The following entry would be recorded by Company ABC if the likelihood of recovery of the amortized carrying value of the MSR is considered remote:

| | | |
|-----------------------------------|----------|----------|
| 31 December 2012 | | |
| MSR charge-off | \$ 3,556 | |
| Mortgage servicing rights (asset) | | \$ 3,556 |

Note: To reduce the carrying value of the MSR as a result of an impairment for which the likelihood of recovery is remote

Additionally, the following amortization expense would be recorded by Company ABC if the likelihood of recovery of the amortized carrying value of the MSR is considered remote:

| | | |
|------------------------------------|----------|----------|
| Year ended 31 December 2013 | | |
| Amortization expense | \$ 1,403 | |
| Accumulated amortization | | \$ 1,403 |

7.5.2.4

Obligation to service refinanced mortgage loans

ASC 860-50-35-17 and 35-18 provide further guidance regarding subsequent measurement for costs relating to acquiring the mortgage servicing asset and considerations for refinancing.

Excerpt from Accounting Standards Codification

Transfers and Servicing – Servicing Assets and Liabilities

Subsequent Measurement

Obligation to Service Refinanced Mortgage Loans

860-50-35-17

When an entity that is servicing mortgage loans refinances a mortgage loan that is being serviced (resulting in prepayment of the old mortgage loan and origination of a new mortgage loan), the entity shall not consider the estimated future net servicing income (that is, servicing revenue in excess of servicing costs) from the new mortgage loan in determining how to amortize any capitalized cost related to acquiring the mortgage servicing asset for the old mortgage loan. The mortgage servicing asset represents a contractual relationship between the servicer and the investor in the mortgage loan, not between the servicer and the borrower.

860-50-35-18

The cost of a mortgage servicing asset that is subsequently measured using the amortization method may require adjustment as a result of the refinancing transaction depending on the servicer's assumptions in recording the servicing asset. If the refinancing transaction represents prepayment activity anticipated by the servicer when the servicing asset was recorded, an adjustment would not be necessary. However, if actual prepayments differ from anticipated prepayments, an adjustment to the servicing asset would be required. If the servicing assets or liabilities are subsequently measured using the fair value measurement method, the entity shall recognize any adjustment as a result of the refinancing transaction directly in earnings.

See Questions 7-7 and 7-8 for additional interpretive guidance.

7.6**Presentation**

ASC 860-50-45-1 and 45-2 provides further guidance on other presentation matters as they relate to servicing assets and liabilities:

Excerpt from Accounting Standards Codification**Transfers and Servicing – Servicing Assets and Liabilities****Other Presentation Matters****General****860-50-45-1**

An entity shall report recognized **servicing assets** and **servicing liabilities** that are subsequently measured using the fair value measurement method in a manner that separates those carrying amounts on the face of the statement of financial position from the carrying amounts for separately recognized servicing assets and servicing liabilities that are subsequently measured using the amortization method.

860-50-45-2

To accomplish that separate reporting, an entity may do either of the following:

- a. Display separate line items for the amounts that are subsequently measured using the fair value measurement method and amounts that are subsequently measured using the amortization method^[72]
- b. Present the aggregate of those amounts that are subsequently measured at fair value and those amounts that are subsequently measured using the amortization method (see paragraphs 860-50-35-9 through 35-11) and disclose parenthetically the amount that is subsequently measured at fair value that is included in the aggregate amount.^[73]

Illustration 7-4: Separate line item reporting method in accordance with ASC 860-50-45-2(a)**Statement of Financial Position**

Servicing assets:

| | | |
|------------------------|----|-----|
| Measured at fair value | \$ | XXX |
| Amortized | | XXX |

⁷² EY note: See Illustration 7-4.

⁷³ EY note: See Illustration 7-5.

Illustration 7-5: Aggregate reporting method in accordance with ASC 860-50-45-2(b)**Statement of Financial Position**

| | |
|--|------------|
| Servicing assets (includes \$XXX measured at fair value) | \$ XXX |
|--|------------|

7.7**Illustration – Sale of receivables with servicing obtained****Illustration 7-6: Transfer of financial assets accounted for as a sale with proceeds of cash, a servicing asset and an interest-only strip**

The following example based on ASC 860-50-55-21, 55-22, 55-25 and 55-26 illustrates the initial accounting and recognition of a sale of financial assets that includes a servicing asset and an interest-only strip as part of the proceeds.

Entity A originates \$1,000 of loans that yield 10 percent interest income for their estimated lives of nine years. Entity A transfers the loans to an unconsolidated entity (accounted for as a sale) and receives as proceeds \$1,000 cash, a beneficial interest to receive 1 percent of the contractual interest on the loans (an interest-only strip receivable) and an additional 1 percent of the contractual interest as compensation for servicing the loans.

The fair values of the servicing asset and the interest-only strip receivable are \$40 and \$60, respectively.

Entity A's (transferor's) accounting for sale with the servicing obtained is illustrated below.

Fair Values

| | |
|--------------------------------|--------------|
| Cash proceeds | \$ 1,000 |
| Servicing asset | 40 |
| Interest-only strip receivable | 60 |

Net Proceeds

| | |
|--------------------------------|--------------|
| Cash proceeds | \$ 1,000 |
| Servicing asset | 40 |
| Interest-only strip receivable | 60 |
| Net proceeds | \$ 1,100 |

Gain on Sale

| | |
|-------------------------------------|--------------|
| Proceeds | \$ 1,100 |
| Less: Carrying amount of loans sold | 1,000 |
| Gain on sale | \$ 100 |

Journal Entry

| | Debit | Credit |
|--------------------------------|--------------|--------------|
| Cash | \$ 1,000 | |
| Interest-only strip receivable | 60 | |
| Servicing asset | 40 | |
| Loans | | \$ 1,000 |
| Gain on sale | | 100 |

Note: To record the transfer and to recognize interest-only strip receivable and servicing asset

In subsequent periods, the servicing asset will be amortized in proportion to, and over the period of estimated net servicing income and assessed for impairment based on fair value at each reporting date.

Illustration 7-6(a): Recognition of impairment on servicing assets subsequently measured using the amortization method

Assume the same fact pattern as in Illustration 7-6 and the following:

- ▶ In accordance with ASC 860-50-35-1, Entity A elects to subsequently measure the servicing asset using the amortization method.
- ▶ At the end of the current fiscal year, Entity A measures and recognizes a \$20 impairment relating to the servicing asset.

There are two different scenarios, based on whether the likelihood of recovery of the amortized carrying value of the MSR is considered remote or more than remote. For simplicity, the scenarios assume that the entire class is the unit of account measured for impairment.

- ▶ **Scenario 1:** Entity A concludes that the likelihood of recovery of the amortized carrying value is more than remote and decides to recognize impairment through a valuation allowance that would be adjusted for subsequent impairments, if any. The amount of impairment (\$20) recognized equals the excess of carrying amount over fair value of the servicing asset as of the measurement date. Entity A records an impairment through the following journal entry:

| | Debit | Credit |
|--|-------|--------|
| Impairment of servicing assets (expense) | \$ 20 | |
| Valuation allowance (contra asset) | | \$ 20 |

Additional accounting considerations:

In subsequent periods, if the fair value of the servicing asset increases, ASC 860-50-35-9(c) clarifies that a valuation allowance should be adjusted to reflect changes in the measurement of impairment after the initial measurement of impairment. Subsequent changes in fair value which are in excess of the carrying amount of servicing assets for that stratum, however, shall not be recognized (i.e., once the valuation allowance is eliminated for that stratum, no further increases in fair value are recognized).

In the case of servicing liabilities, ASC 860-50-35-11 clarifies that if subsequent events have increased the fair value of the liability above the carrying amount, for example, because of significant changes in the amount or timing of actual or expected future cash flows relative to the cash flows previously projected, the servicer should revise its earlier estimates and recognize the increased obligation as a loss in earnings. Similar to the accounting for changes in a valuation allowance for an impaired asset, increases in the servicing obligation may be recovered, but the obligation cannot be reduced below the amortized measurement of the initially recognized servicing liability.

For subsequent measurement purposes, servicing assets or servicing liabilities will need to be assessed for impairment or increased obligation, respectively, based on fair value at each reporting date.

- ▶ **Scenario 2:** Entity A concludes that the likelihood of recovery of the amortized carrying value is remote. Entity A has made an accounting policy election of recording a direct write down for any impaired servicing asset for which the likelihood of the recovery of the amortized carrying value of the MSR is remote. Following its accounting policy, the company writes down the impairment through earnings. The amount of impairment (\$20) recognized is the excess of the carrying amount over fair value of the servicing asset as of the measurement date. Entity A records impairment through the following journal entry:

| | Debit | Credit |
|--|-------|--------|
| Write-off of servicing asset (expense) | \$ 20 | |
| Servicing asset | | \$ 20 |

Additional accounting considerations:

For subsequent measurement purposes, the new carrying amount of the servicing asset should be used to assess (at each reporting date) if subsequent impairments are required.

7.8 Accounting for transfers of servicing assets and servicing liabilities

Servicers of financial assets may transfer their contractual rights and obligations to third-party servicers. Because servicing rights do not meet the definition of financial assets, the FASB developed alternative guidance for determining when it is appropriate to derecognize a servicing asset and servicing liability.

7.8.1 Conditions for sale accounting

Excerpt from Accounting Standards Codification

Transfers and Servicing – Servicing Assets and Liabilities

Derecognition

Overall

860-50-40-2

The following criteria shall be considered when evaluating whether a transfer of servicing rights qualifies as a sale:

- a. Whether the **transferor** has received written approval from the investor if required.
- b. Whether the **transferee** is a currently approved transferor-servicer and is not at risk of losing approved status.
- c. If the transferor finances a portion of the sales price, whether an adequate nonrefundable down payment has been received (necessary to demonstrate the transferee's commitment to pay the remaining sales price) and whether the note receivable from the transferee provides full **recourse** to the transferee. Nonrecourse notes or notes with limited recourse (such as to the servicing) do not satisfy this criterion.
- d. Temporary servicing performed by the transferor for a short period of time shall be compensated in accordance with a subservicing contract that provides **adequate compensation**.

860-50-40-3

Also, the following additional criteria shall be considered when evaluating whether a transfer of servicing rights qualifies as a sale:

- a. Title has passed.
- b. Substantially all risks and rewards of ownership have irrevocably passed to the buyer.
- c. Any **protection provisions** retained by the **seller** are minor and can be reasonably estimated.

860-50-40-4

If a sale is recognized and minor protection provisions exist, a liability shall be accrued for the estimated obligation associated with those provisions. The seller retains only minor protection provisions if both of the following conditions are met:

- a. The obligation associated with those provisions is estimated to be no more than 10 percent of the sales price.
- b. Risk of prepayment is retained for no longer than 120 days.

860-50-40-5

A temporary subservicing contract in which the subservicing will be performed by the transferor for a short period of time would not necessarily preclude recognizing a sale at the closing date.

860-50-40-6

The criteria in paragraphs 860-50-40-2 through 40-4 apply to transfers of servicing rights relating to loans previously sold and to transfers of servicing rights relating to loans that are retained by the transferor. The carrying amount of servicing rights sold relating to loans that have been retained shall be allocated at the date of sale between the servicing rights and the loans retained using relative fair values.

Some of these requirements are further discussed below.

7.8.1.1**Seller financing**

Occasionally a transferor (seller) finances a portion of the sales price for the transferee. Such an arrangement may preclude sale accounting for the transferred servicing rights if, as a result of the financing, substantially all of the risks and rewards of ownership have not irrevocably passed to the transferee. However, a financing arrangement that requires the transferee to make a substantive non-refundable down payment (i.e., sufficient to demonstrate the transferee's commitment to pay the remaining sales price) and provides the transferor full recourse to the transferee, would not, in itself, preclude sale accounting. For purposes of this analysis, we believe the following factors, among others, should be considered:

- ▶ The relationship between the transferor and the transferee
- ▶ The transferee's ability to repay the financing
- ▶ The transferor's intent to pursue collection if the transferee fails to repay the financing
- ▶ The magnitude of the down payment
- ▶ The terms of the financing (a shorter-term amortizing loan versus a longer-term non-amortizing loan) and the amount by which the fair value of the servicing could decline during the period
- ▶ Whether the amounts the seller stands to lose exceed any reasonably estimated costs of litigation or profits (or reduced loss) that may be realized from an alternative willing buyer (assuming other willing buyers exist in the marketplace)

7.8.1.2**Temporary sub-servicing**

In transfers of servicing rights, the transferor typically continues to temporarily service the underlying financial assets during the period that the parties enter into an agreement to sell servicing rights and the time the loan portfolio to be serviced is actually delivered (the transition period). Generally, the transition period is between three to six months and is necessary to accommodate the transferor's (seller's) inability to immediately transfer servicing records and loan files or the transferee's (buyer's) inability to immediately accept delivery. Other factors that typically delay transfer of servicing rights include difficulties in obtaining necessary investor approval and requirements to give advance notification to borrowers, among other considerations.

ASC 860-50-40-5 clarifies that sub-servicing performed by the transferor in accordance with a servicing right at a rate that provides adequate compensation during the transition period does not in itself preclude recognition of the transfer of servicing rights as a sale. Under those circumstances, assuming the sub-servicing is temporary, substantially all of the risks and rewards of ownership are still presumed to pass to the buyer if the other conditions for recognizing a transfer are met.

7.8.1.3 Minor protection provisions

Agreements to sell or transfer servicing rights may contain protection provisions that could affect the amount ultimately paid to the seller. For example, the seller may agree to adjust the sales price for loan prepayments, defaults or foreclosures that occur within a specified period of time. Most of the agreements also contain representation and warranty provisions covering eligibility defects discovered within specified time periods. If any minor protection provisions exist, a liability for such provisions should be accrued. If such liability is more than 10% of the sales price, or if the transferor retains prepayment risks (prepayment of the underlying financial assets) for greater than 120 days from the date of closing, then the transfer does not qualify as a sale (see ASC 860-50-40-4).

7.8.2 Transfers of servicing rights with sub-servicing retained

In some circumstances, a servicer may transfer its servicing rights for certain financial assets to an unrelated party at an economic gain. However, that transferee may not have the facilities or may elect to not perform the required servicing functions and, accordingly, enters into a sub-servicing agreement with the transferor. In this situation, the transferor will continue to perform the same servicing functions, now as a sub-servicer that it was providing immediately prior to the sale.

In these situations, it may not be apparent whether this type of transfer should be recognized as a sale or as a borrowing and, if recognized as a sale, whether any resulting gain should be deferred. A primary difficulty in resolving this question is determining if this transaction is effectively a financing because the transaction has only changed the cash flows relating to the servicing rights, and the transferor is still required to perform the servicing. Further, if the transaction were to be deemed a sale, it may be difficult to determine which portion of the proceeds relates to the sale of the servicing rights and which relates to future servicing obligations. ASC 860-50-40-7 provides relevant guidance for these circumstances:

Excerpt from Accounting Standards Codification

Transfers and Servicing – Servicing Assets and Liabilities

Derecognition

Sales of Servicing Rights with a Subservicing Contract

860-50-40-7

A sale of mortgage servicing rights with a subservicing contract shall be treated as a sale with gain deferred if substantially all the risks and rewards inherent in owning the mortgage servicing rights have been effectively transferred to the transferee, as discussed in paragraph 860-50-40-3. Attributes of the transferee (for example, ability to perform servicing) would not be significant to the accounting for the transaction. The risks and rewards associated with a transferor performing purely administrative functions under a subservicing contract would not necessarily preclude sales treatment. A loss shall be recognized currently if the transferor determines that prepayments of the underlying mortgage loans may result in performing the future servicing at a loss.

The FASB determined that if substantially all of the risks and rewards of ownership of the servicing rights have been transferred to the transferee, the transferor should derecognize the servicing asset or servicing liability, and any gain should be deferred and recognized over the term of the sub-servicing contract.⁷⁴

ASC 860-50-40-8 provides factors that suggest that transfers of servicing rights with a subservicing agreement are more representative of financing transactions.

⁷⁴ Although ASC 860-50-40-7 specifically refers to mortgage servicing rights, we believe that accounting guidance is applicable to all transfers of servicing rights with a subservicing contract.

Excerpt from Accounting Standards Codification

Transfers and Servicing – Servicing Assets and Liabilities

Derecognition

Sales of Servicing Rights with a Subservicing Contract

860-50-40-8

Substantially all the risks and rewards inherent in owning the mortgage servicing rights have not been transferred to the transferee and, therefore, the transaction shall be accounted for as a financing if any of the following factors are present:

- a. The transferor-subservicer directly or indirectly guarantees a yield to the transferee. For example, the transferor-subservicer guarantees prepayment speeds or maximum loan default ratios to the buyer.
- b. The transferor-subservicer is obligated to advance a portion or all of the servicing fees on a nonrecoverable basis to the transferee before receipt of the loan payment from the mortgagor.
- c. The transferor-subservicer indemnifies the transferee for damages due to causes other than failure to perform its duties under the terms of the subservicing contract.
- d. The transferor-subservicer absorbs losses on mortgage loan foreclosures not covered by the Federal Housing Administration, Department of Veterans Affairs, or other guarantors, if any, including absorption of foreclosure costs and costs of managing foreclosed property.
- e. Title to the servicing rights is retained by the transferor-subservicer.

Additionally, ASC 860-50-40-9 provides further guidance on factors which may create a rebuttable presumption that substantially all the risks and rewards inherent in owning the servicing rights have not been transferred.

Excerpt from Accounting Standards Codification

Transfers and Servicing – Servicing Assets and Liabilities

Derecognition

Sales of Servicing Rights with a Subservicing Contract

860-50-40-9

The presence of any of the following factors creates a rebuttable presumption that substantially all the risks and rewards inherent in owning the mortgage servicing rights have not been transferred to the transferee and that the transaction shall be accounted for as a financing:

- a. The transferor-subservicer directly or indirectly provides financing or guarantees the transferee's financing. Nonrecourse financing, for example, would indicate that risks have not been transferred to the transferee. Topic 450 requires a guarantor to recognize, at inception of the guarantee, a liability for the obligation undertaken in issuing the guarantee.
- b. The terms of the subservicing contract unduly limit the transferee's ability to exercise ownership control over the servicing rights or result in the seller's retaining some of the risks and rewards of ownership. For example, if the transferee cannot cancel or decline to renew the subservicing contract after a reasonable period of time, the transferee is precluded from exercising certain rights of ownership. Conversely, if the transferor cannot cancel the subservicing contract after a reasonable period of time, the transferor has not transferred substantially all of the risks of ownership.
- c. The transferee is a special-purpose entity without substantive capital at risk.

See Question 7-9 for additional interpretive guidance.

7.8.3 Sales of servicing rights for participation in an income stream

An entity may sell the right to service loans that are owned by other parties or loans that have been previously sold, with servicing retained, in a separate transaction. In these transactions, the servicing rights can be sold for immediate cash or for a participation in the future interest stream of the loans.

These arrangements raise questions about whether a gain should be recorded on the sale of the servicing rights when the sale is for participation in the future interest income stream and, if a gain is recognized, how that gain should be measured. ASC 860-50-40-11 provides the following guidance for such circumstances:

Excerpt from Accounting Standards Codification

Transfers and Servicing – Servicing Assets and Liabilities

Derecognition

Sales of Servicing Rights for Participation in an Income Stream

860-50-40-11

If a transfer of mortgage servicing rights qualifies as a sale under the criteria beginning in paragraph 860-50-40-2 and the sale is for a participation in the future interest income stream, gain recognition is appropriate at the sale date. There are difficulties in measuring the amount of the gain if the sales price is based on a participation in future payments and there is no specified upper limit on the computed sales price. The transferor of mortgage servicing rights shall consider all available information, including the amount of gain that would be recognized if the servicing rights were to be sold outright for a fixed cash price.

7.9 Questions and interpretive responses

Question 7-1

Initial recognition requirements

Assume an entity that originates loans on a “flow” basis – by acting as an origination agent for a third party that funded and legally owns the loans – also enters into a servicing contract to service the loans for the third party. Should the entity recognize a servicing asset or servicing liability even though it did not own, transfer or securitize the loans that it is servicing?

Yes. ASC 860-50-25-1 requires that a servicing asset or a servicing liability should be recognized any time a servicer acquires or assumes a servicing contract that does not relate to financial assets of the servicer or its consolidated affiliates included in the financial statements.

Question 7-2

Revolving-period securitizations

Do additional transfers under revolving-period securitizations result in the recognition of additional servicing assets or servicing liabilities?

Yes. ASC 860-50-25-9 requires that servicing assets or servicing liabilities for revolving-period receivables should be recognized only for the receivables that exist and have been sold. As new receivables are sold, rights to service them may become assets or liabilities that are recognized. Therefore, additional transfers under revolving-period securitizations (for example, home equity loans or credit card receivables) may result in the recognition of additional servicing assets or servicing liabilities.

Question 7-3 Initial recognition if the servicing contract has no specified fee

Should an entity recognize a servicing liability (and a loss on its income statement) if it transfers a financial asset that is accounted for as a sale and assumes an obligation to service the financial asset but receives no contractually specified servicing fee?

Yes. ASC 860-50-55-5 indicates that in the circumstances described, the transferor-servicer would be required to recognize a servicing liability at fair value if the benefits of servicing are less than adequate compensation. The requirements in paragraph 860-50-25-1 apply even if it is not customary to charge a contractually specified servicing fee. Example 1, Case C (paragraph 860-50-55-25) illustrates a transaction in which a transferor agrees to service loans without explicit compensation.

Question 7-4 Servicing assets assumed without cash payment

When servicing assets are assumed without cash payment, what is the appropriate offsetting entry by the transferee?

ASC 860-50-55-7 states that the offsetting entry depends on whether an exchange or capital transaction has occurred. If an exchange has occurred, the transaction should be recorded based on the facts and circumstances. For example, the servicing asset may represent consideration for goods or services provided by the transferee to the transferor of the servicing. In that case, the offsetting entry by the transferee would be the same as if cash was received in exchange for the goods and services (that is, revenue or a liability as appropriate).

The servicing assets also might be received in full or partial satisfaction of a receivable from the transferor of the servicing. In those cases, the offsetting entry by the transferee would be to derecognize all or part of the receivable satisfied in the exchange. Another possibility is that an investor is in substance making a capital contribution to the investee (the party receiving the servicing asset, that is, the transferee) in exchange for an increased ownership interest. In that case, the investee should recognize an increase in equity from a contribution by owner.

Question 7-5 Transfer of a participating interest with servicing retained

Should an entity recognize a servicing asset or servicing liability if it transfers a portion of a financial asset that meets the definition of a participating interest that is accounted for as a sale, retains at least some of the remaining participating interests and undertakes an obligation to service?

Yes. The selling entity would be required to record a servicing asset or servicing liability for that portion of the financial asset sold, provided that the benefits of servicing are not equal to adequate compensation, as described in ASC 860-50-55-4.

If the entity that transfers a portion of a loan under a participation agreement that meets the definition of a participating interest and qualifies for sale accounting under Subtopic 860-10 obtains the right to receive benefits of servicing that more than adequately compensate it for servicing the loan, and the entity would continue to service the loan regardless of the transfer because it retains part of the participated loan, ASC 860-50-55-4 requires the entity to record a servicing asset for the portion of the loan it sold. The assumption that the entity would service the loan because it retains part of the participated loan does not affect the requirement to recognize a servicing asset. Conversely, an entity could not avoid recording a servicing liability if the benefits of servicing are not expected to adequately compensate the servicer for performing the servicing.

However, if the benefits of servicing are significantly above an amount that would fairly compensate a substitute service provider, should one be required, the transferred portion does not meet the definition of a participating interest, and therefore, the transfer does not qualify for sale accounting (see paragraph 860-10-40-6A(b)).⁷⁵

⁷⁵ See also section 7.3.5 and section 2.3.1.

Question 7-6 **Incorporating ancillary sources of cash flows into a fair value measurement**

How does the existence of the right to receive future cash flows from ancillary sources such as late fees affect the measurement of a servicing right?

The value of a right to potential future cash flows derived from ancillary sources of income (float, late fees, etc.) should be factored into the estimated fair value of a servicing contract because such benefits directly affect the fair value of the servicing rights. However, like all other inputs and assumptions, such factors should be based on a market participant's expectations.

Question 7-7 **Evaluating impairments**

ASC 860-50-35-1 requires that entities separately evaluate and measure impairment of designated stratum of servicing assets within classes of servicing assets that are subsequently measured using the amortization method. Must those classes of servicing assets be stratified based on more than one predominant risk characteristic of the underlying financial assets if more than one characteristic exists?

No. ASC 860-50-35-9 requires servicers to "stratify servicing assets within a class based on one or more of the predominant risk characteristics of the underlying financial assets" for classes of servicing assets that a servicer elects to subsequently measure using the amortization method. Therefore, ASC 860-50 does not require that either the most predominant risk characteristic or more than one predominant risk characteristic be used to stratify the servicing assets for purposes of evaluating and measuring impairment. A servicer must exercise judgment when determining how to stratify servicing assets (i.e., when selecting the most appropriate characteristic(s) for stratification). Such judgments should be based on the characteristics that will result in stratum whose fair values respond similarly to changes in input assumptions.

Question 7-8 **Consistent application of stratum**

ASC 860-50-35-9 requires a servicer to stratify servicing assets within a class based on one or more of the predominant risk characteristics of the underlying financial assets for classes of servicing assets that a servicer elects to subsequently measure using the amortization method. Should the stratum selected by the servicer be used consistently from period to period?

Generally, yes. ASC 860-50-35-14 clarifies that once an entity has determined the predominant risk characteristics to be used in identifying the resulting stratum within each class of servicing assets subsequently measured using the amortization method, that decision should be applied consistently unless significant changes in economic facts and circumstances clearly indicate that the predominant risk characteristics and resulting stratum should be changed. If a significant change in economic facts and circumstances occurs, that change should be accounted for prospectively as a change in accounting estimate in accordance with ASC 250-10-45-17 through 45-19 and ASC 250-10-50-4. If the predominant risk characteristics and resulting stratum are changed, that fact and the reasons for those changes should be included in the disclosures about the risk characteristics of the underlying financial assets used to stratify the recognized servicing assets in accordance with ASC 860-50.

Question 7-9 **Subservicing contracts**

A transferor transfers mortgage loans in their entirety to a third party in a transfer that is accounted for as a sale but undertakes an obligation to service the loans. After the transfer, the transferor enters into a subservicing arrangement with a third party. How should the transferor account for the obligation to service as a result of those transactions?

ASC 860-50-55-11 states that if the transferor's benefits of servicing exceed its obligation under the subservicing contract, that differential shall not be accounted for as an interest-only strip. Rather, the transferor should account for the two transactions separately. First, the transferor should account for the

transfer of mortgage loans in accordance with ASC 860-20. The obligation to service the loans should be initially recognized and measured at fair value according to paragraph 860-50-30-1 as proceeds obtained from the sale of the mortgage loans. Second, the transferor should account for the subcontract with the subservicer.

ASC 860-50-40-2 through 40-5 provides applicable guidance to determine whether the transfer of servicing rights to the subservicer should be recognized as a sale. ASC 860-50-40-7 through 40-11 provides incremental accounting guidance if the transferor retains sub-servicing.

Question 7-10

Scope of income from servicing and subservicing contracts on financial assets

Are the fees received from contracts on servicing and subservicing financial assets in the scope of ASC 606 or ASC 860?

ASC 860-50 provides guidance on when to recognize a servicing asset or liability related to a contract to service or subservice financial assets and how to subsequently account for that servicing asset or liability. The guidance also requires disclosures for servicing arrangements, including total servicing fees earned, a disaggregation of the components of those fees and significant assumptions used to calculate the fair value of any servicing asset or liability.

However, ASC 860 does not provide explicit guidance on revenue accounting related to service or subservice contracts on financial assets, which has resulted in questions about whether servicing income from such contracts should be accounted for under ASC 606.

During the discussions related to the implementation of ASC 606, FASB TRG⁷⁶ members generally agreed that the scope of ASC 606 includes all contracts with customers to provide goods or services in the ordinary course of business, except for contracts with customers that are within the scope of certain other ASC topics that are listed in ASC 606-10-15-2. If the guidance in another ASC topic specifies the accounting for the consideration (e.g., a fee) received in the arrangement, the consideration is outside the scope of ASC 606. FASB TRG members generally agreed that income from servicing financial assets is not in the scope of ASC 606 and that an entity should follow ASC 860 to determine the appropriate accounting for these servicing fees. This is because ASC 606 contains a scope exception for contracts that fall under ASC 860, which provides guidance on the accounting for the fees (despite not providing explicit guidance on revenue accounting).

Because ASC 860-50 explicitly addresses servicing assets and liabilities, some have argued it does not explicitly address the accounting for contracts to service or subservice financial assets where the benefits of servicing (i.e., fees and other forms of compensation) are just adequate to compensate the servicer for performing its servicing responsibilities (i.e., neither a servicing asset nor servicing liability is recognized). We generally believe that determining the adequacy of compensation related to a contract to service or subservice financial assets in accordance with the guidance in ASC 860-50, regardless of the outcome (i.e., more than adequate, less than adequate or just adequate), implies that the contract is within the scope of ASC 860 and thus, outside the scope of ASC 606. Servicers of financial assets should carefully consider their fee structures when evaluating the appropriate revenue recognition model for income received from servicing and subservicing contracts.

⁷⁶ 18 April 2016 FASB TRG meeting; agenda paper no. 52.

8 Secured borrowings and collateral

8.1 Introduction

This section provides guidance on (a) when a transfer should be accounted for as a secured borrowing, (b) the general accounting model for secured borrowings and (c) how collateral should be recognized.

8.2 Secured borrowings

If a transfer of financial assets fails to meet any of the derecognition conditions in ASC 860-10-40-5, both the transferor and transferee are required to account for the transfer as a secured borrowing. For the transferor, the transaction should be accounted for as follows:

- ▶ Continue to report the transferred financial assets in the statement of financial position with no change in their measurement (i.e., the basis of accounting does not change – see ASC 860-30-25-2)
- ▶ Recognize the cash or other consideration received as an asset and an offsetting liability for the secured borrowing arrangement
- ▶ Account for the collateral pledged (cash or noncash) in accordance with ASC 860-30-25 (discussed further below)
- ▶ Contractual rights or obligations related to the transferred asset are not accounted for separately if doing so would result in recognizing the same rights or obligations twice (e.g., a call option retained by the transferor may prevent a transfer from being accounted as a sale so the call option is not separately recognized as a derivative asset); refer to ASC 815-10-15-63
- ▶ In subsequent periods, recognize any income on the transferred assets and any expense incurred on the liability

The transferee in a secured borrowing transaction does not recognize the transferred asset as its asset. Instead, the transferee generally derecognizes cash paid to the transferor and recognizes a receivable (or loan) from the transferor.

In a secured borrowing transaction, the collateral granted by the transferor to the transferee may be in the form of cash or noncash amounts (e.g., securities), and may include recourse to other assets of the transferor.

For these transactions, careful consideration is necessary to determine which entity is the transferor and which entity is the transferee. Contracts and other agreements executed as part of the transaction may provide evidence showing which entity is the transferor or transferee. Entities should also consider whether cash consideration is paid or received as part of the proceeds in these types of transactions. We generally believe that the entity that receives cash consideration would be considered the transferor, and the entity paying cash consideration would be considered the transferee.

The following example illustrates the accounting for a transfer of financial assets, in exchange for cash, that is treated as a secured borrowing because it fails to meet all of the derecognition conditions of ASC 860-10-40-5.

Illustration 8-1: Transfer of financial asset in exchange for cash accounted for as a secured borrowing

On 1 January 2011, Company A transfers a commercial loan with a carrying amount of \$1,000, yielding 10% and maturing on 31 December 2011 to Company B (an unconsolidated operating entity) in exchange for a cash payment of \$1,050. The transfer fails the derecognition requirements of ASC 860-10-40-5(a) because Company B is not allowed to pledge or resell the transferred loan.

The transaction should be accounted for as a secured borrowing with a pledge of collateral (i.e., the commercial loan is pledged as collateral). No gain or loss is recognized on the transfer. The cash received from Company B would be recognized as an asset with an offsetting obligation to settle the amounts borrowed. The transferred loan would remain on Company A's balance sheet with no change in the basis of accounting.

Balance sheet comparison

| | Before | After |
|--|-----------------|-----------------|
| Assets | | |
| Cash | \$ - | \$ 1,050 |
| Commercial loan | 1,000 | 1,000 |
| Total assets | <u>\$ 1,000</u> | <u>\$ 2,050</u> |
| Liabilities | | |
| Obligation under secured borrowing arrangement | \$ - | \$ 1,050 |
| Equity | 1,000 | 1,000 |
| Total liabilities and equity | <u>\$ 1,000</u> | <u>\$ 2,050</u> |

Journal entries
1 January 2011

| | Debit | Credit |
|--|----------|----------|
| Cash | \$ 1,050 | |
| Obligation under secured borrowing arrangement | | \$ 1,050 |

Note: To recognize cash received and record a liability for the commercial loan transfer that does not meet the requirements for sale accounting

Subsequent to the transfer, Company A would continue to recognize the interest income on the commercial loan as if it still held the loan. Additionally, the obligation to Company B should be accreted using the effective interest rate method⁷⁷ so that the liability eventually would equal the face amount of the commercial loan due on the maturity date. That is, the obligation to Company B would accrete from \$1,050 (the amount received from Company B) to \$1,100 (the maturity value of the commercial loan, which includes a principal amount of \$1,000 and annual interest of \$100). The following entries would be recorded by Company A:

| | Debit | Credit |
|---|--------|--------|
| Year ended 31 December 2011 | | |
| Commercial loan | \$ 100 | |
| Interest income | | \$ 100 |
| Note: To recognize the annual interest income on the commercial loan (\$1,000 x 10%) | | |
| Interest expense | \$ 50 | |
| Obligation under secured borrowing arrangement | | \$ 50 |
| Note: To recognize the accretion of interest expense on the obligation to Company B (\$1,100 (liability's maturity value) – \$1,050 (liability's initial carry value)) | | |

⁷⁷ Refer to ASC 835-30 for further guidance on imputing interest for subsequent measurement purposes.

31 December 2011

| | | | |
|--|----|-------|----------|
| Obligation under secured borrowing arrangement | \$ | 1,100 | |
| Commercial loan | | | \$ 1,100 |
| Note: To recognize the maturity of the commercial loan and discharge of the obligation to Company B | | | |

8.3**Accounting for collateral****8.3.1****Cash collateral**

Transfers of financial assets in exchange for cash collateral (consideration for transferred financial assets) cannot be distinguished from borrowing cash. Accordingly, ASC 860-30-25-3 requires that all cash collateral be recorded as an asset by the party receiving it, together with a liability for the obligation to return it to the payer (the transferee). The transferee derecognizes the cash collateral surrendered to the transferor, because it's a fungible asset that makes it impossible to determine whether it has been used by the transferor, and recognizes a receivable from the transferor.

Refer to Illustration 9-1 in section 9.6.1 for an example of a securities lending arrangement accounted for as a secured borrowing in exchange for cash.

8.3.2**Noncash collateral****Excerpt from Accounting Standards Codification****Transfers and Servicing – Secured Borrowing and Collateral****Recognition****Noncash Collateral****860-30-25-5**

The accounting for noncash collateral by the obligor (or debtor) and the secured party depends on whether the secured party has the right to sell or repledge the collateral and on whether the obligor has defaulted. Noncash collateral shall be accounted for as follows:

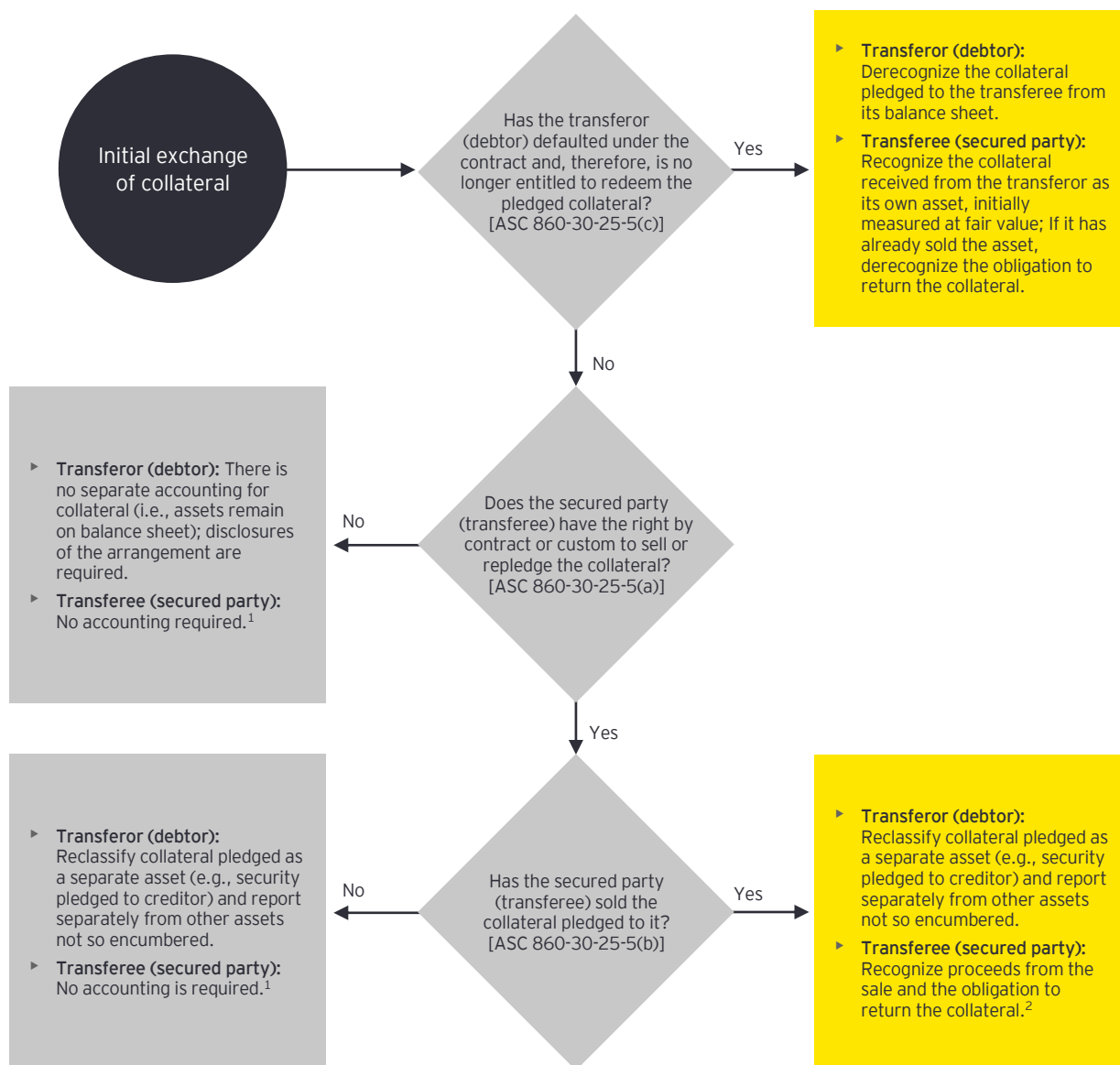
- If the secured party (transferee) has the right by contract or custom to sell or repledge the collateral, then paragraph 860-30-45-1 requires that the obligor (transferor) reclassify that asset and report that asset in its statement of financial position separately (for example, as security pledged to creditors) from other assets not so encumbered.
- If the secured party (transferee) sells collateral pledged to it, it shall recognize the proceeds from the sale and its obligation to return the collateral. The sale of the collateral is a transfer subject to the provisions of this Topic.
- If the obligor (transferor) defaults under the terms of the secured contract and is no longer entitled to redeem the pledged asset, it shall **derecognize** the pledged asset as required by paragraph 860-30-40-1^[78] and the secured party (transferee) shall recognize the collateral as its asset. (See paragraph 860-30-30-1^[79] for guidance on the secured party's initial measurement of collateral recognized. See paragraph 860-30-40-1 for further guidance if the debtor has sold the collateral.)
- Except as provided in paragraph 860-30-40-1 the obligor (transferor) shall continue to carry the collateral as its asset, and the secured party (transferee) shall not recognize the pledged asset.

⁷⁸ EY note: ASC 860-30-40-1 indicates that in circumstances where an obligor (transferor) transfers noncash collateral in a secured borrowing and the obligor (transferor) defaults under the terms of the secured contract and is no longer entitled to redeem the pledged asset, the obligor should derecognize the pledged asset. If the secured party has already sold the collateral, the secured party should derecognize its obligation to return the collateral.

⁷⁹ EY note: ASC 860-30-30-1 requires that noncash **collateral** recognized by the secured party as its asset under ASC 860-30-25-5(c) that the secured party has not already sold should be initially measured at fair value.

The following decision tree illustrates the accounting requirements for transfers of noncash collateral pursuant to ASC 860-30-25-5:

Accounting for noncash collateral decision tree



¹ Pursuant to ASC 860-30-25-5(d), the transferee (secured party) should not recognize the collateral pledged by the transferor.

² Obligations to return to the transferor assets borrowed and then sold have sometimes been effectively recognized as part of a liability for securities sold but not yet purchased. ASC 860 does not require any change in that practice (ASC 860-30-25-10).

8.4

Other collateral accounting considerations

8.4.1

Pledged assets required to be reclassified

A transferor that has transferred collateral that must be reclassified in accordance with ASC 860-30-25-5(a) should not change its measurement of that collateral. The transferor should follow the same measurement principles as before the transfer (see ASC 860-30-35-2). For example, securities reclassified from the available-for-sale category to securities pledged to creditors should continue to be measured at fair value, with changes in fair value reported in comprehensive income, while debt securities reclassified from the held-to-maturity category to securities pledged to creditors should continue to be measured at amortized cost.

8.4.2 Obligation to return transferred collateral

ASC 860 does not provide specific guidance on the subsequent measurement of the obligation to return transferred collateral. The liability to return the collateral should be measured in accordance with other relevant accounting pronouncements. For example, a bank or savings institution that, as a transferee, sells transferred collateral is required to subsequently measure that liability at fair value similar to a short sale. The guidance in ASC 942-405-35-1 clarifies that the obligations incurred in short sales should be subsequently measured at fair value through the statement of operations at each reporting date.

8.4.3 Securities received as collateral in a securities lending arrangement

In a securities lending transaction, the transferor (debtor) must recognize receipts of noncash collateral (e.g., securities) that may be sold or re-pledged regardless of whether the transfer is accounted for as a sale or a secured borrowing. Specifically, as described in ASC 860-30-25-8, the collateral received under such circumstances is considered proceeds from the transfer and, therefore, is recognized by the transferor with a corresponding obligation to return the collateral received. Refer to section 9, *Repurchase agreements, securities lending transactions and similar arrangements*, for further guidance on the accounting for these transactions.

8.5 Statement of financial position presentation considerations

Excerpt from Accounting Standards Codification

Transfers and Servicing – Secured Borrowing and Collateral

Other Presentation Matters

General

860-30-45-1

If the secured party (**transferee**) has the right by contract or custom to sell or repledge the **collateral**, then the obligor (**transferor**) shall reclassify that asset and report that asset in its statement of financial position separately (for example, as security pledged to creditors) from other assets not so encumbered.

860-30-45-2

Liabilities incurred by either the secured party or obligor in securities borrowing or resale transactions shall be separately classified.

860-30-45-3

This Section does not specify the classification or the terminology to be used to describe the following:

- a. Pledged assets reclassified by the transferor of securities loaned or transferred under a **repurchase agreement accounted for as a collateralized borrowing** if the transferee is permitted to sell or repledge those securities
- b. Liabilities incurred by either the secured party or obligor in securities borrowing or resale transactions.

Example 1 (see paragraph 860-30-55-1) illustrates possible classifications and terminology.

9 Repurchase agreements, securities lending transactions and similar arrangements

9.1 Overview

In the capital markets, securities rarely lie idle. If not being purchased and sold in outright market transactions, securities are frequently lent to parties wanting to borrow them or are used as collateral to meet short-term cash needs. These transactions include repurchase agreements and securities lending transactions.

Repurchase agreements and securities lending involve the temporary exchange of securities, usually for other securities or cash of an equivalent value (or occasionally a mixture of cash and securities), with an obligation to redeliver a like quantity of the same or similar securities at a future date. Most repurchase agreements and securities lending transactions are structured to give the transferee legal title to the securities for the life of the transaction, even though, economically, the terms are more akin to a loan.

Repurchase agreements and securities lending transactions are difficult to characterize because those transactions have attributes of both sales and secured borrowings. Although repurchase agreements and securities lending transactions typically are treated as sales under US bankruptcy and tax laws (but only as they relate to income distributions), those arrangements generally are recorded as secured borrowings for accounting purposes because the transferor maintains “effective control” over the transferred financial assets.

This section provides an overview of securities lending transactions and repurchase agreements. It describes the market participants, the typical structure of these secured borrowing arrangements, and the underlying motivations for entering into such transactions. Additionally, this section includes a discussion of the concept of “effective control” under ASC 860-10-40-5(c)(1), including the accounting requirements for when effective control is maintained or surrendered.

9.2 Securities lending transactions

Securities lending transactions typically are initiated by securities dealers, broker-dealers and other financial institutions that need specific securities to make deliveries, either to cover a short sale or a customer’s failure to deliver securities sold. Borrowers of securities generally are required to provide collateral to the lender of securities, which is commonly cash, but sometimes other securities or standby letters of credit, with a value slightly higher than that of the securities borrowed. If the collateral is cash, the lender of securities typically earns a return by investing that cash at rates higher than the rate paid or rebated to the borrower of securities. If the collateral is other than cash, the lender of securities typically receives a fee.

9.2.1 Types of securities lending transactions

There are two somewhat distinct securities lending markets: “securities-driven” and “cash-driven.”

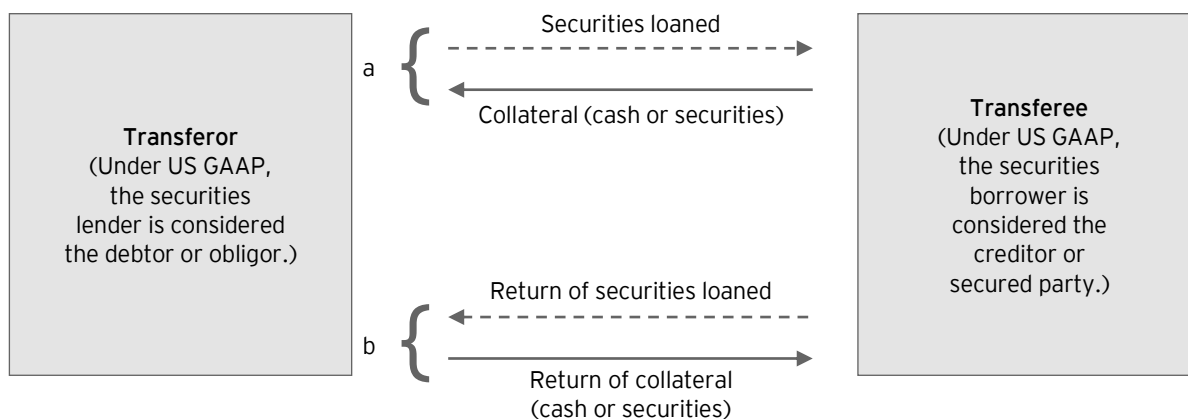
In the securities-driven market, firms seek to gain temporary access to specific securities. This may be because they have failed to receive securities that they are due to make delivery on or because they have deliberately sold a security short and are using the securities obtained through the loan to deliver against this position. The securities borrower will usually give collateral to the lender in the form of other securities, cash or a bank letter of credit. Collateral mitigates the lender’s exposure to the credit risk on the borrower.

In the cash-driven market, firms post securities as collateral to obtain cash financing. The cash lender is not seeking specific securities and will generally allow the cash borrower to select which securities to provide as collateral within defined categories of “general collateral,” for instance, all domestic government securities issues. Market participants use these transactions to finance their portfolios at rates generally below the interbank short-term uncollateralized lending rate.

In both securities-lending markets, any margin (discussed further in section 9.4) is usually provided by the provider of collateral, which value should exceed that of the cash or securities loaned. Therefore, in the cash-driven market, margin gives a measure of protection against adverse movements in market prices to the cash lender. In the securities-driven market, margin protects the securities lender against non-delivery.

9.2.2 Defining the lender and borrower in a typical securities lending transaction

Schematic of a typical securities lending transaction⁸⁰



- a. **Transaction date** – the onset of the securities lending transaction. On this date, the transferor loans securities to the transferee in return for collateral that could be in the form of cash or securities.
- b. **Settlement date** – the conclusion of the securities lending transaction. On this date, the transferee returns the loaned securities to the transferor along with the loan fee (if the transferee provided non-cash collateral, e.g., securities) and simultaneously the transferor returns the collateral (cash or securities) to the transferee along with the rebate fee if the collateral is cash.

⁸⁰ During the term of the transaction, dividends or interest on securities are paid by the issuer to the current security holder (i.e., the party that holds the securities transferred in the securities lending transaction), while the transferor may have only the contractual right to receive from the transferee payments in lieu of dividends or interest. In addition, the voting rights reside with the current security holder because those rights generally cannot be contractually released. Although the rights and obligations are described in the context of a securities lending transaction, the same occurs in a repurchase agreement.

The accounting for securities lending transactions can be confusing because ASC 860 and the marketplace view the lender and the borrower differently. While the marketplace views the party who borrows the security as a debtor and the party who provides the security as the lender, ASC 860 views the security lender as a debtor who borrowed the collateral received and the party who has legally borrowed the security as the lender. The terms “transferor,” “debtor” and “obligor” all refer to the transferor-lender of the securities who, for accounting purposes, is viewed as entering into a borrowing for which it provided collateral in the form of loaned securities. The terms “transferee,” “creditor” and “secured party” all refer to the party providing cash, securities, or standby letters of credit in exchange for the transferred securities. These terms are identical to the terminology used in ASC 860-30-05 and elsewhere in ASC 860.

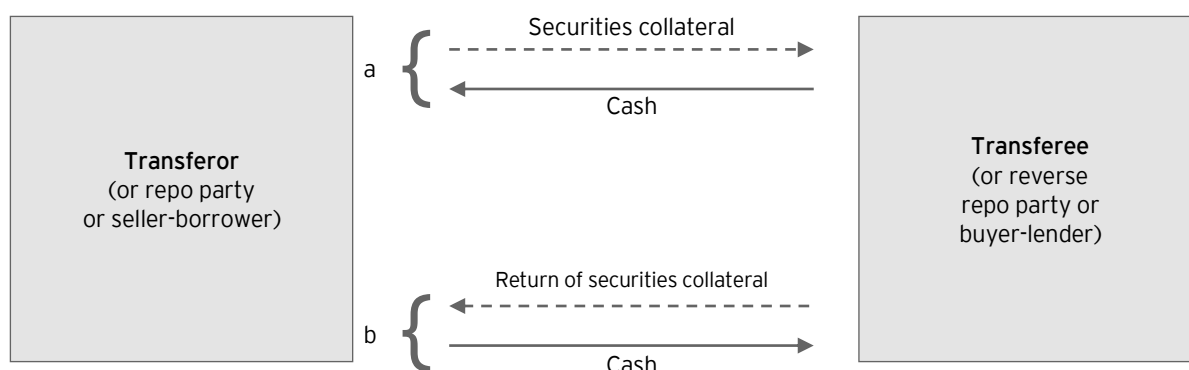
Refer to section 9.6 for further accounting guidance.

9.3 Repurchase agreements

Many financial institutions that purchase fixed income securities finance such purchases through repurchase agreements. In repurchase agreements, the transferor (also referred to as the “repo party” or “seller-borrower”) transfers a security to a transferee (also referred to as the “reverse repo party” or “buyer-lender”)⁸¹ in exchange for cash and simultaneously agrees to reacquire that security at a future date for an amount equal to the cash exchanged plus an interest factor.

Typical repurchase agreements could be described as the “repo party” borrowing funds using the securities as collateral. Government securities dealers, banks and others commonly use repurchase agreements to obtain or invest short-term funds. For the “reverse repo party,” a repurchase agreement is an opportunity to invest cash (secured by collateral) for a period. Many repurchase agreements are for short terms, often overnight, or have indefinite terms that allow either party to terminate the arrangement on short notice. Some repurchase agreements allow for repurchase of securities that need not be identical to the securities transferred. For entities engaged in trading activities, repurchase agreements are used to finance long positions, obtain access to cheaper funding and cover short positions in securities.

Schematic of a typical repurchase agreement



- a. **Transaction date** – the onset of the repurchase agreement. On this date, the transferor borrows cash and provides collateral in the form of securities to the transferee.
- b. **Settlement date** – the conclusion of the repurchase agreement. On this date, the transferor repays the borrowed cash along with the repo fee to the transferee and simultaneously the transferee returns the collateral (securities) to the transferor.

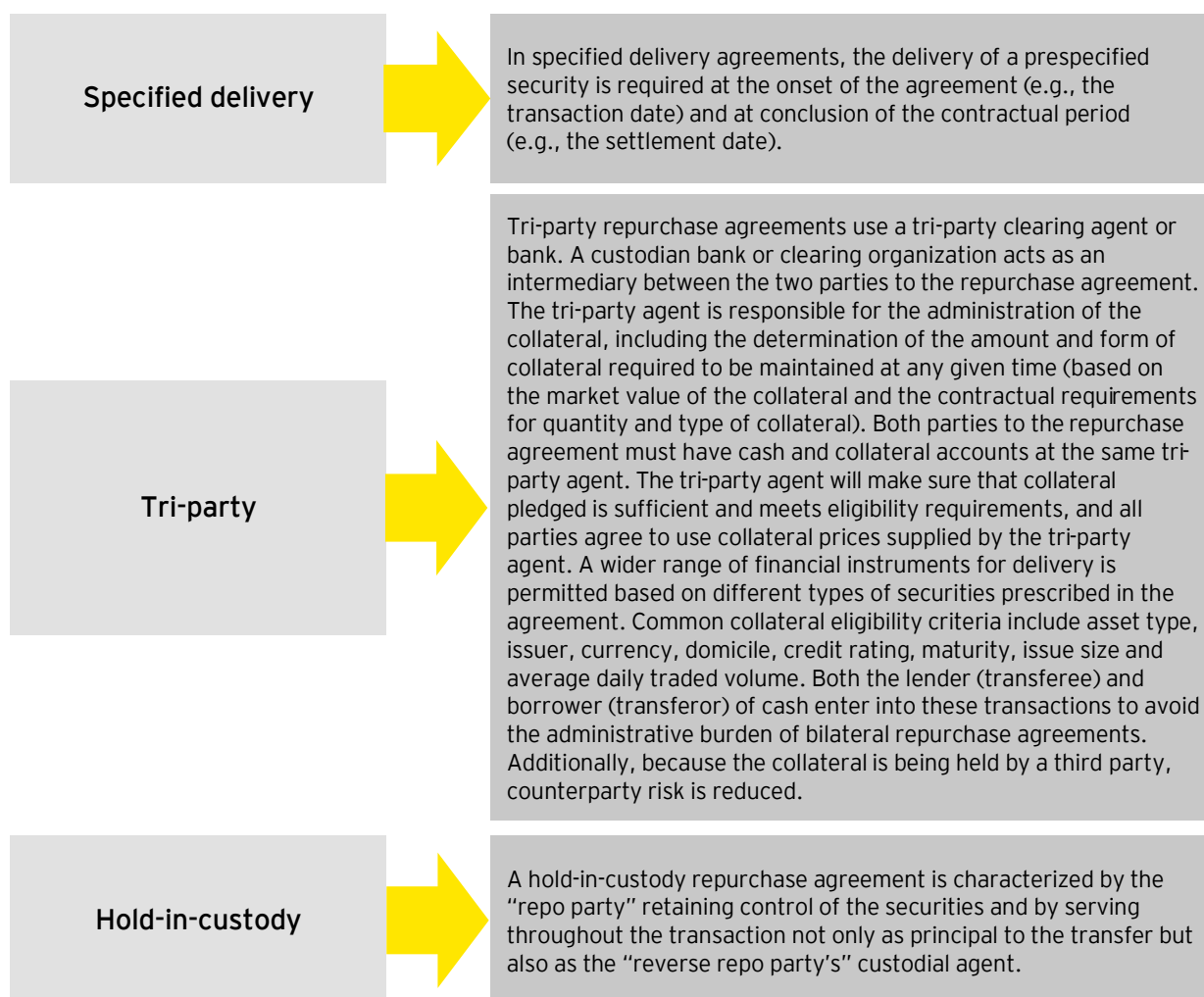
⁸¹ There is some diversity regarding how the term repo and reverse repo are used. Banks, insurance companies, broker dealers and other financial institutions use the term “repo” to refer to sales and repurchases and “reverse repo” to refer to purchases and resales, while investment companies use the same terminology to refer to reciprocal transactions (i.e., they use the reciprocal term “repo” to refer to purchases and resales and “reverse repo” to sales and repurchases).

Under a typical repurchase agreement, the initial valuation and transfer of securities is based on the current market price, including a component for accrued interest. When a repurchase agreement is terminated, the securities are re-sold at a pre-determined price. This price is comprised of two different components, the original sale price, plus a previously determined interest rate, which is also known as the “repo rate.” The difference between the initial transfer and repurchase price is a lending interest rate for the secured borrowing. The repo rate is dependent on the quality of collateral (e.g., the rate for generic government securities is lower than rates for bonds rated BBB). The rate is also impacted by demand for a certain security in the market (i.e., higher for a security which is in greater demand). The creditworthiness of the borrower may also affect the rate (although this tends to affect the level of collateral required rather than the interest earned by the lender as compensation).

Repurchase agreements can take different forms including specified delivery, tri-party and held-in-custody arrangements. They can also have different terms. For example, some repurchase agreements are similar to securities lending transactions in that the transferee has the right to sell or re-pledge the securities to a third party during the term of the repurchase agreement while others do not.

9.3.1

Types of repurchase agreements



9.4 Differences between a securities lending transaction and a repurchase agreement

Although similar economically, securities lending transactions and repurchase agreements have some basic differences. The legal, regulatory and tax implications relevant to these transactions also vary in different markets. The table below highlights some of these basic differences:

| Securities lending transaction | Repurchase agreement |
|--|--|
| Contract | |
| In the US, the most widely used securities lending agreement is the Master Securities Loan Agreement, published by the Bond Market Association. For cross border transactions, the most widely used global master agreement is the Overseas Securities Lending Agreement (OSLA), organized under the English law. | The contract most often used in the US Treasury repo market is the Bond Market Association Master Repurchase agreement, documented under New York law. For cross border transactions, the most common master agreement used is the Global Master Repurchase Agreement, published jointly by the Bond Market Association and the International Securities Market Association (PSA-ISMA Agreement), often with a country-specific annex. |
| Duration | |
| Securities lending transactions are predominantly made on an open basis, such that loans can be returned, recalled or reset either on demand or after an agreed notice period (generally between one and three days). In practice, maturity varies by the type of security lent. The typical length of a loan of equity securities is one to two months, compared to a few days when the securities loaned are fixed income. | Repurchase agreements are generally short-term agreements, often overnight, or have indefinite terms that allow either party to terminate the arrangement on short notice. Other repurchase agreements are for longer terms, sometimes until the maturity of the transferred asset. |
| Collateral and transaction size | |
| Typically involve equity securities and are relatively much smaller in transaction size compared to repurchase agreements. | Typically involve fixed income securities (e.g., government and agency obligations) and are relatively much larger in transaction size compared to securities lending transactions. |
| Pricing⁸² | |
| Compensation to the lender is agreed to at the outset and is generally by fee when securities are received as collateral. When cash is taken as collateral, the securities lender invests the cash collateral and agrees to pay a rebate to the borrower on the value of cash received. The spread between the investment rate earned by the securities lender and the rebate rate agreed to with the borrower represents the lender's revenue on the loaned securities. The fee paid by a borrower is higher when there is a greater demand for the security to be borrowed and securities are provided as collateral. Alternatively, when cash is received as collateral, the rebate rate paid to the borrower is lower when the securities borrowed are in high demand or non-readily obtainable in the marketplace. | The lending or repo rate is reflective of prevailing money market conditions. Repurchase agreements involving generic government securities define the benchmark yield curve in most markets, with collateral of lesser quality commanding higher rates. |

⁸² In addition to the factors discussed in the table above, other factors that may affect the amount of compensation received in a securities lending transaction or repurchase agreement include:

- ▶ The creditworthiness of the borrower (although this tends to affect the level of collateral required rather than the lender's remuneration)
- ▶ The tax status of the lender (particularly if the borrower will gain from a tax arbitrage strategy)

Margin

Lenders typically require margin in addition to the value of the assets loaned to the borrower. Margin may be applied as an increase in the collateral required relative to the value of cash or securities lent (initial margin) or as a reduction in the valuation of the collateral taken (haircut). In principle, the amount of margin may depend on the quality, liquidity and price volatility of the securities loaned, the term of the loan or the frequency with which collateral will be revalued and margin calls made, and the creditworthiness of the counterparty.

In cash-driven transactions, the cash investor in a financing trade will usually take margin if it is more creditworthy than the borrower. In the securities-driven market, the securities lender usually takes margin, especially if it is more creditworthy than the borrower.

9.5 Determining when a securities lending transaction or repurchase agreement should be accounted for as a secured borrowing

When the FASB first developed the derecognition model for transfers of financial assets, it believed that if judged only by the criteria in ASC 860-10-40-5(a) (i.e., legal isolation) and 40-5(b) (i.e., right to pledge or exchange), financial assets transferred under typical securities lending transactions and repurchase agreements would be derecognized because the transferred financial assets, which generally consist of securities that are readily obtainable in the market, are both isolated from the transferor (see also “Legal isolation” discussion below) and the transferee can – and typically does – obtain their benefits by selling or pledging them.

However, the FASB believes that effective control over the financial assets still exists in typical securities lending transactions and repurchase agreements. Consequently, ASC 860-10-40-5(c)(1) was added so that an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity results in the transferor maintaining effective control over the transferred financial assets.

Legal isolation

Financial assets transferred under a typical securities lending transaction or repurchase agreement often are purported to be both contractual and legal sales. While deliberating ASU 2014-11, *Repurchase-to-Maturity Transactions, Repurchase Financings and Disclosures*, the FASB was made aware that in some cases entities may be relying on paragraphs 203 and 204 from the basis for conclusions of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (Statement 140), to conclude that the legal isolation criterion in ASC 860-10-40-5(a) has been met when evaluating such transfers of financial assets for derecognition. Those paragraphs state the following:

The American Law Institute describes the legal status of a securities lending transaction as follows:

The securities lender does not retain any property interest in the securities that are delivered to the borrower. The transaction is an outright transfer in which the borrower obtains full title ... the borrower needs the securities to transfer them to someone else ... if the securities borrower defaults on its redelivery obligation, the securities lender has no property interest in the original securities that could be asserted against any person to whom the securities borrower may have transferred them. ... The securities lender's protection is its right to foreclose on the collateral given to secure the borrower's redelivery obligation. Perhaps the best way to understand securities lending is to note that the word "loan" in securities lending transactions is used in the sense it carries in loans of money, as distinguished from loans of specific identifiable chattels. Someone who lends money does not retain any property interest in the money that is handed over to the borrower. [Footnote reference omitted.]

While that description focuses on securities lending, much of it appears applicable to repurchase agreements as well. If judged by the criteria in paragraphs 9(a) and 9(b) and the legal reasoning in paragraph 203, financial assets transferred under typical repurchase or securities lending agreements

would qualify for derecognition as having been sold for proceeds consisting of cash and a forward purchase contract. During the term of the agreement, the transferred assets are isolated from the transferor, are placed in the hands of a transferee that can—and typically does—obtain their benefits by selling or pledging them, and are readily obtainable in the market.

The FASB noted that the assertions in paragraph 204 of the basis for conclusions of Statement 140 do not apply to all securities lending arrangements and repurchase agreements. When Statements 125⁸³ and 140 were issued, the FASB examined repurchase agreements that were common at that time, when most transactions in the United States involved US Treasury securities and US government agency securities that likely did meet the legal isolation condition because of specific regulations that make these securities isolated and because they were readily obtainable. However, over time, repurchase agreements began to involve different types of assets and, in many cases, less liquid financial assets (e.g., asset-backed securities, structured debt securities, sovereign debt securities). Given the context of the transactions at the time that Statements 125 and 140 were issued, the Board observed that the comments in the basis for conclusions for those Statements were not intended to address all transactions.

The nature and extent of the evidence to support the legal isolation assertion depends on the facts and circumstances of each transaction. However, whenever the transferor has continuing involvement with the transferred financial assets (e.g., in the form of a repurchase agreement), a legal opinion from a specialist is often required to support the assessment. Refer to section 3, *Criteria for a sale – Legal isolation*, for further guidance.

Effective control

If the conditions in ASC 860-10-40-5(a) and 40-5(b) are met, the determination of whether repurchase agreements and securities lending transactions qualify for sale accounting is based on the guidance in ASC 860-10-40-5(c)(1) and the related interpretive guidance in ASC 860-10-40-24. Specifically, ASC 860 explains that an agreement that entitles and obligates the transferor to repurchase or redeem the transferred financial assets from the transferee maintains effective control over those assets (in which case the transfer is accounted for as a secured borrowing) if, and only if, all of the following conditions are met:

- a) The financial assets to be repurchased or redeemed are the same or substantially the same as those transferred.
- b) The agreement is to repurchase or redeem the financial assets before maturity, at a fixed or determinable price.
- c) The agreement is entered into contemporaneously with, or in contemplation of, the transfer.

The guidance in ASC 860 is based on the notion that effective control is maintained for repurchase agreements and securities lending arrangements if they represent a temporary transfer of only some elements of control over the transferred financial assets. If the transfer of control is temporary and the assets to be repurchased are the same or substantially the same as the asset transferred, then effective control is considered to be maintained. Effective control is considered to be maintained because an agreement that involves both a contractual right and obligation to repurchase a financial asset before its maturity effectively ensures the return of the asset, thereby retaining the transferor's control over the asset during the term of the agreement. Accordingly, the guidance results in the majority of repurchase agreements being accounted for as secured borrowing transactions with only certain types of transactions being accounted for as sale transactions.

⁸³ FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

As an exception to the derecognition principles in ASC 860, ASC 860-10-40-5A requires a repurchase-to-maturity transaction to be accounted for as a secured borrowing as if the transferor maintains effective control. Refer to section 9.5.1 for additional discussion regarding the accounting exception for repurchase-to-maturity transactions.

9.5.1

Effective control through both a right and an obligation

Excerpt from Accounting Standards Codification

Transfers and Servicing – Overall

Derecognition

Effective Control through both a Right and an Obligation

860-10-40-24

An agreement that both entitles and obligates the transferor to repurchase or redeem transferred **financial assets** from the transferee maintains the transferor's effective control over those assets as described in paragraph 860-10-40-5(c)(1), if all of the following conditions are met:

- a. The financial assets to be repurchased or redeemed are the same or substantially the same as those transferred. To be substantially the same, the financial asset that was transferred and the financial asset that is to be repurchased or redeemed need to have all of the following characteristics:
 1. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which circumstance the guarantor and the terms of the guarantee must be the same)
 2. Identical form and type so as to provide the same risks and rights
 3. The same maturity (or in the circumstance of mortgage-backed pass-through and pay-through securities, similar remaining weighted-average maturities that result in approximately the same market yield)
 4. Identical contractual interest rates
 5. Similar assets as collateral
 6. The same aggregate unpaid principal amount or principal amounts within accepted good delivery standards for the type of security involved. Participants in the mortgage-backed securities market have established parameters for what is considered acceptable delivery. These specific standards are defined by the Securities Industry and Financial Markets Association and can be found in Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities, which is published by the Securities Industry and Financial Markets Association.

See paragraph 860-10-55-35 for implementation guidance related to these conditions.
- b. [Subparagraph superseded by Accounting Standards Update No. 2011-03]
- c. The agreement is to repurchase or redeem the financial assets before maturity, at a fixed or determinable price.
- d. The agreement is entered into contemporaneously with, or in contemplation of the transfer.

The FASB based its decisions about agreements that maintain effective control over transferred financial assets in part on practices that prevail in the repurchase agreement and securities lending markets. Concerns of market participants about risk of default by the parties to the contract, rights at law in the event of default, and credit risk of transferred financial assets, among other factors, have led to several contractual features intended to ensure that the transferors indeed maintain effective control.

Exception for repurchase-to-maturity transactions

Excerpt from Accounting Standards Codification

Transfers and Servicing – Overall

Derecognition

Exception for a Repurchase-to-Maturity Transaction

860-10-40-24A

Notwithstanding the characteristic in paragraph 860-10-40-24 that refers to a repurchase of the same (or substantially-the-same) financial asset, a **repurchase-to-maturity transaction** shall be accounted for as a secured borrowing as if the transferor maintains effective control.

The ASC Master Glossary defines a repurchase-to-maturity transaction as a repurchase agreement in which the settlement date of the agreement to repurchase a transferred financial asset is at the maturity date of that financial asset and the agreement would not require the transferor to reacquire the financial asset.

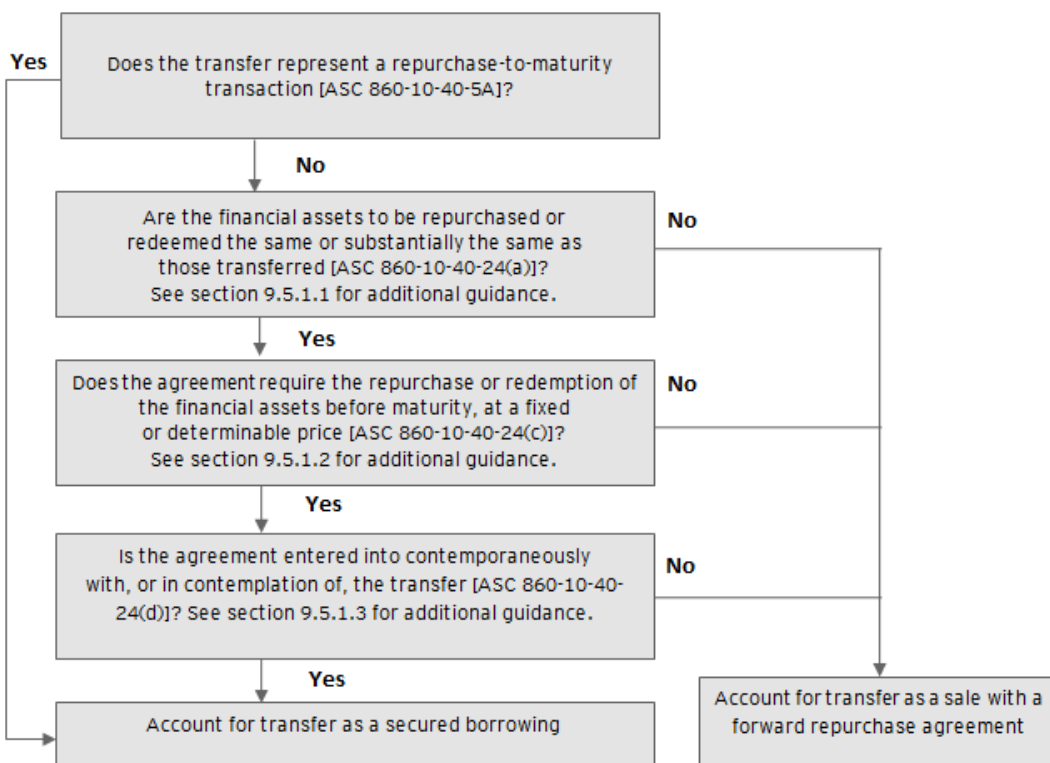
ASC 860-10-40-24A (which was added by ASU 2014-11) requires a repurchase-to-maturity transaction to be accounted for as secured borrowing, even though the transferred financial asset(s) are not returned to the transferor at settlement. This represents an exception to the control-based derecognition model in ASC 860, one that's closer to the "risks and rewards" model for derecognition under International Financial Reporting Standards. The FASB believes that receiving cash at settlement is equivalent to receiving the transferred financial asset because cash is the only possible form of settlement. Because the transferor retains the credit risk and market value exposure of the financial asset, the FASB concluded that the asset should be reflected on the transferor's balance sheet until settlement.

While deliberating the scope of ASU 2014-11, the FASB considered making broader changes to the derecognition requirements of ASC 860 to address transactions that are economically similar to repurchase-to-maturity transactions but decided instead to make only targeted amendments. As a result, economically similar transactions may be accounted for differently. For example, ASC 860-10-55-51B(c) indicates that a transfer of a financial asset with a contemporaneous total return swap to maturity does not meet the definition of a repurchase-to-maturity transaction. Accordingly, those transactions may be accounted for as a sale (if all the ASC 860-10-40-5 criteria are met) with a derivative recognized for the total return swap. Additionally, ASC 860-10-55-51B(d) states that if a financial asset is transferred under a contemporaneous agreement with the same counterparty to repurchase or redeem it before its maturity at a fixed repurchase price or a price equal to the sale price plus or minus a lender's return and the agreement requires the transferee to settle the agreement in cash, the agreement does not maintain the transferor's effective control over the transferred financial asset.

Effective control decision tree

The following flowchart illustrates the steps for evaluating whether an agreement that both entitles and obligates the transferor to repurchase or redeem transferred financial assets from the transferee maintains the transferor's effective control over those assets as described in ASC 860-10-40-5(c)(1):

Note: After considering whether the transfer represents a repurchase-to-maturity transaction, an entity should then determine whether the transferred financial assets are readily obtainable in the marketplace before evaluating the other considerations in the decision tree. If the financial assets are not readily obtainable the repurchase agreement or securities lending transaction would generally be accounted for as a secured borrowing because the transferee's ability to freely pledge or exchange the assets is effectively constrained (ASC 860-10-40-5(b)). Refer to section 4, *Criteria for a sale – Right to pledge or exchange*, for additional information.



Note: The transfer is accounted for as a sale only if all other derecognition criteria (i.e., ASC 860-10-40-5(a) and 40-5(b)) have been met.

Excerpt from Accounting Standards Codification

Transfers and Servicing – Overall

Implementation Guidance and Illustrations

Repurchase Agreements and Securities Lending Transactions

860-10-55-51B

The following illustrates the application of the derecognition guidance in paragraphs 860-10-40-24 through 40-24A:

- a. Repurchase agreements and securities lending transactions—assets that are identical. The following illustrates agreements for which the transferor maintains effective control over the transferred financial asset:
 1. A financial asset is transferred under a contemporaneous agreement with the same counterparty that requires the transferor to repurchase or redeem it before its maturity at a fixed price or at the sale price plus or minus a lender's return.
 2. A financial asset is transferred under a securities lending transaction that requires the transferee to return to the transferor the identical asset before its maturity at a fixed price.
- b. Repurchase agreements and securities lending transactions—assets that are substantially the same. The following illustrates agreements for which the transferor maintains effective control over the transferred financial asset:
 1. A financial asset is transferred under a contemporaneous agreement with the same counterparty to repurchase or redeem an asset that is substantially the same as the initially transferred asset (in accordance with paragraph 860-10-40-24(a)) before its maturity at a fixed price or at the sale price plus or minus a lender's return.

2. A financial asset is transferred under a securities lending transaction that requires the transferee to return to the transferor an asset that is substantially the same as the initially transferred financial asset (in accordance with paragraph 860-10-40-24(a)) before its maturity at a fixed price.
3. Fixed-coupon and dollar-roll repurchase agreements, and other contracts under which the securities to be repurchased are substantially the same in accordance with paragraph 860-10-40-24(a) as the securities initially transferred.
- c. Repurchase-to-maturity transactions. A repurchase-to-maturity transaction is accounted for as a secured borrowing as if it maintains the transferor's effective control over the transferred financial asset. A transfer of a financial asset with a contemporaneous total return swap to maturity does not meet the definition of repurchase-to-maturity transaction.
- d. Cash-settled repurchase agreements. If a financial asset is transferred under a contemporaneous agreement with the same counterparty to repurchase or redeem it before its maturity at a fixed repurchase price or a price equal to the sale price plus or minus a lender's return and the agreement requires the transferee to settle the agreement in cash, the agreement does not maintain the transferor's effective control over the transferred financial assets. An exception is a repurchase-to-maturity transaction as discussed in (c).

9.5.1.1

Financial assets that are the same or substantially the same

ASC 860-10-40-24 clarifies that to maintain effective control the securities to be repurchased or redeemed must be the same or substantially the same as those transferred.⁸⁴ The following criteria should be met in order to conclude that securities are substantially the same.

Excerpt from Accounting Standards Codification

Transfers and Servicing – Overall

Implementation Guidance and Illustrations

Whether Securities Exchanged are Substantially the Same

860-10-55-35

This guidance addresses criteria that must be met for a transfer to fail the condition in paragraph 860-10-40-5(c) through an agreement of the type described in paragraph 860-10-40-5(c)(1), precluding sale accounting and resulting, instead, in secured-borrowing accounting. The following are examples of whether securities exchanged are substantially the same as discussed in paragraph 860-10-40-24:

- a. The same primary obligor (see paragraph 860-10-40-24(a)(1)). The exchange of pools of single-family loans would not meet this criterion because the mortgages comprising the pool do not have the same primary obligor, and would therefore not be considered substantially the same.
- b. Identical form and type (see paragraph 860-10-40-24(a)(2)). The following exchanges would not meet this criterion:
 1. GNMA I securities for GNMA II securities^[85]

⁸⁴ ASC 860 reiterated the guidance regarding whether securities are substantially the same that was originally included in the AICPA Statement of Position 90-3, *Definition of the Term Substantially the Same for Holders of Debt Instruments* (codified under ASC 860-10-55-35).

⁸⁵ EY note: GNMA I securities represent a pool of mortgages issued by one issuer, all with the same interest rate and issued within a three-month period. This is a basic pass-through security. GNMA II securities are also pass-through securities, except that the collateral can have a range of interest rates and can include mortgages issued by more than one issuer.

2. Loans to foreign debtors that are otherwise the same except for different U.S. foreign tax credit benefits (because such differences in the tax receipts associated with the loans result in instruments that vary in form and type)
3. Commercial paper for redeemable preferred stock.
- c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities, similar remaining weighted-average maturities that result in approximately the same market yield) (see paragraph 860-10-40-24(a)(3)). The exchange of a fast-pay GNMA certificate (that is, a certificate with underlying mortgage loans that have a high prepayment record) for a slow-pay GNMA certificate would not meet this criterion because differences in the expected remaining lives of the certificates result in different market yields.
- d. Similar assets as **collateral** (see paragraph 860-10-40-24(a)(5)). Mortgage-backed pass-through and pay-through securities must be collateralized by a similar pool of mortgages, such as single-family residential mortgages, to meet this characteristic.

9.5.1.1.1

Dollar rolls

The term dollar roll covers a variety of transactions that involve an agreement to transfer a mortgage pass-through security in exchange for cash, generally at some future date. Some dollar rolls are similar to futures contracts traded on organized exchanges, while others are similar to financing transactions.

While the term dollar roll is used generically, there are at least two different types of dollar roll transactions.

| Type | Description |
|---|---|
| Rolling transaction | <ul style="list-style-type: none"> ▶ This type of transaction is a commitment to deliver a security at a future date. Typically, delivery of the security is not taken at any time. Rather, the entity's strategy is to keep "rolling" these transactions, thereby earning a trading spread from the price differential of transactions scheduled to settle in different months. The price difference between months is known as the "drop." ▶ In a rolling transaction, the buyer is able to invest the funds that otherwise would have been required to settle the trade. In rolling transactions no transfer of securities occurs. The only transfer that takes place is a money transfer representing the price differential discussed above. |
| Dollar-roll repurchase agreement | <ul style="list-style-type: none"> ▶ This type is more akin to a repurchase agreement and is used as a cost-effective source of financing. An entity transfers a specific mortgage pass-through security held in inventory (i.e., on its balance sheet) in exchange for payment today and simultaneously agrees to re-purchase the same or similar mortgage pass-through security at a specified date in the future. ▶ A dollar roll is analogous to a repurchase agreement, but there are important differences: (1) the party borrowing the securities in a dollar roll does not have to return the same securities but can instead return those that are "substantially similar" and (2) the original owner gives up principal and interest to the temporary holder of the securities (assuming record dates are passed during the period of the roll).⁸⁶ |

⁸⁶ In a repurchase agreement, payments are made to the original owner (i.e., the transferor by the transferee in lieu of principal and interest payments). See footnote 80 for additional information.

Fixed coupon and yield maintenance dollar agreements comprise the most common agreement variations. In a fixed coupon agreement, the seller and buyer agree that delivery will be made with securities having the same stated interest rate as the interest rate stated on the securities sold. In a yield maintenance agreement, the parties agree that delivery will be made with securities that will provide the seller a yield that is specified in the agreement. Dollar-roll transactions should be evaluated to determine (1) whether they should be accounted for as financings or as separate sales and repurchases and (2) if considered separate sales and repurchases, how changes in the value of the underlying security should be recognized (i.e., whether the underlying security should be marked to market). ASC 860-10-55-58 through 55-60 address these questions and provide guidance.

Excerpt from Accounting Standards Codification

Transfers and Servicing – Overall

Implementation Guidance and Illustrations

Dollar Rolls

860-10-55-58

Whether paragraph 860-10-40-5(c) precludes sale accounting for a dollar-roll transaction depends on the facts and circumstances. Paragraph 860-10-40-24 states the conditions under which an agreement that both entitles and obligates the transferor to repurchase or redeem transferred financial assets from the transferee maintains the transferor's effective control over those assets as described in paragraph 860-10-40-5(c)(1). The condition in paragraph 860-10-40-24(a) requires that the financial assets to be repurchased or redeemed are the same or substantially the same as those transferred. Paragraph 860-10-40-24(a) describes six characteristics that must all exist for a transfer to meet the substantially-the-same requirement. Paragraph 860-10-40-24(a)(6) requires (as one of those six characteristics) that the financial asset that was transferred and the financial asset that is to be repurchased or redeemed have the same aggregate unpaid principal amount or principal amounts within accepted good delivery standards for the type of security involved.

860-10-55-59

For transfers of existing securities under a dollar-roll repurchase agreement, the transferee must be committed to return substantially-the-same securities to the transferor, which would indicate that the transferor has maintained effective control. In a transfer of existing securities under a dollar-roll repurchase agreement, if the transferee is committed to return substantially-the-same securities to the transferor but that transferee's securities at the time of the transfer were to-be-announced securities, the transferor would not be precluded from accounting for the transfer as a secured borrowing. The transferor is only required to obtain a commitment from the transferee to return substantially-the-same securities and is not required to determine that the transferee holds the securities that it has committed to return. Therefore, the financial asset to be returned may be a to-be-announced asset at the time of the transfer because the transferor would have no way of knowing whether the transferee held the security to be returned.

860-10-55-60

As illustrated by the following, whether a GNMA roll⁸⁷ is accounted for as a secured borrowing or a sale affects the evaluation of the forward contract embedded in the securities subject to the agreement:

- a. Types 1-3 of dollar rolls would qualify for secured borrowing treatment if the redemption of securities on substantially the same terms is assured (see paragraph 860-10-40-24). In that circumstance, the forward contracts embedded in the Types 1-3 securities are outside the scope of Topic 815 because of the scope exception provided in paragraph 815-10-15-63 for derivative instruments that serve as impediments to sale accounting.
- b. Types 2 and 3 securities that involve repurchase of other than substantially-the-same securities are considered sales of securities and forward contracts. The forward contract would need to be evaluated under Subtopic 815-10 because it has terms that would generally meet the definition of a derivative instrument. If the dollar-roll repurchase agreement is accounted for as a sale under this Subtopic, Subtopic 815-10 provides guidance on the subsequent accounting for the forward contract.

9.5.1.2**Agreement to repurchase (redeem) before maturity, at a fixed or determinable price**

An agreement to repurchase or redeem a transferred financial asset before maturity meets the criterion in ASC 860-10-40-24(c) if the repurchase price for the transferred financial asset is explicitly stated or determinable based on the terms of the contract. On the other hand, an arrangement to repurchase the transferred financial asset at fair value to be determined at some future date would not meet the criterion because the purchase price is neither fixed nor determinable.

9.5.1.3**Agreement is entered into contemporaneously with, or in contemplation of, the transfer of financial assets**

A transferor may maintain effective control over transferred financial assets if either of the following two conditions is met:

- a. The agreement to repurchase or redeem the financial assets is executed concurrent with the transfer of financial assets
- b. The two agreements are executed in contemplation of one another

The transfer of financial assets and the agreement to repurchase the transferred financial assets would be considered to be executed in contemplation of one another if the transactions are contractually contingent on one another. For example, if the pricing and performance of either agreement are contingent on the terms and execution of the other agreement, the two agreements may be considered contractually contingent. Contractual contingencies may be either explicit (e.g., pursuant to a written agreement) or implicit.

⁸⁷ EY note: The term Government National Mortgage Association (GNMA) rolls has been used broadly to refer to a variety of transactions involving mortgage-backed securities, frequently those issued by the GNMA. There are four basic types of transactions:

- a. Type 1: Reverse repurchase agreements for which the exact same security is received at the end of the repurchase period (vanilla repo)
- b. Type 2: Fixed coupon dollar reverse repurchase agreements (dollar repo)
- c. Type 3: Fixed coupon dollar reverse repurchase agreements that are rolled at their maturities, that is, renewed in lieu of taking delivery of an underlying security (GNMA roll)
- d. Type 4: Forward commitment dollar rolls (also referred to as to-be-announced GNMA forward contracts or to-be-announced GNMA rolls), for which the underlying security does not yet exist

9.6 Accounting for securities lending transactions and repurchase agreements

If the conditions for sale accounting are met, a securities lending transaction or repurchase agreement should be accounted for as follows:

- ▶ The transferor should derecognize the transferred securities and recognize as proceeds the cash received and the forward repurchase commitment.

In a securities lending transaction (or similar arrangement), ASC 860-30-25-8 requires that any cash⁸⁸ or securities received as collateral for securities loaned be recognized as an asset by the securities lender (transferor) as long as the securities received as collateral can be sold or repledged, regardless of whether the transaction is accounted for as a sale or a secured borrowing.⁸⁹ The securities lender should also recognize as a liability the obligation to return the cash or securities received as collateral. Refer to sections 9.2 and 9.2.2 for guidance on determining the securities lender in a securities lending transaction.

- ▶ The transferee should recognize both the securities received from the transferor (as purchased) and the forward resale commitment and derecognize the cash paid to the transferor.

The forward repurchase and resale commitments should be evaluated under ASC 815, *Derivatives and Hedging*, to determine if they meet the criteria to be accounted for as a derivative under that literature.

An arrangement in which the asset to be repurchased is not substantially the same as that originally transferred is a common example of a transaction that would be accounted for as sale.

However, typical securities lending transactions and repurchase agreements result in the securities lender (transferor) maintaining effective control over the transferred financial assets pursuant to ASC 860-10-40-24, resulting in the transferor's accounting as a secured borrowing with a pledge of collateral. The transferor would recognize cash received, together with a liability for the obligation to return it to the transferee. The transferee would derecognize the cash and record a receivable from the transferor. The transferor would not derecognize the transferred financial assets, but if the transferee has the right (by contract or custom) to sell or repledge them, the transferor would present those assets in its statement of financial position separately (e.g., as security pledged to creditors as collateral) from other assets not so encumbered. The transferee would not recognize the transferred financial assets pledged to it as collateral unless it sells the assets, in which case the transferee would recognize the proceeds from the sale as an asset and its obligation to return the collateral to the transferor as a liability.

Refer to section 8, *Secured borrowings and collateral*, for further guidance on accounting for secured borrowings and collateral.

⁸⁸ Any investments made with cash received as collateral should be recognized, even if made by agents or in pools with other securities lenders, along with the obligation to return the cash.

⁸⁹ ASC 860-10-55-51(b) states that to the extent that the collateral received by the securities lender consists of letters of credit or other financial instruments that the holder is not permitted by contract or custom to sell or repledge, a securities lending transaction does not satisfy the sale conditions and is accounted for as a loan of securities by the transferor to the transferee.

9.6.1 Examples illustrating accounting for securities lending transactions

Illustration 9-1: Transfer of securities accounted for as a secured borrowing in exchange for cash

Bank A (transferor) lends a mortgage-backed security (MBS) with a fair value of \$1,000 to Dealer B (transferee). Dealer B provides Bank A cash collateral of \$1,020 for its obligation to return the MBS in 90 days. Bank A will pay to Dealer B a rebate of \$2 over the term of the borrowing, which represents interest on the cash received from Dealer B. Bank A invests the cash received from Dealer B in a money market instrument earning a return of \$7 over the term of the borrowing. Dealer B initially holds the MBS and then subsequently sells the MBS to its customer, Insurance Company C, for cash of \$1,000. Assume that the transfer of MBS securities is accounted for as a secured borrowing because the requirements of ASC 860-10-40-24 are met.

Note: For simplicity, this example does not address the accounting for any periodic principal and interest or dividend payments made by the issuer of the securities subject to the securities lending transaction. Additionally, the fair value of the security is assumed not to change during the term of the transaction.

Journal entries for the transferor (Bank A as securities lender)

| | Debit | Credit |
|--|----------|----------|
| At inception: | | |
| Cash | \$ 1,020 | |
| Payable under securities loan agreement | | \$ 1,020 |
| Note: To record the receipt of cash | | |
| MBS pledged to transferee | \$ 1,000 | |
| MBS | | \$ 1,000 |
| Note: To reclassify loaned securities that the securities borrower (transferee) has the right to pledge or exchange | | |
| Money market instrument | \$ 1,020 | |
| Cash | | \$ 1,020 |
| Note: To record investment of cash received from Dealer B – securities borrower (transferee) | | |
| At conclusion: | | |
| Cash | \$ 1,027 | |
| Interest revenue | | \$ 7 |
| Money market instrument | | 1,020 |
| Note: To record results of investment of cash in money market instrument | | |
| MBS | \$ 1,000 | |
| MBS pledged to transferee | | \$ 1,000 |
| Note: To record return of MBS from Dealer B – securities borrower (transferee) | | |
| Payable under securities loan agreement | \$ 1,020 | |
| Interest expense (rebate) | 2 | |
| Cash | | \$ 1,022 |
| Note: To record return of cash plus interest | | |

Journal entries for the transferee (Dealer B as securities borrower)

| | | |
|--|----------|----------|
| At inception: | | |
| Receivable under securities loan agreement | \$ 1,020 | |
| Cash | | \$ 1,020 |
| Note: To record transfer of cash | | |

Upon sale of the collateral:

| | | |
|---|----------|----------|
| Cash | \$ 1,000 | |
| Obligation to return MBS borrowed from transferor | | \$ 1,000 |

Note: To record sale of collateral (MBS) to Insurance Company C and obligation to return MBS (it no longer holds) to Bank A (transferor)⁹⁰

At conclusion:

| | | |
|------|----------|----------|
| MBS | \$ 1,000 | |
| Cash | | \$ 1,000 |

Note: To record purchase of substantially the same MBS in the open market for return to transferor

| | | |
|---|----------|----------|
| Obligation to return MBS borrowed from transferor | \$ 1,000 | |
| MBS | | \$ 1,000 |

Note: To record return of MBS to transferor

| | | |
|--|----------|----------|
| Cash | \$ 1,022 | |
| Receivable under securities loan agreement | | \$ 1,020 |
| Interest revenue (rebate) | | 2 |

Note: To record the receipt of cash and rebate interest revenue from transferor

Illustration 9-2: Transfer of securities accounted for as a secured borrowing in exchange for another security

Bank A lends a mortgage backed security (MBS) with a fair value of \$1,000 to Dealer B. Dealer B provides Bank A with a US Treasury security that has a fair value of \$1,020 as collateral for its obligation to return the MBS in 90 days. In addition, Dealer B will pay Bank A a \$5 fee for the security lending arrangement at its conclusion. Both Bank A and Dealer B are permitted by contract and custom to pledge or sell the respective securities they hold during the term of the lending arrangement. Assume that the transaction qualifies for secured borrowing treatment because the requirements of ASC 860-10-40-24 have been met.

Note: For simplicity, this example does not address the accounting for any periodic principal and interest or dividend payments made by the issuer of the securities subject to the securities lending transaction. Additionally, the fair value of the security is assumed not to change during the term of the transaction.

Journal entries for the transferor (Bank A as securities lender)

| | Debit | Credit |
|--|----------|----------|
| At inception: | | |
| US Treasury securities | \$ 1,020 | |
| Payable under securities loan agreements | | \$ 1,020 |
| Note: To record the receipt of securities collateral from Dealer B ⁹¹ that Bank A could pledge or exchange | | |
| MBS Securities pledged as collateral | \$ 1,000 | |
| MBS Securities | | \$ 1,000 |
| Note: To reclassify loaned securities that Dealer B has the right to sell or repledge | | |

⁹⁰ Obligations to return to the transferor financial assets borrowed and then sold have sometimes been effectively recognized as part of a liability for securities sold but not yet purchased. ASC 860 does not require any change in that practice (see ASC 860-30-25-10).

⁹¹ In a securities lending transaction, the transferor of securities being loaned must recognize securities received as collateral on its balance sheet irrespective of whether the transfer is accounted for as a sale or a secured borrowing provided that the transferor is permitted to sell or repledge such securities. This treatment is no different than how a transferor would account for cash received as collateral (ASC 860-30-25-8).

At conclusion:

| | | | |
|--------------------------------------|----|-------|-------|
| Cash | \$ | 5 | |
| MBS Securities | | 1,000 | |
| Securities lending fees | | | \$ 5 |
| MBS Securities pledged as collateral | | | 1,000 |

Note: To record receipt of lending fee and return of loaned security from Dealer B

| | | | |
|--|----|-------|----------|
| Payable under securities loan agreements | \$ | 1,020 | |
| US Treasury securities | | | \$ 1,020 |

Note: To record return of securities collateral to Dealer B

Journal entries for the transferee (Dealer B as securities borrower)**At inception:**

No entry.⁹²

At conclusion:

| | | | |
|-------------------------|----|---|------|
| Security borrowing fees | \$ | 5 | |
| Cash | | | \$ 5 |

Note: To record return of borrowed securities and payment of fee to Bank A

9.6.2

Examples illustrating accounting for repurchase agreements**Illustration 9-3: Repurchase agreement as a collateralized borrowing**

Bank A holds a security that will mature in three years with a fair value of \$1,000 and a coupon rate of 7%. It enters into a repurchase agreement with Dealer B to transfer the security for \$980 and to repurchase the identical security from Dealer B in one year for \$1,019. Dealer B has the right to pledge or exchange the acquired security but does not choose to do so. At the end of the year, Dealer B returns the identical security to Bank A in exchange for a cash payment of \$1,019.

Additional assumptions and accounting analysis:

This transaction results in Bank A maintaining effective control over the security transferred because it is entitled and obligated to repurchase the security before its maturity and all of the requirements of ASC 860-10-40-24 have been met. Therefore, the transfer subject to the repurchase agreement is treated as a secured borrowing and not a sale. Because Dealer B has the right to pledge or exchange the security, Bank A must reclassify the transferred security on its balance sheet to securities pledged. Although Dealer B is able to pledge or sell the security it receives in the transaction, Dealer B is not required by ASC 860 to record the security received or a liability to return it unless it sells the security or Bank A defaults.

Note: For simplicity, this example does not address the accounting for any periodic principal and interest or dividend payments made by the issuer of the securities subject to the securities lending agreement. Also, the effects of changes in the fair value of the security during the one-year term of the transaction are not considered in this example.

⁹² At inception of the arrangement, Dealer B is not required to recognize the borrowed securities on its balance sheet. The obligation to return the securities is only recorded if the securities are sold by Dealer B or Bank A defaults under the agreement. The security delivered as collateral by Dealer B is disclosed in the notes accompanying the financial statements.

Seller-Borrower (transferor) perspective – Bank A

| | Before transfer | During term | At conclusion |
|---|-----------------|-------------------------|-------------------------|
| Assets | | | |
| Cash | \$ 2,000 | \$ 2,980 ⁽²⁾ | \$ 1,961 ⁽³⁾ |
| Securities | 1,000 | – | 1,000 |
| Securities pledged as collateral ⁽¹⁾ | – | 1,000 | – |
| Total assets | \$ 3,000 | \$ 3,980 | \$ 2,961 |
| Liabilities and equity | | | |
| Payable under repurchase agreement | \$ – | \$ 980 | \$ – |
| Equity | 3,000 | 3,000 | 2,961 |
| Total liabilities and equity | \$ 3,000 | \$ 3,980 | \$ 2,961 |

⁽¹⁾ Regardless of whether Bank A (seller-borrower) has the right to redeem the collateral on short notice or a right to substitute collateral (common in repurchase agreements with no set maturity), this reclassification entry is required.

⁽²⁾ Represents the reporting period's beginning cash balance (\$2,000), plus the net cash payment received on the initial transfer (\$980). Although not shown in the example for purposes of simplicity, Bank A's (seller-borrower's) income statement and balance sheet would also reflect the interest income from the security and investment of the cash proceeds as well as interest expense on an accrual basis on its liability under the repurchase agreement.

⁽³⁾ Represents cash balance at the conclusion of the transaction which includes the beginning cash balance (\$2,980) less the repurchase agreement final settlement payment (\$1,019).

Buyer-Lender (transferee) perspective – Dealer B

| | Before transfer | During term | At conclusion |
|--|-----------------|-----------------|-------------------------|
| Assets | | | |
| Cash | \$ 1,980 | \$ 1,000 | \$ 2,019 ⁽⁵⁾ |
| Receivable under repurchase agreement | – | 980 | – |
| Total assets | \$ 1,980 | \$ 1,980 | \$ 2,019 |
| Liabilities and equity | | | |
| Obligation to return collateral ⁽⁴⁾ | \$ – | \$ – | \$ – |
| Equity | 1,980 | 1,980 | 2,019 |
| Total liabilities and equity | \$ 1,980 | \$ 1,980 | \$ 2,019 |

⁽⁴⁾ The entry by Dealer B (buyer-lender) to record the collateral held is not required, unless Dealer B sells the collateral or Bank A defaults. If the collateral received (i.e., the security) is considered to be sold based on applying the criteria in ASC 860-10-40-5, Dealer B records the proceeds and an obligation to return the collateral. If repledged, it only records the obligation under the new borrowing related to the pledge. If Bank A defaults, then Dealer B would recognize the collateral as its asset (unless it had already been sold), and it would derecognize any recorded obligation to return it.

⁽⁵⁾ Represents cash balance at the conclusion of the transaction which includes the beginning cash balance (\$1,000) plus the repurchase agreement final settlement payment (\$1,019). Although not shown in the example for purposes of simplicity, Dealer B's income statement and balance sheet also would reflect on an accrual basis interest earned on the funds loaned to Bank A.

Illustration 9-4: Repurchase agreement accounted for as a sale transaction

Consider the same fact pattern as described in Illustration 9-3, except that the security to be returned at the maturity of the repurchase agreement is not required to be substantially the same as that tendered at the initiation of the transaction. Rather, any similar security that has the same market yield and fair value may be returned. Provided the transaction meets the criteria of ASC 860-10-40-5(a) and 40-5(b) for sale accounting, the seller-borrower would account for the repurchase agreement as a sale of the financial assets and a forward purchase commitment, and the buyer-lender would account for the agreement as a purchase of the financial assets and a forward sale commitment.

Assume that Bank A's carrying amount (cost) and the fair value of the security transferred is \$1,000, the cash proceeds are \$980 and the agreed repurchase amount is \$1,019. For simplicity, it is assumed that there is no unrealized gain or loss on the transferred security, the effects of changes in the fair value of the security during the one-year term of the transaction and interest earned on the cash proceeds are not considered in this example. In addition, assume that the fair value of the security at the end of one year equals the amount suggested by the transaction (\$1,039). The fair value of the forward contract is assumed to be \$20, which represents an asset for Bank A and a liability for Dealer B. Thus, Bank A has no gain or loss on the sale.

Seller-Borrower (transferor) perspective – Bank A

| | Before transfer | During term | At conclusion |
|---|-----------------|-----------------|-----------------|
| Assets | | | |
| Cash | \$ 2,000 | \$ 2,980 | \$ 1,961 |
| Securities | 1,000 | – | 1,039 |
| Forward contract to repurchase securities | – | 20 | – |
| Total assets | \$ 3,000 | 3,000 | \$ 3,000 |
| Liabilities and equity | | | |
| Liabilities | \$ – | \$ – | \$ – |
| Equity | 3,000 | 3,000 | 3,000 |
| Total liabilities and equity | \$ 3,000 | \$ 3,000 | \$ 3,000 |

The use of a debt security as collateral for an obligation can be considered consistent with an entity's assertion that it has the intent and ability to hold the security to maturity provided the transaction is not considered a sale under ASC 860-10-40-5 and the entity intends and expects to satisfy the obligation without surrendering the debt security (ASC 320-10-25-18). In other words, a held-to-maturity security can be subject to a repurchase agreement or a securities lending agreement as long as the transaction is accounted for as a secured borrowing and the entity intends and expects to be able to satisfy the obligation and recover access to its collateral (ASC 320-10-25-18(e)). However, if the transaction were considered a sale and the held-to-maturity security is transferred for a reason other than those specified in ASC 320-10-25-6, ASC 320-10-25-9 and ASC 320-10-25-14, the transfer would taint the held-to-maturity portfolio.

The forward contract would appear to meet the definition of a derivative to which the provisions of ASC 815, *Derivatives and Hedging*, would be applicable.

Buyer-Lender (transferee) perspective – Dealer B

| | Before transfer | During term | At conclusion |
|-------------------------------------|-----------------|-----------------|-----------------|
| Assets | | | |
| Cash | \$ 1,980 | \$ 1,000 | \$ 2,019 |
| Securities | – | 1,000 | – |
| Total assets | \$ 1,980 | \$ 2,000 | \$ 2,019 |
| Liabilities and equity | | | |
| Forward contract to sell security | \$ – | \$ 20 | \$ – |
| Equity | 1,980 | 1,980 | 2,019 |
| Total liabilities and equity | \$ 1,980 | \$ 2,000 | \$ 2,019 |

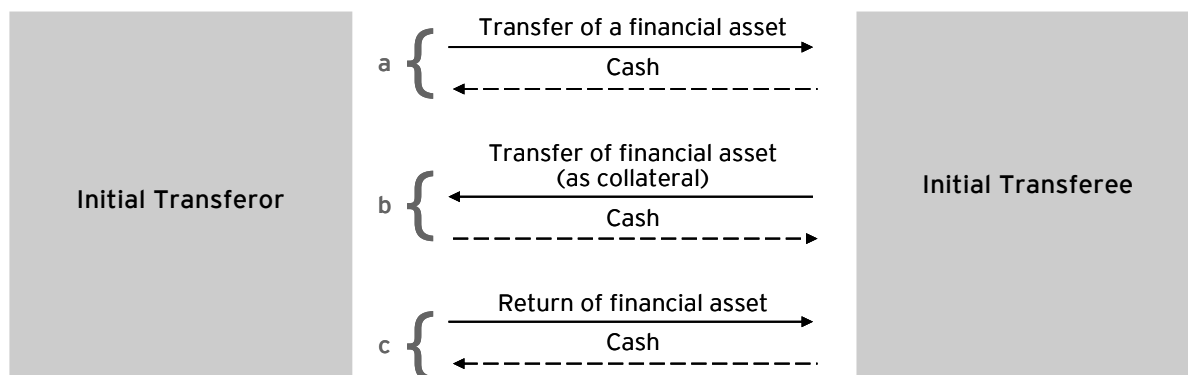
During the term of the repurchase agreement, Dealer B presumably would measure the security at fair value and account for the forward contract pursuant to ASC 815.

9.7

Accounting for repurchase financings

A repurchase financing is defined by the FASB as a repurchase agreement that relates to a previously transferred financial asset between the same counterparties (or consolidated affiliates⁹³ of either counterparty) that is entered into contemporaneously with, or in contemplation of, the initial transfer.

The following diagram (and related notes) from ASC 860-10-55-17A through 55-17B illustrates a repurchase financing:



- a. **Initial transfer** – the initial transferor transfers a financial asset to the initial transferee in return for cash.
- b. **Execution of a repurchase agreement** – the initial transferee enters into a repurchase financing with the initial transferor. The initial transferee transfers the previously transferred financial asset to the initial transferor as collateral for the financing. The initial transferee receives cash from the initial transferor. As part of the repurchase financing, the initial transferee is obligated to repurchase the financial asset (or substantially the same financial asset⁹⁴) at a fixed price within a prescribed period.
- c. **Settlement of the repurchase financing** – the initial transferee makes the required payment to the initial transferor under the terms of the repurchase financing. Upon receipt of payment, the initial transferor returns the transferred asset (or substantially the same asset) to the initial transferee.

ASC 860-10-55-17C clarifies that whether or not the parties agree to net settle steps (a) and (b) should not affect whether the transactions are within the scope of the guidance for repurchase financings in ASC 860-10-40-4C.

Determining the accounting for repurchase financings

As an exception to the general derecognition requirements of ASC 860, ASC 860-10-40-4C requires that when determining the accounting for a repurchase financing, no consideration should be given to the guidance in ASC 860-10-40-4(b) (i.e., the transferor's continuing involvement in the transferred financial assets, including the continuing involvement of the transferor's consolidated affiliates and its agents) and ASC 860-10-40-4(c) (i.e., whether all arrangements or agreements are made contemporaneously with, or in contemplation of, the initial transfer). ASC 860-10-55-17A precludes application of this exception by analogy to other forms of financing transactions.

⁹³ As used in this definition, the term consolidated affiliate is an entity whose assets and liabilities are included with those of the counterparty in the consolidated, combined or other financial statements being presented. The term consolidated affiliate is used in a narrower context than the term affiliate in ASC 850, *Related Party Disclosures*. The Board clarified this point to emphasize that whether a transferor has isolated the transferred assets can depend on which financial statements are being presented. For example, a financial asset transfer to a third party by a wholly owned subsidiary combined with a repurchase agreement between the subsidiary's parent and the same third party could result in a linked transaction at the consolidated level of the parent, but not at the subsidiary level.

⁹⁴ See ASC 860-10-40-24 and ASC 860-10-55-35 for additional guidance on determining whether financial assets are substantially the same.

ASC 860-10-40-4C requires entities to consider the initial transfer and the related repurchase agreement separately when applying the derecognition requirements of ASC 860. This will generally result in the initial transferor accounting for the initial transfer as a sale of a financial asset (if all of the derecognition criteria are met) and the initial transferee accounting for the initial transfer symmetrically as a purchase, with both parties generally accounting for the repurchase agreement component of the transaction as a secured borrowing.

9.8 Wash sale transactions

Wash sales are transactions in which an entity sells a security and then repurchases the same or substantially the same security at some future date. Though the period of time between sale and reacquisition varies, it is often very short (less than 30 days). Unless there is a concurrent contract to repurchase or redeem the transferred financial assets from the transferee, the FASB concluded that the transferor does not maintain effective control over the transferred financial assets during the period they have been sold. As a result, wash sales are accounted for as sales under ASC 860.

Sale accounting may not be appropriate if there is a concurrent agreement (whether explicit or implicit) to repurchase the security (see also ASC 860-10-55-57 for implementation guidance about accounting for wash sales).

Certain wash sales are disregarded for purposes of computing income taxes in the United States.⁹⁵ The US Internal Revenue Service (IRS) defines a wash sale to have occurred when stock or securities are sold or traded at a loss and within 30 days before or after the sale any of the following have been met:

- ▶ Substantially identical stock or securities are bought back by the seller.
- ▶ Substantially identical stock or securities are acquired back in a fully taxable trade by the original seller.
- ▶ A contract or option to buy substantially identical stock or securities is entered into by the original seller.

The IRS has concluded that losses from sales or trades of stock or securities in a wash sale are not deductible for tax purposes.

⁹⁵ Internal Revenue Service publication 550.

10 Securitizations

10.1 Overview

Determining the accounting for transfers of financial assets can be especially challenging for securitization transactions due to the variety and complexity of structures that have evolved over time. This section discusses the fundamentals of the securitization process and describes the application of ASC 860 to some common securitization structures.

Before considering the derecognition criteria, a transferor should first determine whether the securitization entity (the transferee that receives financial assets from a transferor and issues beneficial interests to investors) should be consolidated by the transferor (which obviates the need to determine whether the transferred financial assets can be derecognized). Refer to our FRD, [Consolidation](#), for further guidance.

10.2 Securitizations

Generally, securitization is a structured finance process in which the cash flows and related risks (e.g., credit, prepayment, liquidity) of a pool of financial assets are redistributed by the issuance of new securities backed by the same asset or pool of financial assets. The securities are commonly referred to as asset-backed securities and the investors holding such asset-backed securities are referred to as beneficial interest holders.

There are several stages to a securitization transaction. The following schematic shows the phases of a securitization transaction and the primary activities that take place in each phase. The schematic is not intended to be all inclusive, and the actual activities and market participants may vary depending on the nature of the assets being securitized and the structure of the securitization vehicle.

10.2.1 Pooling and transfer of assets

Transaction initiation stage

- ▶ Entity considers financing alternatives (including securitizations options) and evaluates the advantages and disadvantages of each alternative.
- ▶ If securitization is chosen as the final alternative, an available financial asset pool is identified for securitization.

Transaction structuring stage

- ▶ The transaction is structured, and due diligence is performed, including credit rating agency review.
- ▶ Legal documents are drafted, new legal entities are created and a trustee is appointed for the securitization entity.
- ▶ The asset-backed securities (beneficial interests) to be issued by the securitization entity are marketed and initially priced.

Transaction closing stage

- ▶ Pooled financial assets are transferred to a securitization entity (either in a “single-step” or “two-step” transaction).
- ▶ Ratings are provided by the credit rating agencies.
- ▶ Asset-backed securities (beneficial interests) are sold to investors by the securitization entity to finance the purchase of the asset pool.

Post-transaction closing stage

- ▶ Servicer collects payments received from the asset pool held by the securitization entity and remits to trustee. It addresses delinquencies/defaults and reports collateral data to trustee.
- ▶ Trustee calculates cash flow, distributes funds to beneficial interest holders and enforces provisions of governing documents.
- ▶ Administrator prepares books, records and tax returns.

In a typical asset-backed securitization, the transferor (also known as the sponsor) bundles together financial assets such as credit card receivables or mortgage loans from a number of its customers (or borrowers) and transfers those assets to an entity formed for the specific purpose of funding the assets. A special-purpose entity (SPE, also referred to as a bankruptcy-remote entity) generally is required to ensure that the transferred financial assets are put beyond the reach of the transferor and its creditors even in the event of the transferor's bankruptcy or receivership. In most structures, a second transfer of the assets to a trust occurs (another SPE, broadly referred to as a securitization entity or issuer) and the trust issues the asset-backed securities. As discussed in section 3, *Criteria for a sale – Legal isolation*, the combination of the two transfers (a two-step transaction) typically is necessary to accomplish legal isolation.

10.2.2 Issuance of asset-backed securities (beneficial interests)

To purchase the assets from the transferor, the securitization entity issues securities to investors either through a private offering or a public offering. As explained in ASC 860-10-05-8, these securities may comprise either a single class having equity characteristics or multiple classes of interest, some having debt characteristics and others having equity characteristics. Credit rating agencies rate the securities in order to provide an external assessment and help the potential beneficial interest holders make a more informed investment decision. Credit rating agencies determine their ratings of asset-backed securities based on the anticipated performance of the underlying collateral pool (including the probability of default) and any credit enhancements provided through securitization.

10.2.3 Static and managed pools

Securitizations involve either “static” assets or “managed” pools of assets. In transactions involving static assets, the assets are held by the securitization entity until repaid by the original obligor. In transactions involving managed pools of assets, the assets may be actively traded by the appointed asset manager of the trust to maximize returns and manage exposure to credit, interest and other market risks. In securitizations with static assets, typically the transferor will assemble the underlying assets, help structure the securities and work with the underwriters to sell the securities to investors. In transactions involving managed assets, an asset manager (which may also be the transferor) performs some or all of those same functions.

10.2.4 Fixed and floating interest rates

The securities are issued with either a fixed interest rate or a floating rate. The coupon (interest rate) on fixed rate securities is determined at the time of issuance. In contrast to fixed rate securities, the rates on floating rate securities are periodically adjusted up or down according to a designated index (e.g., the London Interbank Offered Rate (LIBOR)). The floating rate typically reflects an additional fixed margin over the specified index (e.g., LIBOR plus 150 bps) to cover other risks associated with the securities (e.g., credit, liquidity).

10.2.5 Credit enhancement

Unlike most conventional unsecured corporate bonds, securities created in a securitization transaction are credit enhanced – that is, the credit quality of certain securities issued is increased above that of the underlying asset pool. The credit enhancement increases the likelihood that the investors will receive cash flows to which they are entitled, which causes the majority of the issued securities to have a higher credit rating than the assets transferred to the securitization vehicle. Credit enhancement does not transform poor credit assets into good credit investments; instead, credit enhancement helps to offset potential losses. Some securitizations use external credit enhancement such as letters of credit or surety bonds provided by a third party for a fee that provide guarantees or partial guarantees of the assets within the securitization vehicle. Performance guarantees or recourse arrangements may also be provided by the transferor, although this may prevent the transferor from achieving the legal isolation required for sale accounting or derecognition (refer to section 3, *Criteria for a sale – Legal isolation*).

Some other common mechanisms used to provide credit protection or credit enhancement in a securitization transaction include overcollateralization, excess spread, cash collateral and credit tranching. Each of these mechanisms is discussed further below.

10.2.6 Overcollateralization

Overcollateralization can be achieved by transferring excess collateral to a securitization entity thereby providing protection to investors against credit losses. The excess collateral represents the amount by which the face value of the transferred assets (e.g., underlying pool of mortgage loans) exceeds the par value of the securities issued by the securitization entity. Thus, even if some of the payments from the underlying assets are late or default, investors will not experience losses until defaults on the underlying assets exceed the amount of overcollateralization provided.

10.2.7 Excess spread

Another way to enhance credit protection through securitization structures is through the issuance of securities (beneficial interests) that pay a lower interest rate than the underlying assets that serve as collateral. Excess spread represents the difference between the coupon on the underlying assets (collateral) less the cost of financing those assets (e.g., the coupon payable on securities (beneficial interests) issued by the securitization entity, charge-offs, servicing costs and any other trust related costs). The excess spread can be used to absorb collateral losses or to build overcollateralization to its target level.

10.2.8 Cash collateral account

A cash collateral account is a segregated account established by a securitization entity (trust), funded (generally by the transferor) at the time securities (investor certificates or beneficial interests) are issued. These accounts may consist of cash or short-term, highly rated investments and can be used to make up for cash-flow shortfalls. For example, these funds can be used to cover interest or principal on the investor certificates or trust expenses (e.g., servicing fees) when cash flows from underlying assets are insufficient and when the excess spread, if any, falls below zero.

10.2.9 Credit tranching

Credit enhancement can also be provided through the process of credit tranching (also referred to as tranching of cash flows). The securities issued by securitization entities are often split into discrete tranches (e.g., classes of securities) based on degree of subordination. Each tranche has a different level of credit protection or risk exposure. There is generally a senior class of securities and one or more junior subordinated classes that function as protective layers for the senior class. The senior classes have first claim on the cash flow that the securitization entity receives from the assets it holds, and the more junior classes only start receiving payments after the more senior classes have been repaid.

Because of the cascading effect between classes, this arrangement is often referred to as a cash flow waterfall. In the event that the underlying asset pool is insufficient to make payments on all of the securities (e.g., when loans within a portfolio default), the loss is absorbed first by the most subordinated tranche, and the upper-level tranches remain unaffected until the losses exceed the entire amount of the subordinated tranches. The senior securities are typically AAA rated, signifying a lower risk, while the lower-credit quality subordinated classes receive a lower credit rating, signifying a higher risk.

The most junior class (often called the equity class or residual interest) is most exposed to risk. Often the equity class is held by the transferor as part of the proceeds in a transfer of assets accounted for as a sale and receives no periodic payment, but only the residual cash flow (if any) after all the other classes have been paid.

There may also be one or more special class of securities (or beneficial interests) that absorbs the underlying assets' early repayment risk. This is often the case in which the underlying assets are residential mortgage loans. By passing any early repayments on to this class, the other investors in the securitization entity have more predictable cash flow investments. These concepts are discussed further in the section below in which we address common securitization transactions, including real estate mortgage investment conduits.

10.2.10 Repayment of beneficial interests

Most beneficial interests in securitizations are amortized – that is, the principal amount borrowed is repaid gradually over the specified term of the beneficial interest (e.g., asset-backed securities), rather than in one lump sum at the maturity of the beneficial interest. Fully amortizing beneficial interests are generally collateralized by fully amortizing assets such as home equity loans or auto loans. Prepayment uncertainty is a key concern with fully amortizing asset-backed securities. The possible rate of prepayment varies widely with the type of underlying asset pool and other factors. Consequently, many prepayment models have been developed in an attempt to estimate future prepayment activity. The PSA Prepayment Model⁹⁶ is a well-known example.

A controlled amortization structure is a method of providing investors with a more predictable repayment schedule, even though the underlying assets may be non-amortizing. After a predetermined “revolving” period (common in securitizations of credit card receivables), during which only interest payments are made, these securitizations are designed to return principal to investors in a series of defined periodic payments. An early amortization event is the risk of the beneficial interest being retired early (e.g., due to an unplanned liquidation of assets generally due to the deterioration in the credit quality of the underlying assets). However, certain structures return the principal to investors in a single payment referred to as a “bullet” payment.

Securitizations are often structured as a series of “sequential pay” bonds, which are paid off in a sequential manner based on maturity. This means that the first tranche (or most senior asset-backed security class), which may have a one-year average life, will receive all principal payments until it is retired; then the second tranche begins to receive principal payments and so forth. Pro rata bond structures (or pass-through securitizations) pay each tranche a proportionate share of principal throughout the life of the security. Examples of pass-through securitizations include guaranteed mortgage securitizations such as those sponsored by the Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac).

10.2.11 Servicing

Once the underlying assets (e.g., mortgage loans) are transferred to a securitization trust and the securitization process is complete, the assets are serviced in accordance with the servicing agreement for the trust. The servicing agreement contains provisions specifying the allocation and distribution of asset proceeds and losses to the beneficial interest holders. It also contains provisions regarding how the assets are to be serviced and servicing requirements under special circumstances. A securitization trust may appoint a separate master servicer, primary or sub-servicer and a special servicer.

⁹⁶ The PSA Prepayment Model is a **prepayment** model developed by the **Bond Market Association**, formerly known as the Public Securities Association, or PSA, that assumes increasing prepayment rates for the first 30 months of the lifetime and constant prepayment rates thereafter.

The servicer can significantly affect the cash flows to the investors because it controls the collection policy, which influences the proceeds collected on the assets. Any cash remaining after expenses and payments due to beneficial interest holders is usually accumulated, at least in part, in a reserve or spread account, with any remaining cash returned to those holding the residual equity interest (generally, the transferor/seller).

Refer to section 7, *Servicing of financial assets*, for additional information on the different types and roles of servicers of financial assets and for guidance on accounting for servicing rights.

10.2.12

Advantages and disadvantages of securitization

Securitizations allow an entity to raise capital, restructure debt or otherwise adjust its finances and represent an alternative to more traditional corporate finance options such as a loan, bond issue or issuance of equity such as common stock. Listed below are some of the typical advantages and disadvantages of securitizations.

| Advantages | Disadvantages |
|---|--|
| <ul style="list-style-type: none"> ▶ Reduces funding costs: An entity may be able to reduce its funding costs through the securitization process. This is accomplished by legally isolating the pool of assets from the transferor and through credit enhancement (e.g., third-party guarantees, subordination). In other words, an entity rated “BBB” may be able to borrow at “AAA” rates through securitization structures. This represents the primary motive to securitize cash flows and can significantly reduce the cost of funding. ▶ Lower capital requirements: Due to legal, regulatory or other reasons, some entities such as banks and insurance companies have a limit on the amount of leverage (borrowing) they may incur without raising additional equity capital. By securitizing some of their assets and structuring the transfer of financial assets to achieve sale accounting, these entities may be able to reduce the amount of required capital on their balance sheets while maintaining a portion of the “earnings power” of the transferred assets. ▶ Transfer risks: Securitization makes it possible to transfer all or some portion of risk (e.g., credit, liquidity, prepayment, reinvestment, asset concentration) from an entity that does not want to bear it to those that are willing to do so. ▶ Liquidity and locking in profits: Securitization transactions allow an entity to immediately monetize and reinvest the future cash flows of assets that otherwise are not currently available. For example, mortgage originators have historically been in the business of profiting from the fees associated with loan origination and securitization, rather than bearing the long-term risk of the assets they have originated. | <ul style="list-style-type: none"> ▶ Costs: Securitizations result in significant incremental costs due to legal fees, underwriting fees, credit rating fees and ongoing administrative costs. ▶ Size limitations: Securitizations often require a large pool of assets in order to recover, through reduced funding costs, the incremental costs discussed above. Therefore, securitizations of small- and medium-size pools of assets may not be cost efficient. ▶ Risks: Because a securitization is a structured transaction, investors typically demand that the issuer retain a residual or subordinated interest (e.g., residual tranche) in the transferred assets, which provides a form of credit protection to the investors. These retained interests expose the issuer to credit loss and prepayment risk and consequently reduce the overall credit quality of its retained investment portfolio. Additionally, if the underlying assets perform significantly worse than expected, or if the credit protection is not sufficient, the securitization process exposes the sponsor (the transferor) to reputational and legal risk. |

10.3 Common types of securitization transactions

Securitizations can take many different forms depending on the financial assets being transferred, the objective of the transfer, and investor demands for certain type of securities or beneficial interests. Some of the common types of securitization transactions include:

- ▶ Guaranteed mortgage securitizations
- ▶ Transfers of receivables to a conduit entity that issues commercial paper (CP conduits)
- ▶ Securitizations with a reinvestment feature (revolving-period securitizations)
- ▶ CDOs (Cash, market value and synthetic CDOs)
- ▶ Real estate mortgage investment conduits (REMICs) and RE-REMICs
- ▶ Private label mortgage securitizations⁹⁷

10.3.1 Guaranteed mortgage securitization

A guaranteed mortgage securitization (GMS) is a securitization of a mortgage loan or group of loans that includes a substantive third-party guarantee. Fannie Mae and Freddie Mac, two shareholder-owned, congressionally chartered corporations, are the largest providers of guarantees in this market.

Generally, in a GMS guaranteed by Fannie Mae or Freddie Mac (collectively, government-sponsored enterprises or GSEs), mortgage originators or purchasers of mortgages (e.g., commercial banks, credit unions) sell their mortgages to a GSE. The GSE in turn issues securities backed by those mortgages. These securities represent an undivided ownership interest in the pool of mortgages and are generally referred to as “participation certificates,” or “pass-through securities.” The GSE also guarantees the beneficial interest holder payment of interest and principal on the underlying mortgages. This guarantee increases the value and liquidity of the participation certificates. The GSE will charge a management and guarantee fee for managing the underlying assets, issuing the participation certificates and guaranteeing payments on the participation certificates. The fee covers:

- ▶ Projected credit-related losses from borrower defaults over the life of the mortgages
- ▶ Administrative costs associated with underwriting, pooling and servicing the underlying mortgages, investor reporting, etc.
- ▶ The return on capital deployed to securitize and guarantee the underlying mortgages

The GSEs also serve as master servicer and generally have the unilateral right to remove the primary servicer (often the mortgage originator/transferor). The GSEs also establish the servicing standards that must be followed by the primary servicer.

The Government National Mortgage Association (Ginnie Mae) is another significant market participant. Ginnie Mae is a government-owned corporation within the Department of Housing and Urban Development whose securities are backed by the full faith and credit of the United States. Unlike Fannie Mae and Freddie Mac, which support the conventional (conforming mortgage loan) mortgage market, Ginnie Mae primarily supports the market for certain federally insured loans.

⁹⁷ Refer to Question 4-7 for further discussion.

Specifically, Ginnie Mae guarantees the payment of principal and interest on securities that are based on and backed by pools of residential mortgages that are mainly insured by the Federal Housing Administration or guaranteed by the Department of Veterans Affairs. Ginnie Mae's mission is similar to those of Fannie Mae and Freddie Mac (i.e., to work in the secondary mortgage markets and improve homeownership opportunities). However, in addition to differences in the types of mortgages that back the securities guaranteed by these entities, there are significant differences in the structure of their securitization programs. For example, consider the following excerpt from the Mortgage Bankers Association description of the Ginnie Mae MBS program:

"There is no trust holding the mortgages backing Ginnie Mae pass-through certificates. Rather, the Ginnie Mae MBS Program calls for the establishment of custodial pools [so called "virtual entities"], whereby the Issuer/Servicer conveys to Ginnie Mae all the rights, title and interest to the mortgages in the pool. Fannie Mae and Freddie Mac utilize trusts to pool and segregate assets [see Note 1] and they are the Trustee of the trusts, not an independent bank trust department. ... Ginnie Mae has the ability to legally isolate pools of mortgage loans without the use of a trust or other legal entity and to permit the issuance of pools of mortgage loans as securities through the US Federal Reserve's book-entry system. Ginnie Mae itself does not issue any securities, but instead guarantees the Ginnie Mae mortgage backed security issued by banks, thrifts and mortgage bankers that participate in Ginnie Mae's programs."

Note 1: Federal charters grant Fannie Mae and Freddie Mac the ability to legally isolate pools of mortgage loans with the use of a trust or legal entity.^[98]

10.3.2

Commercial paper conduits

Transfers of receivables to conduits that issue commercial paper take many forms. These entities, whose sole purpose is to facilitate asset-backed financing, are referred to as commercial paper (CP) or asset-backed commercial paper conduits. Because trade receivables are non-interest-bearing, they generally are purchased at a discount to their face amount and any collections in excess of those needed to pay the commercial paper holders is returned to the transferor as proceeds in the form of a subordinated interest (e.g., first-loss beneficial interest or a deferred purchase price) in the transferred receivable. Conduits are usually nominally capitalized, bankruptcy-remote special-purpose vehicles that are established by the manager/servicer and not the sponsoring bank or financial institution that transfers financial assets into the conduit.

A CP program is comprised of a conduit that issues commercial paper and uses the proceeds of such issuance primarily to obtain interests in various types of financial assets, either through asset purchases or secured lending transactions. The repayment of commercial paper issued by a conduit depends primarily on the cash collections received from the conduit's underlying asset pool and also on the conduit's ongoing ability to issue new commercial paper.

There are several types of mechanisms present in the typical commercial paper conduit to reduce risk for the commercial paper investors. Some of these protections include credit enhancements, liquidity support and commercial paper stop-issuance and wind-down triggers.⁹⁹ To support liquidity in case cash collections of the conduit are not enough to redeem its commercial paper, liquidity providers are appointed to stand ready to buy the commercial paper issued by the conduit or purchase its assets so that the related proceeds can be used to repay the commercial paper.

⁹⁸ Source: Mortgage Bankers Association letter to Securities and Exchange Commission (Accounting Group – Interpretations), dated 23 December 2009. Topic: *Implementation issues relating to FASB Statement of Accounting Standards (SFAS) No. 166, Accounting for Transfers of Financial Assets and SFAS No. 167, Amendments to FASB Interpretation No. 46(R).*

⁹⁹ To minimize losses resulting from a deteriorating asset portfolio or upon the occurrence of an event that threatens the conduit's ability to repay maturing CP in full, CP programs are typically structured with mandatory CP stop-issuance or wind-down triggers. If triggers (e.g., based on level of default, liquidity, etc.) with respect to a specific transaction or the entire asset portfolio are breached, the conduit immediately ceases issuing new CP or begins liquidating its asset portfolio.

The commercial paper issued by a typical CP conduit is short-term debt, generally limited to a tenor of no more than 270 days and issued on either an interest-bearing or discount basis. Generally, a CP conduit is exempt from the registration requirements of the Securities Act of 1933. The proceeds of CP issuance are primarily used to obtain interests in various types of asset classes including trade receivables, consumer debt receivables, auto and equipment loans and leases, and collateralized debt obligations.

CP programs are generally sponsored by banks or financial institutions to either finance a company's financial assets (generally known as single-seller conduits) or to provide financing alternatives to the sponsor's clients (generally known as multi-seller conduits). The multi-seller structure provides the flexibility to purchase a variety of financial assets from many different sellers.

10.3.3 Revolving-period securitization

The ASC Master Glossary defines revolving-period securitizations as “securitizations in which receivables are transferred at the inception and also periodically (daily or monthly) thereafter for a defined period (commonly three to eight years), referred to as the revolving period. During the revolving period, the special-purpose entity uses most of the cash collections to purchase additional receivables from the transferor on prearranged terms.” Typically, such a structure is used for securitization of open-ended revolving loans (e.g., credit card receivables, revolving lines of credit, automobile dealer loans, and home equity lines of credit).

In a typical revolving-period securitization, a financial institution (the transferor or sponsor) accumulates a pool of receivables from revolving loan accounts (e.g., credit card debt) in its portfolio. The financial institution then transfers that pool of receivables either directly or indirectly (via a two-step transfer) to a securitization entity (e.g., a tax exempt special-purpose finance corporation or trust) in exchange for cash and a subordinated interest in that securitization entity. Typically, the transferor services the receivables for the securitization entity and receives a servicing fee as compensation. As explained in ASC 860-10-05-11, securitizations of credit card and other receivable portfolios usually involve a specified reinvestment period (usually 18 to 36 months), during which the trust will purchase additional credit card receivables generated by the selected accounts. The transferor's beneficial interests in the receivables in the securitization entity will increase or decrease depending on the aggregate outstanding principal balances of the selected accounts. However, during the reinvestment period, the investors' dollar investment remains constant because principal payments allocated to the investors' interest are reinvested into additional credit card receivables.

Given that the transferor has continuing involvement with the transferred financial assets in revolving-period securitizations, both a true sale and a substantive non-consolidation opinion from a specialist are generally required to support a conclusion that the transferred financial assets are isolated from the transferor. Upon a subsequent transfer during the revolving period, the transferor should evaluate whether it is necessary to obtain an updated legal opinion for the subsequent transfer due to any changes in circumstances, including changes in the law, that may have occurred since the initial transfer that could impact the ongoing applicability of the legal opinion. Refer to section 3.2 for further guidance.

Excerpt from Accounting Standards Codification

Transfers and Servicing – Overall

Overview and Background

Securitizations

860-10-05-11

Securitizations of credit card and other receivable portfolios usually involve a specified reinvestment period (usually 18 to 36 months), during which the trust will purchase additional credit card receivables generated by the selected accounts. After the reinvestment period, a period of liquidation occurs during which the investors receive an allocated portion of principal payments relating to receivables in the trust. The **liquidation method** may vary depending on the terms of the agreement and may be a participation method (payout allocation rate may be fixed, preset, or variable) or a **controlled amortization method** (payout based on a predetermined schedule). Specific methods are as follows:

- a. **Fixed participation method**
- b. **Floating participation method**
- c. **Preset participation method.**

As used in ASC 860-10, the ASC Master Glossary defines the methods mentioned above as follows:

Excerpt from Accounting Standards Codification

Glossary

860-10-20

Fixed participation method

Liquidation method used to allocate principal payments on the receivables in a trust to the investors, under which all principal payments on the receivables in the trust are allocated to the investors based on their respective participation interests in the credit card receivables in the trust at the end of the reinvestment period.

Floating participation method

Liquidation method used to allocate principal payments on the receivables in a trust to the investors, under which principal payments allocated to the investors are based on the investors' actual participation interests in the receivables in the trust each month. Each month, investors' participation interests in the credit card receivables in the trust are redetermined for that month's allocation of principal payments.

Preset participation method

Liquidation method used to allocate principal payments on receivables in a trust to investors. The preset participation method is similar to the fixed participation method except that the percentage used to determine the principal payments allocated to the investors is preset higher than the investors' expected participation interests in the receivables in the trust at the end of the reinvestment period. This method results in a faster payout to the investors than the fixed participation method because a higher percentage of the principal payments is allocated to the investors.

Credit card and other revolving-period securitizations are typically structured as a master trust. Once a master trust is created, it can be used for multiple issuances from the same trust. A master trust can be thought of as a pool of receivables, to which, at times, new receivables are added so that more beneficial interests can be issued to third-party investors. Use of a master trust increases flexibility for the issuer and is cost effective from an administrative perspective as a separate trust is not created for each issuance.

10.3.4 Collateralized debt obligation

A collateralized debt obligation (CDO) is a securitization structure that involves a bankruptcy-remote special-purpose vehicle that issues multiple classes of beneficial interests backed by a pool of financial assets. The beneficial interests issued may be comprised of both debt and equity components. The collateral pool can be static or revolving. A revolving CDO will usually have an asset manager who will actively manage the financial assets of the CDO through reinvesting, hedging and perhaps a limited amount of trading, in return for fees that could be dependent on how effectively the asset manager is able to manage the assets and generate returns while minimizing losses. CDOs allow investors to choose beneficial interests suitable to their risk-reward profile and, in some cases, CDOs can be structured to meet specific customer appetite for risk.

Broadly, CDOs can be divided into three categories:

| Category | Description |
|--------------------------|---|
| Cash flow CDOs | In these structures, credit quality and performance of the underlying financial assets are of primary importance and market price fluctuations are of secondary importance. Financial assets in cash flow CDOs generally are not traded, but are held to maturity to generate cash flows for beneficial interest holders. The principal risk to collateral cash flows is credit risk (i.e., the possibility that the expected stream of cash flows will not be collected due to potential default in the underlying financial assets/collateral). Also, in cash flow CDO structures, the ratings of the securities issued by the CDO trust would depend upon the ability of the underlying collateral pool to generate sufficient cash flows to cover interest and principal payments. |
| Market value CDOs | These structures are rated based on market value over-collateralization. In such structures, market fluctuations (market risk) constitute the primary risk. This type of structure is not very common and is generally used for securitization of more volatile asset classes (e.g., equity securities and similar funds) that may be actually traded by the asset manager. |
| Synthetic CDOs | As the name suggests, these structures synthetically provide exposure to a particular bond portfolio to the beneficial interest holders through use of credit default swaps (CDS). For example, the securitization entity may synthetically create exposure to the bonds of a particular issue by purchasing US Treasury securities and writing a CDS. The combination of the US Treasury securities and CDS replicates the economic characteristics of a bond of the entity whose credit risk underlies the CDS. In a Synthetic CDO transaction, the trust effectively sells credit protection on an underlying pool of assets and in return receives a fee (a guarantee premium) as compensation for bearing the credit risk. The trust then redistributes the credit risk to the noteholders and also passes through the premiums received from the protection buyers. |

A variety of asset types can be included as a collateral pool in a CDO structure. For example:

- ▶ Collateralized Bond Obligations are securities backed by corporate bonds or emerging market debt.
- ▶ Collateralized Loan Obligations are securities backed by bank loans.
- ▶ Structured Finance CDOs are securities backed by commercial mortgage-backed securities, asset-backed securities, REIT debt or beneficial interests issued by other CDOs.
- ▶ Collateralized Synthetic Obligations are securities backed by debt securities and credit default swaps.
- ▶ Collateralized Fund Obligations are securities backed by investments in hedge funds or hedge fund units.

10.3.5 Real estate mortgage investment conduit (REMIC) and RE-REMICs

A real estate mortgage investment conduit (REMIC) is a multiple-class security vehicle designed to achieve preferred tax treatment for issuers and investors. Like other securitizations, interest and principal payments from the underlying financial assets (mortgage-related collateral in this case) are structured into tranches of separate securities. A REMIC securitization entity (REMIC trust) redistributes the cash flow from the underlying mortgage-related collateral to the holders of each tranche (or class) of securities. These classes are contractually distinguished by their sensitivity to the prepayment risk of the underlying mortgage-related collateral. Therefore, each class may have different coupon rates, average lives and final maturities. REMIC trusts that meet certain conditions are subjected to special tax provisions, which exclude them from taxation at the trust level. Instead, only the distributions to investors are taxed. The largest issuers of REMIC securities are the government sponsored entities (i.e., Fannie Mae and Freddie Mac). However, some private institutions, including investment banks, other financial institutions and home builders also issue mortgage-backed securities (referred to as private-label REMICs).

10.3.5.1 REMIC classes

A REMIC may include any number of interest-paying classes, including a residual interest class. These classes can pay fixed-, floating- or zero-interest rates. In a typical REMIC structure, principal on senior classes is retired on a sequential basis. An investor in this senior class is paid interest calculated on the outstanding principal balance of the class; however, principal repayments to an investor typically do not begin until the previous class is retired or as otherwise described in the security's prospectus.

The general characteristics of typical REMIC classes are described below.

| Characteristic | Description |
|---|---|
| Sequential pay classes ("Plain Vanilla" classes) | In sequential pay structures, all principal amortization and prepayments allocable to the senior classes go to the shortest maturity, most senior class until it is fully retired; then principal payments are directed to the next shortest maturity class. This process continues until all classes are paid down. While principal is paying down on one class, remaining classes (except for classes representing residual interests) receive monthly interest payments at the coupon rate on their principal. The actual time that each class is outstanding, as well as the period that principal payments begin and end for each class, will vary based on actual prepayment experience. |
| Planned amortization classes (PACs) | PACs are designed to produce more stable cash flow by directing prepayments from the underlying mortgage-related collateral to other classes, called companion or support classes (discussed further in the following paragraphs). The investor typically receives principal payments in a predetermined time period based on a range of prepayment scenarios (the PAC "band"). PACs are designed to provide investors with both prepayment and extension risk protection. However, the payment schedule will be met only if the underlying mortgage-related collateral prepays at a rate within the range assumed for the structuring of the PAC. For example, if cash collections or repayments from the underlying mortgage-related collateral occurs slower than anticipated (i.e., below the lower range of the PAC band), the life of the PAC is extended; similarly, if the speed of repayment is faster than anticipated (above the upper range of the PAC band), the life of the PAC is shortened. |
| Targeted amortization classes (TACs) | TACs are classes that pay "targeted" principal payments based on a constant prepayment speed. As long as the underlying mortgage-related collateral does not prepay at a rate slower than the targeted constant prepayment speed, the payment schedule will be met. If prepayments are faster than the targeted prepayment speed, excess cash flow will be paid to support classes and the TAC will pay principal according to schedule. If prepayments are slower than anticipated, the average life of the TAC will extend because there will be insufficient funds available to meet the principal payment schedule. TACs are usually found in REMIC transactions that have PAC classes and may serve to absorb some of the cash flow variability directed away from PAC classes. Compared to PACs, TACs have greater cash flow uncertainty and greater extension risk. |

| Characteristic | Description |
|---|--|
| Support or companion classes | <p>These classes are designed to absorb the prepayment risk of the underlying mortgage-related collateral to provide more stable cash flows to other classes in the structure. By their nature, they have more volatile cash flows depending upon the volatility of the prepayment speeds of the underlying mortgage-related collateral. When prepayment speeds fluctuate, the average life of a support class can change dramatically. The average lives of support or companion classes are extended during periods of low prepayments and shortened during periods of accelerated prepayments. Principal cash flows are paid to any PAC, TAC or other scheduled class in a REMIC transaction before they are paid to support classes. Any excess principal cash flow is used to pay down the principal on the outstanding support class (classes). If no support class remains outstanding, then the principal cash flow is used to retire the outstanding PACs, TACs and scheduled classes in order of their stated priorities. On the other hand, when principal cash flow is slower than expected, support classes may not receive any principal during the period in which prepayments are low.</p> |
| Accrual classes | <p>Investors in accrual classes receive no cash flow from the security until certain other classes are paid off. Unlike other classes that pay interest each month, interest that would have been paid to the accrual class is added to its principal balance until the applicable prior classes have paid off. Over time the balance grows and the interest earned, but not paid, is calculated upon this increasing balance (i.e., interest compounds). Once the prior classes have been paid off, the accrual class becomes an interest-paying amortizing class that pays down like a sequential pay class.</p> |
| Interest only and principal only classes (IO/PO) | <p>REMIC structures can contain IO/PO classes in which each class receives a portion of the monthly principal or interest payments from the underlying mortgage-related collateral by “stripping apart” the principal and interest cash flow streams. The underlying mortgage-related collateral’s scheduled principal amortization and prepayments go to the principal only (PO) class. The interest cash flow goes to the interest only (IO) class.</p> <p>The value of an IO class can fluctuate significantly due to changes in interest rates. An IO class not only faces the market risks associated with fixed rate securities, but also faces risk of early prepayment of the amount of the principal on the underlying collateral upon which the IO cash flows are based. For example, if all underlying mortgage loans held as collateral by a securitization entity were to prepay at a rate faster than originally anticipated, investors holding an IO beneficial interest in such assets would not only experience loss of anticipated income, they would also experience the likelihood of not recovering the initial investment. That scenario is likely in periods of declining interest rates when sales of real estate tend to rise and homeowners look to refinance their mortgages at cheaper rates.</p> <p>During a rising interest rate environment, slower than expected prepayments generally are observed. In those instances, the cash flows to the IO class will increase, thereby increasing the yield to investors. Conversely, while early prepayments of underlying mortgage loans negatively affect the value of the IO class, such prepayments provide an enhancement to the yield of the PO class because investors receive the principal cash flows at an accelerated rate. However, if principal prepayments do not materialize as assumed at the time of investment (i.e., the prepayments are slower than anticipated), then the yield on the PO class would be less favorable.</p> |
| Floating-rate and inverse floating-rate classes | <p>A floating-rate class is structured so that the coupon rate payable to the investor adjusts periodically (usually monthly) by adding a certain spread to a benchmark index. In some cases, a cap is present that regulates the highest coupon the class can pay in its lifetime. As the name implies, an inverse floating-rate class is a security class with a coupon rate of interest that varies inversely with changes in specified interest rate levels or indexes (e.g., LIBOR).</p> |

10.3.5.2

RE-REMICs

In a typical RE-REMIC structure, the securities issued by a REMIC trust are backed by the securities of another REMIC. These transactions are sometimes referred to as “re-securitizations.” Operationally, the process begins with an investor transferring ownership of one or more REMIC issued securities to a special-purpose entity that in turn transfers the REMIC securities to a securitization trust. The trust then issues new “RE-REMIC” securities using the original REMIC securities as the underlying assets (rather than whole loans, for example). The new structure may contain securities issued by multiple underlying REMICs.

Similar to other securitization structures, a trustee is appointed to manage the operations of the new securitization trust. This trustee is responsible for receiving the cash distributions on the underlying securities and making the cash distributions to the holders of the RE-REMIC securities. In a simple RE-REMIC structure, as few as one senior and one subordinate class may exist. In that case, realized losses may be first allocated to the subordinated class and then to the senior class. Other structures may have multiple sequential classes and more complex interest and principal waterfalls. The RE-REMIC classes are rated by one or more rating agencies based upon their current assessment of the expected performance of the underlying mortgage-related assets in the original REMIC, as well as the payment priorities of the underlying REMIC and RE-REMIC structures.

Often the primary objective of the re-securitization process is to reduce the credit risk inherent in the underlying REMIC securities.

Illustration 10-1: Transfer to a securitization trust

An entity may transfer a group of existing mortgage-backed securities to a newly created securitization trust and obtain most, if not all, of the senior beneficial interests issued by the securitization trust. Investors other than the transferor purchase some or all of the subordinated interests, thereby reducing the transferor’s overall credit exposure. These higher credit quality interests also receive more favorable regulatory capital treatment resulting in a lower capital charge. As a hypothetical example, a \$50 million asset that required \$1 million in capital at an “AAA” rating may require \$17.5 million if downgraded to “BB-.” At “CCC,” the capital requirement might rise to 100%, or \$50 million. In a RE-REMIC, 75% of the same asset may regain an “AAA” rating, requiring just \$750 thousand in capital. The remaining one-quarter may require 100% capital, but the total capital requirement would fall to \$13.25 million.

Another objective of the re-securitization process is to provide a new source of corporate financing. For example, these transactions may increase the likelihood that the highly rated RE-REMIC security will be accepted as collateral at attractive rates (e.g., at the Federal Home Loan Banks). The transaction also increases the overall marketability of the instrument should the security be marketed for sale at some future date.

10.4

Accounting for securitization transactions

At a conceptual level, the securitization process can result in identification of various financial components (i.e., economic benefits or obligations) related to the transferred financial assets. Examples of financial components that arise in a securitization include servicing assets or liabilities, recourse obligations or various beneficial interests in the cash flows from the securitized assets.

10.5

Illustrative examples

In this section, we illustrate the application of the provisions of ASC 860 through the following example transactions:

- ▶ Transfers of receivables to a conduit entity that issues asset-backed commercial paper
- ▶ Transfers of REMIC securities to a multi-seller securitization entity
- ▶ Securitization with transferor call option

All amounts used in these examples are hypothetical and do not necessarily represent the fair value, gains or losses that would result in the types of transactions illustrated. In practice, the amounts depend on the characteristics of the specific assets securitized, the securitization structure and market conditions. Additionally, the transactions described below are assumed to meet the conditions for sale accounting in ASC 860-10-40-5 and the transferor is not required to consolidate the transferee. There is no assurance or presumption that these transactions would meet the conditions for derecognition and nonconsolidation.

10.5.1

Transfer of receivables to a conduit entity that issues asset-backed commercial paper

Illustration 10-2: Transfer of receivables to a conduit entity that issues asset-backed commercial paper

Company B has \$100 million of short-term non-interest-bearing trade receivables that have an average estimated life of two months. The company has recorded an allowance for credit losses of \$1.1 million for these receivables. A commercial bank (Bank X) has formed a “multi-seller” special-purpose finance entity (Securitization Entity C) to finance trade receivables totaling more than \$1 billion from more than 20 unrelated companies. In a “two-step” securitization, Company B transfers \$95 million of the receivables (book value of \$94 million net of the attributable allowance for credit losses) to a bankruptcy-remote entity and then to Securitization Entity C in exchange for net cash proceeds of \$93 million. To finance this purchase, Securitization Entity C issues commercial paper collateralized by the short-term trade receivables.

The terms of the transaction are summarized as follows:

- ▶ Securitization Entity C issues commercial paper on a continuous basis.
- ▶ Company B agrees to service only the trade receivables transferred by Company B into Securitization Entity C. It receives a servicing fee of 0.25% per annum based on the underlying assets' outstanding principal amount. Because Company B estimates that the benefits of servicing are inadequate, it estimates the fair value of the servicing contract to be a liability of \$0.5 million.
- ▶ Company B has the ability, but is not required, to transfer additional newly-originated receivables (up to an additional \$50 million) for a two-year period under the same terms as the original sale. The purchase price of future receivables will be determined based on the then current commercial paper rates. At inception, based on the terms of the contract, the put option is assumed to have a fair value of zero.
- ▶ Company B provides limited recourse to Securitization Entity C by agreeing to repurchase defaulted receivables at their face amount and bear the effect of any dilution caused by sales returns, rebates, discounts, etc. The fair value of the recourse liability is estimated to be \$1.3 million. Bank X also arranges third-party letters of credit to provide backup credit and liquidity enhancements.
- ▶ Bank X (as sponsoring bank) retains the benefits from, or is at risk for (except for the limited recourse provided by Company B), any positive or negative spread between the amount collected from the receivables (i.e., \$95 million) and the amounts due to the holders of the commercial paper and other administrative expenses of Securitization Entity C. Accordingly, Company B is not entitled to receive any future payments with respect to the transferred receivables except for the servicing fees of 0.25%.
- ▶ Company B has concluded that it should not consolidate Securitization Entity C and that the transfer qualifies for sale accounting.
- ▶ In connection with the sale, Company B has acquired or become obligated with respect to the following newly-created financial instruments (amounts shown in millions):

| | | <u>Estimated fair value</u> |
|--|---------|-----------------------------|
| Asset acquired | | |
| Put option with respect to future receivables | | \$ - |
| Obligations incurred | | |
| Recourse obligation | | 1.3 |
| Servicing liability | | 0.5 |
| <p>► The following illustrates the loss on sale calculation (amounts shown in millions):</p> | | |
| Receivables sold of \$95.0, net of related allowance for credit losses of \$1.0 | | \$ 94.0 |
| Cash proceeds received from transaction | \$ 93.0 | |
| Newly-created interest (at fair value) | | |
| Recourse obligation | (1.3) | |
| Servicing liability | (0.5) | |
| Net proceeds received | | 91.2 |
| Loss on sale | | <u>\$ (2.8)</u> |

The loss on the sale of the receivables arises from the following three unrelated factors:

1. Because the receivables are non-interest-bearing, the price at which they are sold reflects a discount from their face amount of \$2 million (\$95 million – \$93 million). This discount is required to enable Securitization Entity C to pay interest on its commercial paper. The discount also reflects the market return required in exchange for accepting the risk of non-performance beyond the limited recourse provided by the transferor. However, because the receivables are financed in an off-balance-sheet manner, there will not be any subsequent interest expense attributable to funding the receivables. Accordingly, this portion of the loss is often thought of as an acceleration of the cost of funding the receivables over their lives.
2. The contractual servicing fee is less than adequate compensation that would be required to contract with an unrelated party to assume the servicing obligation. As a result, Company B estimates that it has an initial liability (the fair value of which is \$0.5 million) arising from the servicing arrangement. At the date of the transaction, this amount would be considered as a reduction of proceeds.
3. The fair value of the recourse obligation (\$1.3 million) exceeds the recorded allowance for credit losses (\$1 million). The fair value of the recourse obligation generally will exceed the amount of allowances for credit losses. This is primarily because the fair value of the receivables reflects the risk of expected losses in the portfolio, which are typically in excess of those that are currently considered to be probable of occurring and recognized under the incurred loss model for recognizing impairments. The fair value of the recourse obligation will also include a risk premium based on the level of volatility of potential losses. Additionally, the fair value provides a profit to a third party for assuming the recourse obligation risk.

Balance sheet comparison (in millions)

| | <u>Before</u> | <u>After</u> |
|--|----------------|----------------|
| Assets | | |
| Cash | \$ - | \$ 93.0 |
| Trade receivables, net of allowance for credit losses | 98.9 | 4.9 |
| Put option ¹ with respect to future receivables | - | - |
| Total assets | <u>\$ 98.9</u> | <u>\$ 97.9</u> |

Liabilities and equity

| | | | | |
|-------------------------------------|-----------|-------------|-----------|-------------|
| Recourse obligation ² | \$ | – | \$ | 1.3 |
| Servicing liability | | – | | 0.5 |
| Equity | | 98.9 | | 96.1 |
| Total liabilities and equity | \$ | 98.9 | \$ | 97.9 |

¹ The put option is assumed to have met the definition of a derivative instrument as described in ASC 815, *Derivatives and Hedging*. Derivative instruments within the scope of ASC 815 are initially recognized and subsequently measured at fair value (refer to ASC 815-10-35-1 and 35-2).

² ASC 460, *Guarantees*, provides guidance for initial recognition and measurement of guarantees (which include recourse obligations) that are within its scope. However, ASC 460 does not provide detailed guidance for subsequent measurement of such guarantees. A guarantee that is also a derivative instrument pursuant to the provisions of ASC 815 should be subsequently measured at fair value. Section 6, *Recognition and measurement*, provides a brief discussion of appropriate subsequent measurement alternatives.

Other accounting considerations

Gain or loss recognition for revolving-period receivables sold to a securitization trust is limited to receivables that exist and have been sold. As new receivables are sold, rights to service them may become assets or liabilities that are recognized. In many situations, companies that engage in these types of securitization programs commit all newly originated receivables to the program and establish procedures so that all collections are remitted directly to the commercial paper conduit. In these situations, the sale of receivables occurs contemporaneously with its origination.

In the example above, the calculation of loss on sale does not consider certain direct transaction costs typically associated with securitization transactions (see section 6.3.1 for additional information and a listing of commonly incurred transaction costs). ASC 860-20-35-10 specifies that transaction costs relating to a sale of the receivables may be recognized over the initial and reinvestment periods in a rational and systematic manner unless the transaction results in a loss. Transaction costs for a past sale are not an asset and thus are part of the gain or loss on sale. In a credit card securitization, however, some of the transaction costs incurred at the outset relate to the future sales that are to occur during the revolving period, and thus can qualify as an asset. Although ASC 860-20-35-10 specifically refers to credit card securitizations, we believe this guidance is applicable to all revolving-period securitizations.

10.5.2**Transfers of REMIC securities to a multi-seller securitization entity****Illustration 10-3: Transfers of REMIC securities to a multi-seller securitization entity**

Company B owns \$1 billion of residential mortgaged-backed REMIC securities made up of various classes from multiple REMIC issuances. These securities are classified as available-for-sale securities in its investment portfolio. In December 2010, Company B decides to re-securitize its investments in REMIC securities primarily to: (a) raise cash, (b) obtain new securities with enhanced loss protection and (c) obtain more favorable regulatory capital treatment. To assist Company B and others, Bank A (acting as a sponsor) forms a “multi-seller” special-purpose securitization entity (RE-REMIC trust) to purchase Company B’s REMIC securities and issue new RE-REMIC securities.

On 31 December 2010, in a “two-step” securitization, Company B transfers its entire portfolio of REMIC securities to a bankruptcy-remote entity and then to the RE-REMIC trust. The amortized cost basis and fair value of the REMIC securities on the transfer date are \$1 billion and \$814.4 million, respectively. In exchange for the securities, Company B receives cash of \$424.2 million and RE-REMIC securities with an estimated fair value of \$392.2 million.

Other terms of the transaction are summarized as follows:

- ▶ Bank A's fees are fixed and paid from the proceeds from the sale of RE-REMIC securities.

An independent third party trustee is appointed to manage the affairs of the trust including servicing the RE-REMIC securities by collecting the cash flows from the underlying REMIC securities and passing them through to the holders of the RE-REMIC securities. The trustee's servicing fee is fixed and is subject to cancellation provisions that are customary for such contracts. The activities of the trustee are considered ministerial in nature (i.e., they do not have any real effect on credit risk or prepayment risk and, therefore, should not be considered to represent power to direct activities in the consolidation analysis).

- ▶ Company B has concluded that consolidation of the RE-REMIC trust is not required and the transfer qualifies for sale accounting.

The following illustrates the loss on sale calculation (amounts shown in millions):

| | |
|--|------------|
| Proceeds from sale of REMIC securities | |
| Cash received | \$ 424.2 |
| Newly-created interests received (at fair value) | |
| RE-REMIC securities ¹ | 392.2 |
| Proceeds from sale | 816.4 |
| Less: Carrying value of the available-for-sale (AFS) securities | |
| \$1,000 cost basis, less unrealized loss of \$185.6 | (814.4) |
| Other comprehensive income (OCI) – unrealized loss ² | (185.6) |
| Loss on sale | \$ (183.6) |

¹ Overall, the RE-REMIC securities received by Company B are assumed to be of higher quality than the REMIC securities originally transferred by Company B into the RE-REMIC trust. As a result of the enhanced credit quality, the RE-REMIC securities are presumably more easily traded in the marketplace and command a relatively higher price than the securities transferred to the RE-REMIC trust.

² This example assumes that Company B's decision to sell and actual sale of the REMIC securities occurs in the same reporting period. Otherwise, an other-than-temporary impairment would have been recognized in an earlier period in accordance with ASC 320, *Investments – Debt Securities*, if the company intended to sell the impaired securities before their recovery.

Balance sheet comparison (in millions)

| | Before | After |
|--------------------------------------|-----------------|-----------------|
| Assets | | |
| Cash | \$ – | \$ 424.2 |
| REMIC securities, available-for-sale | 814.4 | – |
| RE-REMIC securities | – | 392.2 |
| Total assets | \$ 814.4 | \$ 816.4 |
| Liabilities and equity | | |
| Liabilities | \$ – | \$ – |
| Equity | | |
| OCI – unrealized (loss) | (185.6) | – |
| Retained earnings | 1,000.0 | 816.4 |
| Total equity | 814.4 | 816.4 |
| Total liabilities and equity | \$ 814.4 | \$ 816.4 |

10.5.3 Securitization with transferor call option

Illustration 10-4: Securitization with transferor call option

Company A originates \$100 million of mortgage loans that yield 13% interest (a fixed rate) and have an average estimated life of five years. Company A transfers \$100 million of such loans in a two-step securitization transaction to Securitization Entity F, which raises \$100 million by issuing floating rate senior bonds at LIBOR + 1% to third-party investors. Company A places \$5 million into a “spread account,” which provides credit enhancement as losses are charged against it. The initial \$5 million deposit is funded by Company A by allocating a portion of the cash proceeds received from the transfer of the loans. Additionally, through the spread account, Company A retains the rights to any excess spread (an interest-only strip).

The terms of the transaction are summarized as follows:

- ▶ The excess interest income (interest-only strip) retained by Company A accumulates in the spread account retained within the structure. Any defaulting mortgage loans for which any required payment becomes 90 days past due will be treated as being repaid in full by utilization of funds that are in the spread account.
- ▶ The spread account / interest-only strip has a fair value of \$6 million, which represents the present value of the estimated excess spread after deducting the (a) contractual servicing fees, (b) floating rate of interest to the bondholders and (c) expected principal and interest losses due to borrower defaults (which in this example are assumed to equal the value of the cash allocated to fund the spread account – that is, \$5 million). Company A will continue to provide limited servicing activities for the loans under a servicing contract that stipulates a fee of 1% of the outstanding balances, which represents more than adequate compensation. This contract is deemed to result in an asset of \$100 thousand.
- ▶ Company A has concluded that it should not consolidate Securitization Entity F. Additionally, the criteria of ASC 860-10-40-5 for the transaction to be treated as a sale have been met, except for a call option retained by Company A that permits it to acquire specified loans that make up 20% of the total amount transferred.¹

The following illustrates the gain on sale calculation (amounts shown in millions):

| | |
|--|----------|
| Cash received from sale of loans | \$ 100.0 |
| Newly-created interest (at fair value) | |
| Servicing asset | 0.1 |
| Spread account / Interest-only strip | 6.0 |
| Reduction of proceeds | |
| Initial deposit to spread account | (5.0) |
| Amount attributable to loans not considered sold | (20.0) |
| Net proceeds of sale | 81.1 |
| Less: carrying value of loans sold | (80.0) |
| Gain on sale ² | \$ 1.1 |

¹ It should be noted that if the call had provided Company A with the right to repurchase any loan transferred up to a total aggregate purchase of 20% of the initial balance of the securitized pool of loans, none of the loans would have been considered sold until 20% of the pool was repurchased.

² In the example above, the calculation of gain on sale does not consider transaction costs typically associated with securitization transactions. Refer to section 6.3.1 for additional information and a listing of commonly incurred transaction costs.

Balance sheet comparison (in millions)

| | Before | After |
|---|-----------------|-----------------|
| Assets | | |
| Cash | \$ – | \$ 95.0 |
| Loans | 100.0 | 20.0 |
| Spread account / Interest-only strip ³ | – | 6.0 |
| Servicing asset ⁴ | – | 0.1 |
| Total assets | \$ 100.0 | \$ 121.1 |
| Liabilities and equity | | |
| Liabilities ⁵ | \$ – | \$ 20.0 |
| Equity | 100.0 | 101.1 |
| Total liabilities and equity | \$ 100.0 | \$ 121.1 |

³ Because the terms of the securitization structure stipulate that the delinquent mortgage loans will be repaid from funds that are available in the spread account / interest-only strip, and there is no further recourse against the transferor (Company A), we consider the transferor to have a single beneficial interest in transferred assets that is valued net of the expected losses arising from accounts that become delinquent.

The subsequent measurement for an interest-only strip that is not a derivative is included in ASC 325-40, *Investments – Other – Beneficial Interests in Securitized Financial Assets*. Additionally, ASC 320 generally requires such instruments to be classified and measured as an available for sale investment or as a trading investment. Also refer to section 6.5.3.1 for subsequent measurement considerations for an interest-only strip.

⁴ A servicing asset (or servicing liability) is subsequently measured either at fair value through earnings or at amortized cost, subject to impairment (or increased obligation). Refer to section 7, *Servicing of financial assets*, and ASC 860-50-35 for further information.

⁵ Cash proceeds related to a transferred asset that does not qualify for sale accounting is initially recognized with an offsetting liability. The transferred asset is effectively collateral for a secured borrowing transaction. Unless a fair value option is elected, the recognized liability is subsequently reduced only when the conditions in ASC 405-20-40-1 are met. Generally, the liability has recourse to only the transferred assets and, therefore, there are no subsequent increases in the measurement of the obligation.

11 Disclosures

11.1 Introduction

ASC 860's disclosure requirements apply to both public and nonpublic entities. As with any disclosure requirements, the relevance of the information being disclosed as well as the significance to the overall financial statements will differ among entities based on the nature and size of affected transactions, the types of assets transferred and forms of continuing involvement, among other reasons. Such factors should be considered in developing the most meaningful disclosures.

11.2 Objectives

The principal objectives of ASC 860's disclosure requirements are to provide financial statement users with an understanding of the nature and extent of a transferor's continuing involvement with transferred financial assets and how a transfer affects a transferor's financial statements.

Excerpt from Accounting Standards Codification

Transfers and Servicing – Overall

Disclosure

Disclosure Objectives

860-10-50-3

The principal objectives of the disclosure requirements of this Topic are to provide financial statement users with an understanding of all of the following:

- a. A transferor's **continuing involvement**, if any, with **transferred financial assets**
- b. The nature of any restrictions on assets reported by an entity in its statement of financial position that relate to a transferred **financial asset**, including the carrying amounts of those assets
- c. How servicing assets and servicing liabilities are reported under Subtopic 860-50
- d. For both of the following, how the **transfer** of financial assets affects an entity's financial position, financial performance, and cash flows:
 1. Transfers accounted for as sales, if a transferor has continuing involvement with the transferred financial assets
 2. Transfers of financial assets accounted for as secured borrowings.

860-10-50-4

The objectives in the preceding paragraph apply regardless of whether this Topic requires specific disclosures. The specific disclosures required by this Topic are minimum requirements, and an entity may need to supplement the required disclosures depending on any of the following:

- a. The facts and circumstances of a transfer
- b. The nature of an entity's continuing involvement with the transferred financial assets
- c. The effect of an entity's continuing involvement on the transferor's financial position, financial performance, and cash flows.

Disclosures required for a particular form of continuing involvement shall be considered when determining whether the disclosure objectives of this Topic have been met.

The FASB included the overall disclosure objectives because it is not possible to develop specific disclosure requirements that would anticipate all existing and future transactions. Nonetheless, the FASB developed an extensive list of specific required disclosures.

The disclosure objectives apply even when there is no specific rules-based requirement or the specific required disclosures do not adequately meet the objectives. Entities should also consider disclosures required by other US GAAP (e.g., for derivatives, guarantees, beneficial interests) when determining whether the disclosure objectives have been met.

The FASB considered leading practices in developing its disclosure requirements, including the April 2008 Senior Supervisors Report, *Leading-Practice Disclosures for Selected Exposures*,¹⁰⁰ which was issued by banking commissions and regulators from five countries. We believe entities may find this report helpful in developing their disclosures.

11.3 Aggregation of financial information

ASC 860-10-50-4A through 50-7 provide guidance about whether disclosure requirements should be made at the individual transfer level or for a group of similar transfers.

Excerpt from Accounting Standards Codification

Transfers and Servicing – Overall

Disclosure

Aggregation of Certain Disclosures

860-10-50-4A

Disclosures required by this Topic may be reported in the aggregate for similar transfers if separate reporting of each transfer would not provide more useful information to financial statement users. A transferor shall both:

- a. Disclose how similar transfers are aggregated
- b. Distinguish between transfers that are accounted for as secured borrowings and transfers that are accounted for as sales.

860-10-50-5

In determining whether to aggregate the disclosures for multiple transfers, the reporting entity shall consider quantitative and qualitative information about the characteristics of the transferred financial assets, including all of the following:

- a. The nature of the transferor's continuing involvement^[101]
- b. The types of financial assets transferred^[102]

¹⁰⁰ https://www.newyorkfed.org/medialibrary/media/newsevents/news/banking/2008/SSG_Leading_Practice_Disclosures.pdf.

¹⁰¹ EY note: The ASC Master Glossary defines continuing involvement as any involvement with the transferred financial assets that permits the transferor to receive cash flows or other benefits that arise from the transferred financial assets or that obligates the transferor to provide additional cash flows or other assets to any party related to the transfer. For related implementation guidance, see ASC 860-10-55-79A and 55-79B.

¹⁰² EY note: We believe an entity may aggregate disclosures based upon a combination of the transferred financial assets' (a) legal form (e.g., equity interests vs. debt interests) and (b) nature (e.g., trade receivables, securities, mortgages). Additionally, an entity may consider information about the underlying financial assets' geographic origin, asset type and credit risk.

- c. Risks related to the transferred financial assets to which the transferor continues to be exposed after the transfer and the change in the transferor's risk profile as a result of the transfer
- d. The guidance in paragraph 310-10-50-25 (for risks and uncertainties) and paragraphs 825-10-55-1 through 55-2 (for concentrations involving loan product terms).^[103]

In determining whether to aggregate the disclosures for multiple transfers, we believe a transferor may consider the following factors, among others, when addressing the requirements in ASC 860-10-50-5(c) and 50-5(d):

- ▶ Form of continuing involvement – for example, whether through beneficial interests received as proceeds, derivatives (such as total return swaps), or commitments to provide liquidity and/or credit support
- ▶ Information related to the risk associated with the continuing involvement, including the extent of impairments recognized on any beneficial interests received as proceeds
- ▶ Amount of continuing involvement that is hedged and how it is hedged
- ▶ How continuing involvement is valued and the nature of the assumptions used to value continuing involvement

Excerpt from Accounting Standards Codification

Transfers and Servicing – Overall

Disclosure

Aggregation of Certain Disclosures

860-10-50-6

The disclosures shall be presented in a manner that clearly and fully explains to financial statement users the transferor's risk exposure related to the transferred financial assets and any restrictions on the assets of the entity. An entity shall determine, in light of the facts and circumstances, how much detail it must provide to satisfy disclosure requirements of this Topic and how it aggregates information for assets with different risk characteristics. The entity shall strike a balance between obscuring important information as a result of too much aggregation and excessive detail that may not assist financial statement users to understand the entity's financial position. For example, an entity shall not obscure important information by including it with a large amount of insignificant detail. Similarly, an entity shall not disclose information that is so aggregated that it obscures important differences between the different types of involvement or associated risks.

860-10-50-7

To apply the disclosures required in this Topic, an entity shall consider all involvements by the transferor, its **consolidated affiliates** included in the financial statements being presented, or its **agents** to be involvements by the transferor.

¹⁰³ EY note: The guidance in ASC 310-10-50-25 and ASC 825-10-55-1 was previously included in FSP SOP 94-6-1, *Terms of Loan Products That Give Rise to a Concentration of Credit Risk*.

11.4 Specific disclosure requirements

11.4.1 Transfers of financial assets accounted for as sales

Excerpt from Accounting Standards Codification

Transfers and Servicing – Sales of Financial Assets

Disclosure

All Entities within Scope of Subtopic

860-20-50-2

Paragraphs 860-20-50-3 through 50-4 address disclosures for **securitizations**, asset-backed financing arrangements, and similar **transfers** that have both of the following characteristics:

- a. The transfer is accounted for as a sale
- b. The transferor has continuing involvement with the **transferred financial assets**.

860-20-50-2A

If specific disclosures are required for a particular form of a transferor's continuing involvement by other Topics, the transferor shall provide the information required in paragraphs 860-20-50-3(b) through (cc) and 860-20-50-4(a) with a cross-reference to the separate notes to financial statements so a financial statement user can understand the risks retained in the transfer. The entity does not need to provide each specific disclosure required in paragraphs 860-20-50-3(d) and 860-20-50-4 if the disclosure is not required by other Topics and the objectives of paragraphs 860-10-50-3 through 50-4 are met. For example, if the transferor's only form of continuing involvement is a derivative, the entity shall provide the disclosures required in paragraphs 860-20-50-3(b) through (cc) and 860-20-50-4(a) and the disclosures about derivatives required by applicable Topics. In addition, the entity shall evaluate whether the other disclosures in paragraphs 860-20-50-3 through 50-4 are necessary for the entity to meet the objectives in those paragraphs.

For transfers of financial assets accounted for as sales in which the transferor has continuing involvement, ASC 860 requires certain disclosures for each period an income statement is provided (e.g., three years for most SEC registrants), while other disclosures are required only for the periods for which statements of financial position are provided (e.g., two years for most SEC registrants).

11.4.1.1 Disclosures for each income statement presented

Excerpt from Accounting Standards Codification

Transfers and Servicing – Sales of Financial Assets

Disclosure

Disclosures for Each Income Statement Period

860-20-50-3

For each income statement presented, the entity shall disclose all of the following:

- a. [Subparagraph superseded by Accounting Standards Update No. 2009-16]
- b. The characteristics of the **transfer** including all of the following:
 1. A description of the transferor's **continuing involvement** with the transferred financial assets

2. The nature and initial fair value of both of the following:
 - i. The asset obtained as proceeds
 - ii. The liabilities incurred in the transfer.
 3. The gain or loss from sale of transferred financial assets.
- bb. For the initial fair value measurements in item (b)(2), the level within the fair value hierarchy in Topic 820 in which the fair value measurements fall, segregating fair value measurements using each of the following:
1. Quoted prices in active markets for identical assets or liabilities (Level 1)
 2. Significant other observable inputs (Level 2)
 3. Significant unobservable inputs (Level 3).
- c. For the initial fair value measurements in item (b)(2), the key inputs and assumptions used in measuring the fair value of assets obtained and liabilities incurred as a result of the sale that relate to the transferor's continuing involvement, including quantitative information about all of the following:
1. Discount rates.
 2. Expected prepayments including the expected weighted-average life of prepayable financial assets. The weighted-average life of prepayable assets in periods (for example, months or years) can be calculated by multiplying the principal collections expected in each future period by the number of periods until that future period, summing those products, and dividing the sum by the initial principal balance.
 3. Anticipated credit losses, including expected static pool losses.
- If an entity has aggregated transfers during a period in accordance with the guidance beginning in paragraph 860-10-50-5, it may disclose the range of assumptions.
- cc. For the initial fair value measurements in item (b)(2), the valuation technique(s) used to measure fair value.
- d. Cash flows between a transferor and transferee, including all of the following:
1. **Proceeds** from new transfers
 2. Proceeds from collections reinvested in revolving-period transfers
 3. Purchases of previously transferred financial assets
 4. Servicing fees
 5. Cash flows received from a transferor's interests.

Sales of Loans and Trade Receivables

860-20-50-5

The aggregate amount of gains or losses on sales of loans or trade receivables (including adjustments to record loans held for sale at the lower of amortized cost basis or fair value) shall be presented separately in the financial statements or disclosed in the notes to financial statements. See Topic 310 on receivables and Topic 326 on measurement of credit losses for a full discussion of disclosure requirements for loans and trade receivables.

11.4.1.2

Disclosures for each statement of financial position presented**Excerpt from Accounting Standards Codification****Transfers and Servicing – Sales of Financial Assets***Disclosure**Disclosures of Each Statement of Financial Position Presented***860-20-50-4**

For each statement of financial position presented, regardless of when the transfer occurred, an entity shall disclose all of the following:

- a. Qualitative and quantitative information about the transferor's continuing involvement with transferred financial assets that provides financial statement users with sufficient information to assess the reasons for the continuing involvement and the risks related to the transferred financial assets to which the transferor continues to be exposed after the transfer and the extent that the transferor's risk profile has changed as a result of the transfer (including, but not limited to, credit risk, interest rate risk, and other risks), including all of the following:
 1. The total principal amount outstanding
 2. The amount that has been derecognized
 3. The amount that continues to be recognized in the statement of financial position
 4. The terms of any arrangements that could require the transferor to provide financial support (for example, liquidity arrangements and obligations to purchase assets) to the transferee or its beneficial interest holders, including both of the following:
 - i. A description of any events or circumstances that could expose the transferor to loss
 - ii. The amount of the maximum exposure to loss.
 5. Whether the transferor has provided financial or other support during the periods presented that it was not previously contractually required to provide to the transferee or its beneficial interest holders, including – when the transferor assisted the transferee or its beneficial interest holders in obtaining support – both of the following:
 - i. The type and amount of support
 - ii. The primary reasons for providing the support.

An entity also is encouraged to disclose information about any liquidity arrangements, guarantees, or other commitments by third parties related to the transferred financial assets that may affect the fair value or risk of the related transferor's interest.
- aa. The entity's accounting policies for subsequently measuring assets or liabilities that relate to the continuing involvement with the transferred financial assets.
- b. The key inputs and assumptions used in measuring the fair value of assets or liabilities that relate to the transferor's continuing involvement including, at a minimum, but not limited to, quantitative information about all of the following:
 1. Discount rates

2. Expected prepayments including the expected weighted-average life of prepayable financial assets (see paragraph 860-20-50-3(c)(2))
3. Anticipated credit losses, including expected static pool losses, if applicable. Expected static pool losses can be calculated by summing the actual and projected future credit losses and dividing the sum by the original balance of the pool of assets.

If an entity has aggregated transfers during a period in accordance with the guidance beginning in paragraph 860-10-50-5, it may disclose the range of assumptions.

- c. For the transferor's interest in the transferred financial assets, a sensitivity analysis or stress test showing the hypothetical effect on the fair value of those interests (including any servicing assets or servicing liabilities) of two or more unfavorable variations from the expected levels for each key assumption that is reported under item (b) of this paragraph independently from any change in another key assumption.
- d. A description of the objectives, methodology, and limitations of the sensitivity analysis or stress test.
- e. Information about the asset quality of transferred financial assets and any other financial assets that it manages together with them. This information shall be separated between assets that have been derecognized and assets that continue to be recognized in the statement of financial position. This information is intended to provide financial statement users with an understanding of the risks inherent in the transferred financial assets as well as in other financial assets and liabilities that it manages together with transferred financial assets. For example, information for receivables shall include, but is not limited to both of the following:
 1. [Subparagraph superseded by Accounting Standards Update No. 2009-16]
 2. [Subparagraph superseded by Accounting Standards Update No. 2009-16]
 3. [Subparagraph superseded by Accounting Standards Update No. 2009-16]
 4. Delinquencies at the end of the period
 5. Credit losses, net of recoveries, during the period.

As noted in the requirements above, an entity should disclose the characteristics of the transfer (including a description of the transferor's continuing involvement with the transferred financial assets, the nature and initial fair value of the assets obtained as proceeds and the liabilities incurred in the transfer) and the gain or loss from sale of transferred financial assets. Historically, some entities using revolving securitization structures had separately disclosed only the gain or loss resulting from the initial securitization and not the gains or losses resulting from the subsequent transfers during the revolving period. However, all gains and losses (both initial and subsequent) must be disclosed.

11.4.1.3

Disclosure for transactions accounted for as sales that result in the transferor retaining substantially all of the exposure to the economic return on the transferred financial asset**Excerpt from Accounting Standards Codification****Transfers and Servicing – Sales of Financial Assets***Disclosure**Disclosures for Each Statement of Financial Position Presented***860-20-50-4A**

The disclosure requirement in paragraph 860-20-50-4D applies to transactions accounted for as a sale that comprise both of the following:

- a. A transfer of financial assets to a transferee
- b. An agreement entered into in contemplation of the initial transfer with the transferee that results in the transferor retaining substantially all of the exposure to the economic return on the transferred financial asset throughout the term of the transaction. For purposes of this paragraph, an agreement entered into in contemplation of the initial transfer refers to transactions that depend on the execution of one another and that are entered into for the same business purpose.

860-20-50-4B

The transactions described in paragraph 860-20-50-4A include both of the following types:

- a. Transfers of financial assets with an agreement to repurchase the transferred financial asset (or a substantially-the-same financial asset) before maturity at a fixed or determinable price that will be settled in a form other than the return of the transferred financial asset (for example, the transaction is cash-settled)
- b. Transfers of financial assets with an agreement that requires that the transferor retain substantially all of the exposure to the economic return on the transferred financial asset (for example, a sale with a total return swap).

860-20-50-4C

The following items are not subject to the requirements in paragraph 860-20-50-4D:

- a. Transfers of financial assets with an agreement to purchase another financial asset that is not substantially the same as the initial transferred financial asset in accordance with paragraph 860-10-40-24(a), for example, a dollar roll transaction accounted for as a sale because the financial asset to be purchased is not substantially the same as the initially transferred financial asset in accordance with paragraph 860-10-40-24(a)
- b. Transactions described in paragraph 860-20-50-2 that are subject to the disclosures in paragraphs 860-20-50-3 through 50-4.

860-20-50-4D

To provide an understanding of the nature of the transactions, the transferor's continuing exposure to the transferred financial assets, and the presentation of the components of the transaction in the financial statements, an entity shall disclose the following for outstanding transactions at the reporting date that meet the scope guidance in paragraphs 860-20-50-4A through 50-4B by type of transaction (for example, **repurchase agreement**, securities lending transaction, and sale and total return swap) (except for those transactions that are excluded from the scope, as described in paragraph 860-20-50-4C):

- a. The carrying amount of assets derecognized as of the date of derecognition:
 1. If the amounts that have been derecognized have changed significantly from the amounts that have been derecognized in prior periods or are not representative of the activity throughout the period, a discussion of the reasons for the change shall be disclosed.
- b. The amount of gross cash proceeds received by the transferor for the assets derecognized as of the date of derecognition.
- c. Information about the transferor's ongoing exposure to the economic return on the transferred financial assets:
 1. As of the reporting date, the fair value of assets derecognized by the transferor.
 2. Amounts reported in the statement of financial position arising from the transaction (for example, the carrying value or fair value of forward repurchase agreements or swap contracts). To the extent that those amounts are captured in the derivative disclosures presented in accordance with paragraph 815-10-50-4B, an entity shall provide a cross-reference to the appropriate line item in that disclosure.
 3. A description of the arrangements that result in the transferor retaining substantially all of the exposure to the economic return on the transferred financial assets and the risks related to those arrangements.

ASC 860-20-50-4A requires a transferor to provide the disclosures in ASC 860-20-50-4D for all transfers of financial assets accounted for as sales that involve an agreement with the transferee entered into in contemplation of the initial transfer that result in the transferor retaining substantially all of the exposure to the economic return on the transferred assets throughout the term of the transaction.

For purposes of these disclosures, an agreement "entered into in contemplation of the initial transfer" refers to transactions that depend on the execution of one another and that are only entered into for the same business purpose.

Determining what types of transactions result in an entity retaining substantially all of the exposure to the economic return on the transferred financial assets throughout the term of the transaction will be based on facts and circumstances and will require significant judgment. For example, a transferred financial asset coupled with a credit default swap may be within the scope of these disclosure requirements when the reference asset is nonperforming at the time of transfer, though it's unlikely such a transaction would meet the legal isolation criterion for sale accounting.

ASC 860 does not define what is meant by "substantially all." Based on its use in other US GAAP, it may be interpreted to mean at least 90% of the exposure to the economic return on the transferred financial assets. ASC 860 also doesn't explain how a reporting entity should assess its "exposure to the economic return on the transferred asset." Under the financial asset derecognition guidance in IFRS,¹⁰⁴ the

¹⁰⁴ Specifically, paragraph 21 of International Accounting Standard 39, *Financial Instruments: Recognition and Measurement*, and paragraph 3.2.7 of IFRS 9, *Financial Instruments*.

assessment of transfer of risks and rewards is based on whether the entity has transferred substantially all of the variability in expected gains or losses. This is similar to the guidance on the quantitative analysis of “expected variability” and “expected losses and expected residual returns” in ASC 810-10-20. We believe the risks and rewards analysis required under IFRS would generally meet the objectives of these disclosures. Other approaches may also be acceptable.

Because companies are required to exercise significant judgment, the basis for their conclusions should be documented and accounting policies and related internal controls should be developed.

ASC 860-20-55-108 provides the following example to illustrate one approach for satisfying the quantitative disclosure requirements of ASC 860-20-50-4D:

| Transfers of Financial Assets Accounted for as Sales (Dollars in millions) | | | | | |
|---|---|--|----------------------------------|---|--|
| Type of Transaction | At the Date of Derecognition for Transactions Outstanding | | At the Reporting Date | | |
| | Carrying Amount Derecognized | Gross Cash Proceeds Received for Assets Derecognized | Fair Value of Transferred Assets | Gross Derivative Assets Recorded ^{(a) (b)} | Gross Derivative Liabilities Recorded ^{(a) (b)} |
| Repurchase agreements | \$ XX | \$ XX | \$ XX | \$ XX | \$ XX |
| Sale and a total return swap | XX | XX | XX | XX | XX |
| Securities lending | XX | XX | XX | XX | XX |
| Total | \$ XX | \$ XX | \$ XX | \$ XX | \$ XX |

(a) Balances are presented on a gross basis, before the application of counterparty and cash collateral offsetting.

(b) \$XX of gross derivative assets and \$XX of gross derivative liabilities are included as interest rate contracts in footnote X on derivative disclosures.
\$XX of gross derivative assets and \$XX of gross derivative liabilities are included as credit risk contracts in footnote X on derivative disclosures.

11.4.2

Secured borrowings and collateral

ASC 860-30-50-1A requires certain disclosures for transfers of financial assets accounted for as secured borrowings, including repurchase agreements and securities lending arrangements.

Excerpt from Accounting Standards Codification

Transfers and Servicing – Secured Borrowing and Collateral

Disclosure

General

860-30-50-1A

An entity shall disclose all of the following for **collateral**:

- a. If the entity has entered into **repurchase agreements** or securities lending transactions, it shall disclose its policy for requiring collateral or other security.
- b. As of the date of the latest statement of financial position presented, both of the following:
 1. The carrying amount and classifications of both of the following:
 - i. Any assets pledged as collateral that are not reclassified and separately reported in the statement of financial position in accordance with paragraph 860-30-25-5(a)
 - ii. Associated liabilities.
 2. Qualitative information about the relationship(s) between those assets and associated liabilities; for example, if assets are restricted solely to satisfy a specific obligation, a description of the nature of restrictions placed on those assets.

- c. If the entity has accepted collateral that it is permitted by contract or custom to sell or repledge, it shall disclose all of the following:
 1. The fair value as of the date of each statement of financial position presented of that collateral
 2. The fair value as of the date of each statement of financial position presented of the portion of that collateral that it has sold or repledged
 3. Information about the sources and uses of that collateral.

For overall guidance on Topic 860's disclosures, see Section 860-10-50.

Repurchase agreements and securities lending activities can vary considerably in practice. Given the various risk management practices in place, policies for collateral and other security may significantly affect the amount of credit risk, market risk, settlement risk and other risks an entity assumes. Accordingly, an understanding of an entity's credit risk management practices may be useful to investors, creditors and other users of financial statements in assessing the amount of exposure an entity retains for transactions accounted for as borrowings. Regarding ASC 860-30-50-1A(a), we believe an entity's disclosure about its policy of requiring collateral or other security for such financing transactions should include:

- ▶ The types of transactions the entity enters into
- ▶ The types of assets that are provided or received as collateral
- ▶ Whether collateral levels are monitored and how often they are monitored
- ▶ Other significant aspects of the arrangement

11.4.2.1

Disclosures for repurchase agreements, securities lending transactions and repurchase-to-maturity transactions accounted for as secured borrowings

Excerpt from Accounting Standards Codification

Transfers and Servicing – Secured Borrowing and Collateral

Disclosure

Disclosures for Repurchase Agreements, Securities Lending Transactions, and Repurchase-to-Maturity Transactions

860-30-50-7

To provide an understanding of the nature and risks of short-term collateralized financing obtained through **repurchase agreements**, securities lending transactions, and **repurchase-to-maturity transactions**, that are accounted for as secured borrowings at the reporting date, an entity shall disclose the following information for each interim and annual period about the collateral pledged and the associated risks to which the transferor continues to be exposed after the transfer:

- a. A disaggregation of the gross obligation by the class of collateral pledged. An entity shall determine the appropriate level of disaggregation and classes to be presented on the basis of the nature, characteristics, and risks of the collateral pledged.
 1. Total borrowings under those agreements shall be reconciled to the amount of the gross liability for repurchase agreements and securities lending transactions disclosed in accordance with paragraph 210-20-50-3(a) before any adjustments for offsetting. Any difference between the amount of the gross obligation disclosed under this paragraph and the amount disclosed in accordance with paragraph 210-20-50-3(a) shall be presented as reconciling item(s).

- b. The remaining contractual maturity of the repurchase agreements, securities lending transactions, and repurchase-to-maturity transactions. An entity shall use judgment to determine an appropriate range of maturity intervals that would convey an understanding of the overall maturity profile of the entity's financing agreements.
- c. A discussion of the potential risks associated with the agreements and related collateral pledged, including obligations arising from a decline in the fair value of the collateral pledged and how those risks are managed.

ASC 860-30-50-7 requires a transferor to disclose information about the collateral pledged and the associated risks to which the transferor continues to be exposed to after a transfer subject to a repurchase agreement, securities lending transaction or repurchase-to-maturity transaction that is accounted for as a secured borrowing.

ASC 860-30-55-4 provides the following example to illustrate one approach for satisfying the quantitative disclosure requirements of ASC 860-30-50-7:

| Repurchase Agreements, Securities Lending Transactions, and Repurchase-to-Maturity Transactions Accounted for as Secured Borrowings <i>(Dollars in millions)</i> | | | | | |
|--|--|---------------|---------------|----------------------|---------------|
| 20XX | | | | | |
| | Remaining Contractual Maturity of the Agreements | | | | |
| | Overnight and Continuous | Up to 30 Days | 30-90 days | Greater Than 90 days | Total |
| Repurchase agreements and repurchase-to-maturity transactions | | | | | |
| U.S. Treasury and agency securities | \$ XXX | \$ XXX | \$ XXX | \$ XXX | \$ XXX |
| State and municipal securities | XXX | XXX | XXX | XXX | XXX |
| Asset-backed securities | XXX | XXX | XXX | XXX | XXX |
| Corporate securities | XXX | XXX | XXX | XXX | XXX |
| Equity securities | XXX | XXX | XXX | XXX | XXX |
| Non-U.S. sovereign debt | XXX | XXX | XXX | XXX | XXX |
| Loans | XXX | XXX | XXX | XXX | XXX |
| Other | XXX | XXX | XXX | XXX | XXX |
| Total | XXX | XXX | XXX | XXX | XXX |
| Securities lending transactions | | | | | |
| U.S. Treasury and agency securities | XXX | XXX | XXX | XXX | XXX |
| State and municipal securities | XXX | XXX | XXX | XXX | XXX |
| Corporate securities | XXX | XXX | XXX | XXX | XXX |
| Equity securities | XXX | XXX | XXX | XXX | XXX |
| Non-U.S. sovereign debt | XXX | XXX | XXX | XXX | XXX |
| Loans | XXX | XXX | XXX | XXX | XXX |
| Other | XXX | XXX | XXX | XXX | XXX |
| Total | XXX | XXX | XXX | XXX | XXX |
| Total borrowings | \$ XXX | \$ XXX | \$ XXX | \$ XXX | \$ XXX |
| Gross amount of recognized liabilities for repurchase agreements and securities lending in footnote X | | | | | \$ XXX |
| Amounts related to agreements not included in offsetting disclosure in footnote X | | | | | \$ XXX |

11.4.2.2

Balance sheet offsetting disclosure requirements for repurchase agreements and securities lending transactions**Excerpt from Accounting Standards Codification****Transfers and Servicing – Secured Borrowing and Collateral***Disclosure**Disclosures for Repurchase Agreements, Securities Lending Transactions, and Repurchase-to-Maturity Transactions***860-30-50-8**

A reporting entity also shall disclose the information required by paragraphs 210-20-50-1 through 50-6 for both of the following that are either offset in accordance with Section 210-20-45 or subject to an enforceable master netting arrangement or similar agreement:

- a. Recognized repurchase agreements accounted for as a collateralized borrowing and reverse repurchase agreements accounted for as a collateralized borrowing
- b. Recognized securities borrowing and securities lending transactions.

11.4.2.3

SEC Regulation S-X disclosure requirements for repurchase and reverse repurchase agreements

For each period that a statement of financial position is presented by a publicly traded entity, SEC Regulation S-X §210.4.08(m) requires certain information about repurchase and reverse repurchase agreements. As indicated in the excerpt below, this information is required on the face of the appropriate financial statement or in appropriately captioned notes to the financial statements.

Excerpt from SEC Regulation S-X**§210.4.08(m)****(m) Repurchase and reverse repurchase agreements.****(1) Repurchase agreements (assets sold under agreements to repurchase).**

- (i) If, as of the most recent balance sheet date, the carrying amount (or market value, if higher than the carrying amount or if there is no carrying amount) of the securities or other assets sold under agreements to repurchase (repurchase agreements) exceeds 10% of total assets, disclose separately in the balance sheet the aggregate amount of liabilities incurred pursuant to repurchase agreements including accrued interest payable thereon.
- (ii)(A) If, as of the most recent balance sheet date, the carrying amount (or market value, if higher than the carrying amount) of securities or other assets sold under repurchase agreements, other than securities or assets specified in paragraph (m)(1)(ii)(B) of this section, exceeds 10% of total assets, disclose in an appropriately captioned footnote containing a tabular presentation, segregated as to type of such securities or assets sold under agreements to repurchase (e.g., U.S. Treasury obligations, U.S. Government agency obligations and loans), the following information as of the balance sheet date for each such agreement or group of agreements (other than agreements involving securities or assets specified in paragraph (m)(1)(ii)(B) of this section) maturing (1) overnight; (2) term up to 30 days; (3) term of 30 to 90 days; (4) term over 90 days and (5) demand:
 - (i) The carrying amount and market value of the assets sold under agreement to repurchase, including accrued interest plus any cash or other assets on deposit under the repurchase agreements; and

- (ii) The repurchase liability associated with such transaction or group of transactions and the interest rate(s) thereon.
- (B) For purposes of paragraph (m)(1)(ii)(A) of this section only, do not include securities or other assets for which unrealized changes in market value are reported in current income or which have been obtained under reverse repurchase agreements.
- (iii) If, as of the most recent balance sheet date, the amount at risk under repurchase agreements with any individual counterparty or group of related counterparties exceeds 10% of stockholders' equity (or in the case of investment companies, net asset value), disclose the name of each such counterparty or group of related counterparties, the amount at risk with each, and the weighted average maturity of the repurchase agreements with each. The amount at risk under repurchase agreements is defined as the excess of carrying amount (or market value, if higher than the carrying amount or if there is no carrying amount) of the securities or other assets sold under agreement to repurchase, including accrued interest plus any cash or other assets on deposit to secure the repurchase obligation, over the amount of the repurchase liability (adjusted for accrued interest). (Cash deposits in connection with repurchase agreements shall not be reported as unrestricted cash pursuant to rule 5-02.1.)
- (2) Reverse repurchase agreements (assets purchased under agreements to resell).
 - (i) If, as of the most recent balance sheet date, the aggregate carrying amount of reverse repurchase agreements (securities or other assets purchased under agreements to resell) exceeds 10% of total assets: (A) Disclose separately such amount in the balance sheet; and (B) Disclose in an appropriately captioned footnote: (1) The registrant's policy with regard to taking possession of securities or other assets purchased under agreements to resell; and (2) Whether or not there are any provisions to ensure that the market value of the underlying assets remains sufficient to protect the registrant in the event of default by the counterparty and if so, the nature of those provisions.
 - (ii) If, as of the most recent balance sheet date, the amount at risk under reverse repurchase agreements with any individual counterparty or group of related counterparties exceeds 10% of stockholders' equity (or in the case of investment companies, net asset value), disclose the name of each such counterparty or group of related counterparties, the amount at risk with each, and the weighted average maturity of the reverse repurchase agreements with each. The amount at risk under reverse repurchase agreements is defined as the excess of the carrying amount of the reverse repurchase agreements over the market value of assets delivered pursuant to the agreements by the counterparty to the registrant (or to a third party agent that has affirmatively agreed to act on behalf of the registrant) and not returned to the counterparty, except in exchange for their approximate market value in a separate transaction.

11.4.3

Servicing assets and servicing liabilities

ASC 860-50-50-2 through 50-5 require certain disclosures for servicing assets and servicing liabilities, including specific disclosures for those servicing assets and liabilities subsequently measured at fair value or subsequently amortized.

11.4.3.1

Disclosures required for all servicing assets and servicing liabilities

Excerpt from Accounting Standards Codification

Transfers and Servicing – Servicing Assets and Liabilities

Disclosure

All Servicing Assets and Servicing Liabilities

860-50-50-2

For all servicing assets and servicing liabilities, all of the following shall be disclosed:

- a. Management's basis for determining its classes of servicing assets and servicing liabilities.
- b. A description of the risks inherent in servicing assets and servicing liabilities and, if applicable, the instruments used to mitigate the income statement effect of changes in fair value of the servicing assets and servicing liabilities.
- c. The amount of **contractually specified servicing fees**, late fees, and ancillary fees recognized for each period for which results of operations are presented, including a description of where each amount is reported in the statement of income.
- d. Quantitative and qualitative information about the assumptions used to estimate fair value (for example, discount rates, anticipated credit losses, and prepayment speeds).

Disclosure of quantitative information about the instruments used to manage the risks inherent in servicing assets and servicing liabilities, including the fair value of those instruments at the beginning and end of the period, is encouraged but not required. An entity that provides such quantitative information is also encouraged, but not required, to disclose quantitative and qualitative information about the assumptions used to estimate the fair value of those instruments. Section 235-10-50 provides guidance on disclosures of accounting policies.

11.4.3.2

Determining classes of servicing assets and servicing liabilities

The approach to determining classes of servicing assets and servicing liabilities varies in practice. ASC 860-50-35-5 states that these classes shall be identified based on one or both of the following:

- (a) The availability of market inputs used in determining the fair value of servicing assets or servicing liabilities
- (b) An entity's method for managing the risks of its servicing assets or servicing liabilities

Other than these conditions, ASC 860 does not provide explicit guidance about how to identify classes of servicing assets or servicing liabilities.

11.4.3.3

Risks inherent in servicing

Certain servicing activities may be more complex than others, depending upon the type of underlying asset that is being serviced. For example, servicing for conventional mortgage loans is less complex than servicing for subprime mortgage loans, which have a higher probability of defaulting and of requiring some form of remediation (e.g., loan modification or foreclosure). The predominant risk characteristics of the underlying assets may include asset type (e.g., mortgage loans vs. auto loans), size, interest rate (fixed vs. floating), date of origination, term and/or geographic location.

The fair value of the related servicing assets and servicing liabilities is directly affected by, among other things, changes in each of the following factors associated with the underlying assets: (a) prepayment speeds, (b) delinquency and default rates and (c) cost of servicing. An entity may develop and implement an economic hedge program to, among other things, mitigate the overall risk of loss due to changes in the fair value of its servicing rights. The success or failure of any economic hedging program may significantly affect the results of an entity's operations. Each of these risks factors, including an entity's policies and procedures for mitigating these risks, if any, should be adequately disclosed.

11.4.3.4

Disclosures required for servicing assets and servicing liabilities subsequently measured at fair value

For each period that results of operations are presented, ASC 860 also requires a rollforward of the balances of servicing assets and servicing liabilities subsequently measured at fair value.

Excerpt from Accounting Standards Codification

Transfers and Servicing – Servicing Assets and Liabilities

Disclosure

Servicing Assets and Servicing Liabilities Subsequently Measured at Fair Value

860-50-50-3

For servicing assets and servicing liabilities subsequently measured at fair value, the following shall be disclosed:

- a. For each class of servicing assets and servicing liabilities, the activity in the balance of servicing assets and the activity in the balance of servicing liabilities (including a description of where changes in fair value are reported in the statement of income for each period for which results of operations are presented), including, but not limited to, the following:
 1. The beginning and ending balances
 2. Additions through any of the following:
 - i. Purchases of servicing assets
 - ii. Assumptions of servicing obligations
 - iii. Recognition of servicing obligations that result from **transfers of financial assets**.
 3. Disposals
 4. Changes in fair value during the period resulting from either of the following:
 - i. Changes in valuation inputs or assumptions used in the valuation model
 - ii. Other changes in fair value and a description of those changes.
 5. Other changes that affect the balance and a description of those changes.

[EY Note: See Example 2 (paragraph 860-50-55-27) for an illustration of the disclosure requirement in paragraph 860-50-50-3(a).]
- b. Subparagraph superseded by Accounting Standards Update No. 2009-16.

11.4.3.5

Disclosures required for servicing assets and servicing liabilities subsequently amortized

A rollforward is also required for servicing assets and servicing liabilities subsequently measured at amortized cost. However, because the reasons for changes in carrying amounts differ between servicing assets or liabilities that are amortized compared to those subsequently measured at fair value, a different rollforward with different line items is required for servicing assets and liabilities subsequently amortized.

Excerpt from Accounting Standards Codification

Transfers and Servicing – Servicing Assets and Liabilities

Disclosure

Servicing Assets and Servicing Liabilities Subsequently Amortized

860-50-50-4

For servicing assets and servicing liabilities measured subsequently under the amortization method in paragraph 860-50-35-1(a), all of the following shall be disclosed:

- a. For each class of servicing assets and servicing liabilities, the activity in the balance of servicing assets and the activity in the balance of servicing liabilities (including a description of where changes in the carrying amount are reported in the statement of income for each period for which results of operations are presented), including, but not limited to, the following:
 1. The beginning and ending balances
 2. Additions through any of the following:
 - i. Purchases of servicing assets
 - ii. Assumptions of servicing obligations
 - iii. Recognition of servicing obligations that result from transfers of financial assets.
 3. Disposals
 4. Amortization
 5. Application of valuation allowance to adjust carrying value of servicing assets
 6. Other-than-temporary impairments
 7. Other changes that affect the balance and a description of those changes.

[EY Note: See Example 2 (paragraph 860-50-55-27) for an illustration of the disclosure requirement in paragraph 860-50-50-4(a).]
- b. For each class of servicing assets and servicing liabilities, the fair value of recognized servicing assets and servicing liabilities at the beginning and end of the period.
- c. Subparagraph superseded by Accounting Standards Update No. 2009-16.
- d. The risk characteristics of the underlying financial assets used to stratify recognized servicing assets for purposes of measuring impairment in accordance with paragraph 860-50-35-9. If the predominant risk characteristics and resulting stratum are changed, that fact and the reasons for those changes shall be included in the disclosures about the risk characteristics of the underlying financial assets used to stratify the recognized servicing assets in accordance with this paragraph.

- e. For each period for which results of operations are presented, the activity by class in any valuation allowance for impairment of recognized servicing assets, including all of the following:
 - 1. Beginning and ending balances
 - 2. Aggregate additions charged and recoveries credited to operations
 - 3. Aggregate write-downs charged against the allowance.

11.4.3.6

Disclosures required for a change in subsequent measurement of servicing assets and servicing liabilities from amortization to fair value

Excerpt from Accounting Standards Codification

Transfers and Servicing – Servicing Assets and Liabilities

Disclosure

Servicing Assets and Servicing Liabilities Subsequently Amortized

860-50-50-5

If an entity elects under paragraph 860-50-35-3(d) to subsequently measure a class of servicing assets and servicing liabilities at fair value at the beginning of the fiscal year, the amount of the cumulative-effect adjustment to retained earnings shall be separately disclosed.

Because this adjustment is presented in the statement of operations, we believe that the disclosure should be presented for each period such an adjustment affects a presented statement of operations.

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Glossary

This appendix defines terms used in ASC 860, which are also included in the ASC Master Glossary.

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| Adequate compensation | The amount of benefits of servicing that would fairly compensate a substitute servicer should one be required, which includes the profit that would be demanded in the marketplace. It is the amount demanded by the marketplace to perform the specific type of servicing. Adequate compensation is determined by the marketplace; it does not vary according to the specific servicing costs of the servicer. |
| Affiliate | A party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with an entity. |
| Agent | A party that acts for and on behalf of another party. For example, a third-party intermediary is an agent of the transferor if it acts on behalf of the transferor. |
| Attached call option | A call option held by the transferor of a financial asset that becomes part of and is traded with the underlying instrument. Rather than being an obligation of the transferee, an attached call option is traded with and diminishes the value of the underlying instrument transferred subject to that call option. |
| Bankruptcy-remote entity | An entity that is designed to make remote the possibility that it would enter bankruptcy or other receivership. |
| Beneficial interests | <p>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:</p> <ul style="list-style-type: none"> 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 |
| Benefits of servicing | Revenues from contractually specified servicing fees, late charges, and other ancillary sources, including float. |
| Cash | Consistent with common usage, cash includes not only currency on hand but demand deposits with banks or other financial institutions. Cash also includes other kinds of accounts that have the general characteristics of demand deposits in that the customer may deposit additional funds at any time and also effectively may withdraw funds at any time without prior notice or penalty. All charges and credits to those accounts are cash receipts or payments to both the entity owning the account and the bank holding it. For example, a bank's granting of a loan by crediting the proceeds to a customer's demand deposit account is a cash payment by the bank and a cash receipt of the customer when the entry is made. |

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| Cleanup call option | An option held by the servicer or its affiliate, which may be the transferor, to purchase the remaining transferred financial assets, or the remaining beneficial interests not held by the transferor, its affiliates, or its agents in an entity (or in a series of beneficial interests in transferred financial assets within an entity) if the amount of outstanding financial assets or beneficial interests falls to a level at which the cost of servicing those assets or beneficial interests becomes burdensome in relation to the benefits of servicing. |
| Collateral | Personal or real property in which a security interest has been given. |
| Consolidated affiliate | An entity whose assets and liabilities are included in the consolidated, combined, or other financial statements being presented. |
| Continuing involvement | Any involvement with the transferred financial assets that permits the transferor to receive cash flows or other benefits that arise from the transferred financial assets or that obligates the transferor to provide additional cash flows or other assets to any party related to the transfer. |
| Contractually specified servicing fees | All amounts that, per contract, are due to the servicer in exchange for servicing the financial asset and would no longer be received by a servicer if the beneficial owners of the serviced assets (or their trustees or agents) were to exercise their actual or potential authority under the contract to shift the servicing to another servicer. Depending on the servicing contract, those fees may include some or all of the difference between the interest rate collectible on the financial asset being serviced and the rate to be paid to the beneficial owners of those financial assets. |
| Controlled amortization method | Liquidation method used to allocate principal payments on the receivables in a trust to the investors, under which a predetermined monthly payment schedule is established so that payout to the investors will occur over a specified liquidation period. Principal payments are allocated to the investors based on their participation interests in the receivables in the trust, using one of the liquidation methods (fixed, preset, or floating). Principal payments in excess of the predetermined monthly payment, if any, are allocated to the transferor and increase the investors' ownership interests. If the principal payments allocated to the investors are insufficient to cover the predetermined monthly payment, that payment is reduced by the amount of the deficiency. If the principal payments allocated to the investors in subsequent months exceed the predetermined monthly payment, the deficiency is recovered. |
| Derecognize | Remove previously recognized assets or liabilities from the statement of financial position. |
| Derivative financial instrument | A derivative instrument (as defined in ASC 815) that is a financial instrument. |

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| Dollar-roll repurchase agreement | <p>An agreement to sell and repurchase similar but not identical securities. The securities sold and repurchased are usually of the same issuer. Dollar rolls differ from regular repurchase agreements in that the securities sold and repurchased have all of the following characteristics:</p> <ul style="list-style-type: none"> a. They are represented by different certificates. b. They are collateralized by different but similar mortgage pools (for example, conforming single-family residential mortgages). c. They generally have different principal amounts. <p>Fixed coupon and yield maintenance dollar agreements comprise the most common agreement variations. In a fixed coupon agreement, the seller and buyer agree that delivery will be made with securities having the same stated interest rate as the interest rate stated on the securities sold. In a yield maintenance agreement, the parties agree that delivery will be made with securities that will provide the seller a yield that is specified in the agreement.</p> |
| Embedded call option | <p>A call option held by the issuer of a financial instrument that is part of and trades with the underlying instrument. For example, a bond may allow the issuer to call it by posting a public notice well before its stated maturity that asks the current holder to submit it for early redemption and provides that interest ceases to accrue on the bond after the early redemption date. Rather than being an obligation of the initial purchaser of the bond, an embedded call trades with and diminishes the value of the underlying bond.</p> |
| Equitable right of redemption | <p>The right of a property owner who has defaulted on a secured obligation to recover the securing property before its sale by paying the amounts due and any appropriate fees and charges. Other creditors of or a receiver for the property owner also may be able to exercise that right. After a transfer of a financial asset, a right of redemption may allow the transferor to buy back the transferred asset.</p> |
| Financial asset | <p>Cash, evidence of an ownership interest in an entity, or a contract that conveys to one entity a right to do either of the following:</p> <ul style="list-style-type: none"> a. Receive cash or another financial instrument from a second entity b. Exchange other financial instruments on potentially favorable terms with the second entity. |
| Financial instrument | <p>Cash, evidence of an ownership interest in an entity, or a contract that both:</p> <ul style="list-style-type: none"> a. Imposes on one entity a contractual obligation either: <ul style="list-style-type: none"> 1. To deliver cash or another financial instrument to a second entity 2. To exchange other financial instruments on potentially unfavorable terms with the second entity b. Conveys to that second entity a contractual right either: <ul style="list-style-type: none"> 1. To receive cash or another financial instrument from the first entity 2. To exchange other financial instruments on potentially favorable terms with the first entity |

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| Financial instrument (continued) | <p>The use of the term financial instrument in this definition is recursive (because the term financial instrument is included in it), though it is not circular. The definition requires a chain of contractual obligations that ends with the delivery of cash or an ownership interest in an entity. Any number of obligations to deliver financial instruments can be links in a chain that qualifies a particular contract as a financial instrument.</p> <p>Contractual rights and contractual obligations encompass both those that are conditioned on the occurrence of a specified event and those that are not. All contractual rights (contractual obligations) that are financial instruments meet the definition of asset (liability) set forth in FASB Concepts Statement No. 6, <i>Elements of Financial Statements</i>, although some may not be recognized as assets (liabilities) in financial statements – that is, they may be off-balance-sheet – because they fail to meet some other criterion for recognition.</p> <p>For some financial instruments, the right is held by or the obligation is due from (or the obligation is owed to or by) a group of entities rather than a single entity.</p> |
| Financial liability | <p>A contract that imposes on one entity an obligation to do either of the following:</p> <ul style="list-style-type: none"> a. Deliver cash or another financial instrument to a second entity b. Exchange other financial instruments on potentially unfavorable terms with the second entity |
| Fixed participation method | <p>Liquidation method used to allocate principal payments on the receivables in a trust to the investors, under which all principal payments on the receivables in the trust are allocated to the investors based on their respective participation interests in the credit card receivables in the trust at the end of the reinvestment period.</p> |
| Floating participation method | <p>Liquidation method used to allocate principal payments on the receivables in a trust to the investors, under which principal payments allocated to the investors are based on the investors' actual participation interests in the receivables in the trust each month. Each month, investors' participation interests in the credit card receivables in the trust are redetermined for that month's allocation of principal payments.</p> |
| Freestanding call option | <p>A call that is neither embedded in nor attached to an asset subject to that call option.</p> |
| Government National Mortgage Association Rolls | <p>The term Government National Mortgage Association (GNMA) rolls has been used broadly to refer to a variety of transactions involving mortgage-backed securities, frequently those issued by the GNMA. There are four basic types of transactions:</p> <ul style="list-style-type: none"> a. Type 1: Reverse repurchase agreements for which the exact same security is received at the end of the repurchase period (vanilla repo) b. Type 2: Fixed coupon dollar reverse repurchase agreements (dollar repo) |

**Government National
Mortgage Association Rolls
(continued)**

- c. Type 3: Fixed coupon dollar reverse repurchase agreements that are rolled at their maturities, that is, renewed in lieu of taking delivery of an underlying security (GNMA roll)
- d. Type 4: Forward commitment dollar rolls (also referred to as to-be-announced GNMA forward contracts or to-be-announced GNMA rolls), for which the underlying security does not yet exist

**In substance nonfinancial
asset**

An in substance nonfinancial asset is a financial asset (for example, a receivable) promised to a counterparty in a contract if substantially all of the fair value of the assets (recognized and unrecognized) that are promised to the counterparty in the contract is concentrated in nonfinancial assets. If substantially all of the fair value of the assets that are promised to a counterparty in a contract is concentrated in nonfinancial assets, all of the financial assets promised to the counterparty in the contract are in substance nonfinancial assets. For purposes of this evaluation, when a contract includes the transfer of ownership interests in one or more consolidated subsidiaries that is not a business, an entity evaluates the underlying assets in those subsidiaries. (See also ASC 610-20-15-6 through 15-8.)

Interest-only strip

A contractual right to receive some or all of the interest due on a bond, mortgage loan, collateralized mortgage obligation, or other interest-bearing financial asset.

Liquidation method

The method used to allocate the principal payments on the receivables in a trust to the investors.

Loan origination fees

Origination fees consist of all of the following:

- a. Fees that are being charged to the borrower as prepaid interest or to reduce the loan's nominal interest rate, such as interest buy-downs (explicit yield adjustments)
- b. Fees to reimburse the lender for origination activities
- c. Other fees charged to the borrower that relate directly to making the loan (for example, fees that are paid to the lender as compensation for granting a complex loan or agreeing to lend quickly)
- d. Fees that are not conditional on a loan being granted by the lender that receives the fee but are, in substance, implicit yield adjustments because a loan is granted at rates or terms that would not have otherwise been considered absent the fee (for example, certain syndication fees addressed in paragraph 310-20-25-19)
- e. Fees charged to the borrower in connection with the process of originating, refinancing, or restructuring a loan. This term includes, but is not limited to, points, management, arrangement, placement, application, underwriting, and other fees pursuant to a lending or leasing transaction and also includes syndication and participation fees to the extent they are associated with the portion of the loan retained by the lender.

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| Loan participation | A transaction in which a single lender makes a large loan to a borrower and subsequently transfers undivided interests in the loan to groups of banks or other entities. |
| Loan syndication | A transaction in which several lenders share in lending to a single borrower. Each lender loans a specific amount to the borrower and has the right to repayment from the borrower. It is common for groups of lenders to jointly fund those loans when the amount borrowed is greater than any one lender is willing to lend. |
| Money-over-money lease | A transaction in which an entity manufactures or purchases an asset, leases the asset to a lessee, and obtains nonrecourse financing in excess of the asset's cost using the leased asset and the future lease rentals as collateral. |
| Nonpublic entity | <p>Any entity other than one with any of the following characteristics:</p> <ul style="list-style-type: none"> a. Whose debt or equity securities trade in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter market, including securities quoted only locally or regionally b. That is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets) c. That makes a filing with a regulatory agency in preparation for the sale of any class of debt or equity securities in a public market d. That is controlled by an entity covered by a., b., or c. <p>Conduit debt securities refers to certain limited-obligation revenue bonds, certificates of participation, or similar debt instruments issued by a state or local governmental entity for the express purpose of providing financing for a specific third party (the conduit bond obligor) that is not a part of the state or local government's financial reporting entity. Although conduit debt securities bear the name of the governmental entity that issues them, the governmental entity often has no obligation for such debt beyond the resources provided by a lease or loan agreement with the third party on whose behalf the securities are issued. Further, the conduit bond obligor is responsible for any future financial reporting requirements.</p> |

Participating interest

A participating interest has the following characteristics:

- a. From the date of the transfer, it represents a proportionate (pro rata) ownership interest in an entire financial asset. The percentage of ownership interests held by the transferor in the entire financial asset may vary over time, while the entire financial asset remains outstanding as long as the resulting portions held by the transferor (including any participating interest retained by the transferor, its consolidated affiliates included in the financial statements being presented, or its agents) and the transferee(s) meet the other characteristics of a participating interest. For example, if the transferor's interest in an entire financial asset changes because it subsequently sells another interest in the entire financial asset, the interest held initially and subsequently by the transferor must meet the definition of a participating interest.
- b. From the date of the transfer, all cash flows received from the entire financial asset are divided proportionately among the participating interest holders in an amount equal to their share of ownership. Cash flows allocated as compensation for services performed, if any, shall not be included in that determination provided those cash flows are not subordinate to the proportionate cash flows of the participating interest and are not significantly above an amount that would fairly compensate a substitute service provider, should one be required, which includes the profit that would be demanded in the marketplace. In addition, any cash flows received by the transferor as proceeds of the transfer of the participating interest shall be excluded from the determination of proportionate cash flows provided that the transfer does not result in the transferor receiving an ownership interest in the financial asset that permits it to receive disproportionate cash flows.
- c. The rights of each participating interest holder (including the transferor in its role as a participating interest holder) have the same priority, and no participating interest holder's interest is subordinated to the interest of another participating interest holder. That priority does not change in the event of bankruptcy or other receivership of the transferor, the original debtor, or any other participating interest holder. Participating interest holders have no recourse to the transferor (or its consolidated affiliates included in the financial statements being presented or its agents) or to each other, other than standard representations and warranties, ongoing contractual obligations to service the entire financial asset and administer the transfer contract, and contractual obligations to share in any set-off benefits received by any participating interest holder. That is, no participating interest holder is entitled to receive cash before any other participating interest holder under its contractual rights as a participating interest holder. For example, if a participating interest holder also is the servicer of the entire financial asset and receives cash in its role as servicer, that arrangement would not violate this requirement.
- d. No party has the right to pledge or exchange the entire financial asset unless all participating interest holders agree to pledge or exchange the entire financial asset.

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| Preset participation method | Liquidation method used to allocate principal payments on receivables in a trust to investors. The preset participation method is similar to the fixed participation method except that the percentage used to determine the principal payments allocated to the investors is preset higher than the investors' expected participation interests in the receivables in the trust at the end of the reinvestment period. This method results in a faster payout to the investors than the fixed participation method because a higher percentage of the principal payments are allocated to the investors. |
| Proceeds | Cash, beneficial interests, servicing assets, derivative instruments, or other assets that are obtained in a transfer of financial assets, less any liabilities incurred. |
| Protection provisions | Provisions in some contracts to sell or transfer mortgage servicing rights that could affect the amount ultimately paid to the transferor. For example, the transferor may agree to adjust the sales price for loan prepayments, defaults, or foreclosures that occur within a specified period of time. |
| Publicly traded entity | Any entity that does not meet the definition of a nonpublic entity. |
| Purchased financial assets with credit deterioration | Acquired individual financial assets (or acquired groups of financial assets with similar risk characteristics) that, as of the date of acquisition, have experienced a more-than-insignificant deterioration in credit quality since origination, as determined by an acquirer's assessment. |
| Recourse | <p>The right of a transferee of receivables to receive payment from the transferor of those receivables for any of the following:</p> <ul style="list-style-type: none"> a. Failure of debtors to pay when due b. The effects of prepayments c. Adjustments resulting from defects in the eligibility of the transferred receivables |
| Remote | The chance of the future event or events occurring is slight. |
| Repurchase agreement | An agreement under which the transferor (repo party) transfers a financial asset to a transferee (repo counterparty or reverse party) in exchange for cash and concurrently agrees to reacquire that financial asset at a future date for an amount equal to the cash exchanged plus or minus a stipulated interest factor. Instead of cash, other securities or letters of credit sometimes are exchanged. Some repurchase agreements call for repurchase of financial assets that need not be identical to the financial assets transferred. |
| Repurchase agreement accounted for as a collateralized borrowing | A repurchase agreement (repo) refers to a transaction in which a seller-borrower of securities sells those securities to a buyer-lender with an agreement to repurchase them at a stated price plus interest at a specified date or in specified circumstances. A repurchase agreement accounted for as a collateralized borrowing is a repo that does not qualify for sale accounting under Topic 860. The payable under a repurchase agreement accounted for as a collateralized borrowing refers to the amount of the seller-borrower's obligation recognized for the future repurchase of the securities from the buyer-lender. In certain industries, the terminology is reversed; that is, entities in those industries refer to this type of agreement as a reverse repo. |

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| Repurchase financing | A repurchase agreement that relates to a previously transferred financial asset between the same counterparties (or consolidated affiliates of either counterparty) that is entered into contemporaneously with, or in contemplation of, the initial transfer. |
| Repurchase-to-maturity transaction | A repurchase agreement in which the settlement date of the agreement to repurchase a transferred financial asset is at the maturity date of that financial asset and the agreement would not require the transferor to reacquire the financial asset. |
| Reverse repurchase agreements accounted for as a collateralized borrowing | A reverse repurchase agreement accounted for as a collateralized borrowing (also known as a reverse repo) refers to a transaction that is accounted for as a collateralized lending in which a buyer-lender buys securities with an agreement to resell them to the seller-borrower at a stated price plus interest at a specified date or in specified circumstances. The receivable under a reverse repurchase agreement accounted for as a collateralized borrowing refers to the amount due from the seller-borrower for the repurchase of the securities from the buyer-lender. In certain industries, the terminology is reversed; that is, entities in those industries refer to this type of agreement as a repo. |
| Revolving-period securitizations | Securitizations in which receivables are transferred at the inception and also periodically (daily or monthly) thereafter for a defined period (commonly three to eight years), referred to as the revolving period. During the revolving period, the special-purpose entity uses most of the cash collections to purchase additional receivables from the transferor on prearranged terms. |
| Securitization | The process by which financial assets are transformed into securities. |
| Security | <p>A share, participation, or other interest in property or in an entity of the issuer or an obligation of the issuer that has all of the following characteristics:</p> <ol style="list-style-type: none"> It is either represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer. It is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment. It either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations. |
| Security interest | A form of interest in property that provides that upon default of the obligation for which the security interest is given, the property may be sold in order to satisfy that obligation. |
| Seller | A transferor that relinquishes control over financial assets by transferring them to a transferee in exchange for consideration. |

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| Servicing assets | <p>A contract to service financial assets under which the benefits of servicing are expected to more than adequately compensate the servicer for performing the servicing. A servicing contract is either:</p> <ul style="list-style-type: none"> a. Undertaken in conjunction with selling or securitizing the financial assets being serviced b. Purchased or assumed separately |
| Servicing liability | <p>A contract to service financial assets under which the estimated future revenues from contractually specified servicing fees, late charges, and other ancillary revenues (benefits of servicing) are not expected to adequately compensate the servicer for performing the servicing.</p> |
| Set-off right | <p>A common law right of a party that is both a debtor and a creditor to the same counterparty to reduce its obligation to that counterparty if that counterparty fails to pay its obligation.</p> |
| Standard representations and warranties | <p>Representations and warranties that assert the financial asset being transferred is what it is purported to be at the transfer date.</p> |
| Transfer | <p>The conveyance of a noncash financial asset by and to someone other than the issuer of that financial asset.</p> <p>A transfer includes the following:</p> <ul style="list-style-type: none"> a. Selling a receivable b. Putting a receivable into a securitization trust c. Posting a receivable as collateral. <p>A transfer excludes the following:</p> <ul style="list-style-type: none"> a. The origination of a receivable b. Settlement of a receivable c. The restructuring of a receivable into a security in a troubled debt restructuring |
| Transferee | <p>An entity that receives a financial asset, an interest in a financial asset, or a group of financial assets from a transferor.</p> |
| Transferor | <p>An entity that transfers a financial asset, an interest in a financial asset, or a group of financial assets that it controls to another entity.</p> |
| Transferred financial assets | <p>Any of the following:</p> <ul style="list-style-type: none"> a. An entire financial asset b. A group of entire financial assets c. A participating interest in an entire financial asset |
| Unilateral ability | <p>A capacity for action not dependent on the actions (or failure to act) of any other party.</p> |

B Abbreviations used in this publication

| Abbreviation | FASB Accounting Standards Codification |
|--------------|--|
| ASC 230 | FASB ASC Topic 230, <i>Statement of Cash Flows</i> |
| ASC 250 | FASB ASC Topic 250, <i>Accounting Changes and Error Corrections</i> |
| ASC 310 | FASB ASC Topic 310, <i>Receivables</i> |
| ASC 320 | FASB ASC Topic 320, <i>Investments – Debt Securities</i> |
| ASC 321 | FASB ASC Topic 321, <i>Investments – Equity Securities</i> |
| ASC 323 | FASB ASC Topic 323, <i>Investments – Equity Method and Joint Ventures</i> |
| ASC 325 | FASB ASC Topic 325, <i>Investments – Other</i> |
| ASC 326 | FASB ASC Topic 326, <i>Financial Instruments – Credit Losses</i> |
| ASC 360-10 | FASB ASC Topic 360-10, <i>Property, Plant, and Equipment – Overall</i> |
| ASC 405 | FASB ASC Topic 405, <i>Liabilities</i> |
| ASC 450 | FASB ASC Topic 450, <i>Contingencies</i> |
| ASC 460 | FASB ASC Topic 460, <i>Guarantees</i> |
| ASC 470 | FASB ASC Topic 470, <i>Debt</i> |
| ASC 606 | FASB ASC Topic 606, <i>Revenue from Contracts with Customers</i> |
| ASC 610-20 | FASB ASC Topic 610-20, <i>Other Income – Gains and Losses from the Derecognition of Nonfinancial Assets</i> |
| ASC 810 | FASB ASC Topic 810, <i>Consolidation</i> |
| ASC 815 | FASB ASC Topic 815, <i>Derivatives and Hedging</i> |
| ASC 820 | FASB ASC Topic 820, <i>Fair Value Measurement</i> |
| ASC 825 | FASB ASC Topic 825, <i>Financial Instruments</i> |
| ASC 835 | FASB ASC Topic 835, <i>Interest</i> |
| ASC 842 | FASB ASC Topic 842, <i>Leases</i> |
| ASC 845 | FASB ASC Topic 845, <i>Nonmonetary Transactions</i> |
| ASC 850 | FASB ASC Topic 850, <i>Related Party Disclosures</i> |
| ASC 860 | FASB ASC Topic 860, <i>Transfers and Servicing</i> |
| ASC 942 | FASB ASC Topic 942, <i>Financial Services – Depository and Lending</i> |
| ASC 946 | FASB ASC Topic 946, <i>Financial Services – Investment Companies</i> |
| ASC 948 | FASB ASC Topic 948, <i>Financial Services – Mortgage Banking</i> |
| Abbreviation | FASB Accounting Standards Updates |
| ASU 2009-16 | Transfers and Servicing (Topic 860), <i>Accounting for Transfers of Financial Assets</i> |
| ASU 2009-17 | Consolidations (Topic 810): <i>Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities</i> |
| ASU 2011-03 | Transfers and Servicing (Topic 860), <i>Reconsideration of Effective Control for Repurchase Agreements</i> |
| ASU 2014-11 | Transfers and Servicing (Topic 860), <i>Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures</i> |
| ASU 2020-06 | Debt – Debt with Conversion and Other Options (Subtopic 470-20) and Derivatives and Hedging – Contracts in Entity's Own Equity (Subtopic 815-40) – <i>Accounting for Convertible Instruments and Contracts in an Entity's Own Equity</i> |

| Abbreviation | Other Authoritative Standards |
|-----------------|--|
| AI 11 | PCAOB Auditing Interpretation 11, <i>Using the Work of a Specialist: Auditing Interpretations</i> |
| AU-C 9620 | AICPA Auditing Interpretation 9620, <i>Using the Work of an Auditor's Specialist: Auditing Interpretations of Section 620</i> |
| S-X 210.4.08(m) | SEC Regulation S-X §210.4.08(m) |
| S-X 5-02.1. | SEC Regulation S-X Rule 5-02.1. |
| Rule 144A | Securities Act Rule 144A, <i>Private resales of securities to institutions</i> |
| Abbreviation | Non-Authoritative Standards |
| Statement 125 | FASB Statement No. 125, <i>Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities</i> |
| Statement 140 | FASB Statement No. 140, <i>Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities – a replacement of FASB Statement No. 125</i> |
| Statement 166 | FASB Statement No. 166, <i>Accounting for Transfers of Financial Assets – an amendment of FASB Statement No. 140</i> |
| Statement 167 | FASB Statement No. 167, <i>Amendments to FASB Interpretation No. 46(R)</i> |
| FSP SOP 94-6-1 | FASB Staff Position No. SOP 94-6-1, <i>Terms of Loan Products That May Give Rise to a Concentration of Credit Risk</i> |
| SAB Topic 5.V | SEC Staff Accounting Bulletin No. 5.V, <i>Certain Transfers of Nonperforming Assets</i> |

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| 860-20-55-87 | 6.6.2 | Examples that illustrate the requirements of ASC 860-20-25-8 through 25-13 (regaining control) |
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| 860-30-50-7 | 11.4.2.1 | Disclosures for repurchase agreements, securities lending transactions and repurchase-to-maturity transactions accounted for as secured borrowings |
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| ASC Paragraph | Section | Section title |
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| 860-50-30-3 | 7.3.2 | Initial measurement |
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| 860-50-35-1(a) | 7.5.2.3 | Examples illustrating servicing assets subsequently measured under the amortization method and tested for impairment |
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| 860-50-35-3 | 7.5 | Subsequent measurement election |
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| 860-50-40-2 | 7.8.1 | Conditions for sale accounting |
| 860-50-40-2 through 40-5 | 7.9 | Question 7-9 – Subservicing contracts |
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| ASC Paragraph | Section | Section title |
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| 860-50-40-5 | 7.8.1 | Conditions for sale accounting |
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Summary of important changes

The following highlights important changes to this publication since the May 2024 edition of our FRD, *Transfers and servicing of financial assets*:

Section 1: **Basic principles and scope**

- ▶ Question 1-2 in section 1.11 was updated to clarify our interpretive guidance and for the FASB's proposed Codification improvements to clarify the guidance for the transfer of receivables from contracts with customers.

Section 6: **Recognition and measurement**

- ▶ Sections 6.2 and 6.6 were updated to reflect the status of the FASB's proposal on purchased financial assets.
- ▶ Section 6.5.3.1.2.4 was updated to reflect the status of the FASB's proposal on purchased financial assets, as well as the proposed codification improvements to clarify the calculation of the reference amount in ASC 325-40.
- ▶ Section 6.5.3.4 was updated to clarify our interpretive guidance on financial guarantees.
- ▶ Section 6.5.3.5 was updated to clarify our interpretive guidance on recourse obligations.

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