

Statutory Issue Paper No. 122

Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities

STATUS

Adopted December 8, 2003

Current Authoritative Guidance for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities: SSAP No. 103R

This issue paper may not be directly related to the current authoritative statement.

Original SSAP from Issue Paper: SSAP No. 91

Type of Issue:

Common

SUMMARY OF ISSUE

1. Current statutory accounting guidance for transfers and servicing of financial assets and extinguishments of liabilities is provided in *SSAP No. 18—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (SSAP No. 18). Current statutory accounting guidance for asset securitizations and securitizations of policy acquisition costs is provided in *SSAP No. 33—Securitization* (SSAP No. 33). Current statutory accounting guidance for repurchase agreements, reverse repurchase agreements, dollar repurchase and dollar reverse repurchase agreements is provided in *SSAP No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements* (SSAP No. 45). SSAP No. 18, SSAP No. 33 and SSAP No. 45 adopted *FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 125) with modification for statutory accounting purposes. The modifications to FAS 125 primarily relate to:

- a. The nonadmission of servicing rights assets;
- b. The accounting for repurchase agreements, reverse repurchase agreements, and dollar repurchase agreements;
- c. The accounting for realized gains and losses for reporting entities required to maintain an IMR;
- d. The accounting for financial assets subject to prepayment;
- e. The accounting for assets pledged as collateral;
- f. The accounting for leases in accordance with *SSAP No. 22—Leases* (SSAP No. 22);
- g. The accounting for sales of receivables with recourse; and
- h. Paragraph 14 of FAS 125 is rejected as it relates to classifications of securities under *FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities* (FAS 115). FAS 115 is rejected in *SSAP No. 26—Bonds, excluding Loan-backed and Structured Securities* (SSAP No. 26).

2. In September 2000, the Financial Accounting Standards Board (FASB) issued *FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*

(FAS 140). FAS 140 replaces FAS 125. FAS 140 reconsiders or clarifies the guidance in FAS 125 concerning the following:

- a. Circumstances in which a special-purpose entity (SPE) can be considered qualifying;
- b. Circumstances in which the assets held by a qualifying SPE should appear in the consolidated financial statements of the transferor;
- c. Whether sale accounting is precluded if the transferor holds a right to repurchase transferred assets that is attached to, is embedded in, or is otherwise transferable with the financial assets;
- d. Circumstances in which sale accounting is precluded if transferred financial assets can be removed from a SPE by the transferor (for example under a removal-of-accounts provision (ROAP));
- e. Whether arrangements that obligate, but do not entitle, a transferor to repurchase or redeem transferred financial assets should affect the accounting for those transfers;
- f. The impact of the powers of the Federal Deposit Insurance Corporation (FDIC) on isolation of assets transferred by financial institutions;
- g. Whether transfers of financial assets measured using the equity method of accounting should continue to be included in the scope of FAS 125;
- h. Whether disclosures should be enhanced to provide more information about assumptions used to determine the fair value of retained interests and the gain or loss on financial assets sold in securitizations; and
- i. The accounting for and disclosure about collateral that can be sold or repledged.

3. The purpose of this issue paper is to establish statutory accounting principles for transfers and servicing of financial assets, including asset securitizations and securitizations of policy acquisition costs, extinguishments of liabilities, repurchase agreements and reverse repurchase agreements, including dollar repurchase and dollar reverse repurchase agreements that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts). This issue paper discusses generalized situations. Facts and circumstances and specific contracts need to be considered carefully in applying this issue paper. Securitizations of nonfinancial assets are outside the scope of this issue paper.

RECOMMENDED CONCLUSION

4. See *SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties* (SSAP No. 25) for additional accounting and disclosure guidance concerning related party transactions. In addition the guidance for the following topics have been addressed in Interpretations of the Emerging Accounting Issues Working Group:

- a. *INT 99-22: EITF 98-8 Accounting for Transfers of Investments That Are in Substance Real Estate* resolved this conflict between application of *SSAP No. 40—Real Estate Investments* and SSAP No. 18.
- b. *INT 99-21: EITF 98-7 Accounting for Exchanges of Similar Equity Method Investments* resolved this conflict between application of *SSAP No. 28—Nonmonetary Transactions* and SSAP No. 18.

5. SSAP No. 18, SSAP No. 33 and SSAP No. 45 are superseded by the conclusions outlined in this issue paper.

6. This issue paper does not address the securitization of mortality or morbidity risk. The NAIC's Insurance Securitization Working Group of the Financial Condition (E) Committee is charged with the development of model laws, model regulations and proposed accounting guidance for the securitization of mortality and morbidity risk. When such proposed accounting guidance is finalized the development of an issue paper will be considered.

7. Except as discussed in paragraphs 57 and 89, a transfer of a group of financial assets, or a portion of a financial asset in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if, and only if, all of the following conditions are met:

- a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership (see paragraphs 18 and 19);
 - b. Either (i) each transferee obtains the right, free of conditions that constrain it from taking advantage of that right (see paragraphs 20-24), to pledge or exchange the transferred assets or (ii) the transferee is a qualifying special-purpose entity as defined in paragraph 26 and the holders of beneficial interests in that entity have the right, free of conditions that constrain them from taking advantage of that right (see paragraph 25), to pledge or exchange those interests and no condition both constrains the transferee (or holder) from taking advantage of its right to pledge or exchange and provide more than a trivial benefit to the transferor; and
 - c. The transferor does not maintain effective control over the transferred assets through (i) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (see paragraphs 39-41) or (ii) the ability to unilaterally cause the holder to return specific assets, other than through a cleanup call (see paragraphs 23-24 and 42-46).
8. Upon completion of any transfer of financial assets, the transferor shall:
- a. Continue to carry in its balance sheet any retained interest in the transferred assets, including, if applicable, beneficial interests in assets transferred to a qualifying special-purpose entity in a securitization, and retained undivided interests (see paragraphs 9.c., 49 and 50); and
 - b. Allocate the previous carrying amount between the assets sold, if any, and the retained interests, if any, based on their relative fair values at the date of transfer (see paragraphs 49 and 50).
9. Upon completion of a transfer of assets that satisfies the conditions to be accounted for as a sale (see paragraph 7), the transferor (seller) shall:
- a. Eliminate the transferred assets from the balance sheet;
 - b. Allocate the previous carrying amount of the transferred assets to the securities representing beneficial interests retained by the reporting entity, if any, and the securities representing beneficial interests not retained, if any, based on the relative fair values of the transferred assets at the date of transfer;

- c. Record in its balance sheet, the allocated carrying value of the securities representing retained beneficial interests in the assets (e.g., loan-backed securities). Subsequent to the transfer of assets:
 - i. Retained residuals are to be carried at fair value with the difference between fair value and the allocated cost basis recognized as an unrealized gain or loss;
 - ii. Retained beneficial interests shall be accounted for in accordance with the statutory accounting principles for the specific asset type (e.g., bonds shall be accounted for in accordance with SSAP No. 26, loan-backed securities shall be accounted for in accordance with *SSAP No. 43—Loan-Backed and Structured Securities*, preferred stock in accordance with *SSAP No. 32—Investments in Preferred Stock (including investments in preferred stock of subsidiary, controlled or affiliated entities)*).
- d. Recognize all additional assets obtained (i.e., other than the securities representing retained beneficial interests which are recorded in accordance with 9 c.) and liabilities incurred in consideration as proceeds of the sale;
- e. Initially measure such additional assets obtained and liabilities incurred in the sale at fair value (see Glossary), or if it is not practicable to estimate the fair value of an asset or a liability, apply alternative measures (paragraph 51); and
- f. For reporting entities required to maintain an Interest Maintenance Reserve (IMR), the accounting for realized and unrealized capital gains and losses shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve* (SSAP No. 7). For reporting entities not required to maintain an IMR, realized capital gains and losses shall be reported as net realized capital gains or losses in the statement of income, and unrealized capital gains and losses shall be reported as net unrealized gains and losses in unassigned funds (surplus).

10. The transferee shall recognize all assets obtained and any liabilities incurred, and initially measure them at fair value (in aggregate, presumptively the price paid).

11. Repurchase agreements, reverse repurchase agreements, and dollar repurchase agreements are described in paragraphs 68-78. When an asset is sold and the proceeds are reinvested within 30 days in the same or substantially the same security, such transfers shall be considered to be wash sales and shall be accounted for as sales and disclosed as required by paragraph 92. Unless there is a concurrent contract to repurchase or redeem the transferred financial assets from the transferee, the transferor does not maintain effective control over the transferred assets.

12. If a transfer of financial assets in exchange for cash or other consideration (other than beneficial interests in the transferred assets) (a) does not meet the criteria for a sale in paragraph 7, or (b) is a sale of receivables with recourse (see paragraph 89); the transferor and transferee shall account for the transfer as a secured borrowing with pledge of collateral (see paragraph 14).

Recognition and Measurement of Servicing Assets and Liabilities

13. Servicing rights become a distinct asset or liability only when contractually separated from the underlying assets by sale or securitization of the assets with servicing retained, or separate purchase or assumption of the servicing. If distinct servicing rights to transferred assets exist and are retained by the reporting entity, the reporting entity shall recognize a servicing asset or liability. When the servicing fees to be received exceed the cost of servicing the transferred assets, a servicing asset is recognized and nonadmitted. When the cost of servicing the transferred assets is greater than the servicing fees to be

received, a liability shall be recorded for the excess to recognize this obligation. A corresponding loss shall be recorded through the Summary of Operations in other income. If the servicing asset or liability was purchased or assumed rather than undertaken in a sale or securitization of the financial assets being serviced, it shall be measured initially at its fair value, presumptively the price paid. The servicing asset or liability shall be amortized into income in proportion to, and over the period of estimated servicing income (if an asset) or estimated servicing loss (if a liability). A servicing asset or liability shall be assessed for impairment or increased obligation based on its fair value.

Secured Borrowings and Collateral

14. A debtor may grant a security interest in certain assets to a lender (the secured party) to serve as collateral for its obligation under a borrowing, with or without recourse to other assets of the debtor. An obligor under other kinds of current or potential obligations, for example, interest rate swaps, also may grant a security interest in certain assets to a secured party. 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 repledge (or otherwise transfer) collateral held under a pledge. The same relationships occur, under different names, in transfers documented as sales that are accounted for as secured borrowings (see paragraph 12). The accounting for collateral by the debtor (or obligor) and the secured party depends on whether the secured party has taken control over the collateral, and on the rights and obligations that result from the collateral arrangement:

- a. If the secured party is permitted to sell or repledge the collateral, and the debtor does not have the right and ability to redeem the collateral on short notice, (e.g., by substituting other collateral or terminating the contract), then:

The debtor shall reclassify that asset and report that asset in its balance sheet separately (for example, as security pledged to creditors) from other assets not so encumbered;

The secured party shall recognize that collateral as its asset, initially measure it at fair value, and also recognize its obligation to return it.

- b. If the secured party sells or repledges collateral on terms that do not give it the right and ability to repurchase or redeem the collateral from the transferee on short notice, the secured party shall recognize the proceeds from the sale or the asset repledged and its obligation to return the asset to the extent that it has not already recognized them. The sale or repledging of the asset is a transfer subject to the provisions of this statement;
- c. If the debtor defaults under the terms of the secured contract and is no longer entitled to redeem the collateral, it shall derecognize the collateral. The secured party shall recognize the collateral as an asset (to the extent it has not already recognized it) and initially measure it at fair value;
- d. Otherwise, the debtor shall continue to carry the collateral as an asset, and the secured party shall not recognize the pledged asset.

15. Insurers may enter into certain transactions that require the granting of a security interest in certain assets to another party to serve as collateral for their performance under a contract. If the assets pledged are recorded as admitted assets under *SSAP No. 4—Assets and Nonadmitted Assets* (SSAP No. 4) and are not impaired under the provisions of *SSAP No. 5—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5), the pledging insurer records the collateral as an admitted asset until committing a contract default that has not been cured in accordance with the contract provisions. At the time of an uncured default, the provisions of paragraph 14 above shall be used to determine the appropriate accounting treatment for the collateral. If the secured party utilizes collateral to offset all or a portion of

the liability owed by the pledging insurer as a result of the default, then the collateral amount utilized to offset the liability shall be removed from the balance sheet. At the same time, the amount of the liability that was offset shall be removed from the balance sheet since that obligation has been satisfied through the secured party's utilization of that collateral. To the extent that an uncured default remains without the secured party utilizing the collateral to offset the obligation, the pledging insurer shall only record an admitted asset for the amount of collateral that it can redeem.

Extinguishments of Liabilities

16. A debtor shall derecognize a liability if, and only if, it has been extinguished (see *SSAP No. 15—Debt and Holding Company Obligations*). A liability has been extinguished if either of the following conditions is met:

- a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes delivery of cash, other financial assets, goods, or services or reacquisition by the debtor of its outstanding debt securities whether the securities are canceled or held as so-called treasury bonds; or
- b. The debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor.

17. If a creditor releases a debtor from primary obligation on the condition that a third party assumes the obligation and that the original debtor becomes secondarily liable, that release extinguishes the original debtor's liability. However, in those circumstances, whether or not explicit consideration was paid for that guarantee, the original debtor becomes a guarantor. As a guarantor, it shall recognize a guarantee obligation in the same manner as would a guarantor that had never been primarily liable to that creditor, with due regard for the likelihood that the third party will carry out its obligations. The guarantee obligation shall be initially measured at fair value, and that amount reduces the gain or increases the loss recognized on extinguishment.

Isolation Beyond the Reach of the Transferor and Its Creditors

18. 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 and its creditors, either by a single transaction or a series of transactions taken as a whole—depend on the facts and circumstances. All available evidence that either supports or questions an assertion shall be considered. That consideration includes making judgments about whether the contract or circumstances permit the transferor to revoke the transfer. It also may include making judgments about the kind of bankruptcy or other receivership into which a transferor or special-purpose entity might be placed, whether a transfer of financial assets would likely be deemed a true sale at law, whether the transferor is affiliated with the transferee, and other factors pertinent under applicable law. Derecognition of transferred assets is appropriate only if the available evidence provides reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor. Transactions between related parties or affiliates are accounted for in accordance with SSAP No. 25.

19. Many common financial transactions, for example, typical repurchase agreements and securities lending transactions, isolate transferred assets from the transferor, although they may not meet the other criteria for surrender of control.

Conditions That Constrain a Transferee

20. Sale accounting is allowed under paragraph 7 only if each transferee has the right to pledge, or the right to exchange, the transferred assets or beneficial interests it received, but constraints on that right

also matter. Many transferor-imposed or other conditions on a transferee's right to pledge or exchange a transferred asset both constrain a transferee from pledging or exchanging the transferred assets and, through that constraint, provide more than a trivial benefit to the transferor. For example, a provision in the transfer contract that prohibits selling or pledging a transferred loan receivable not only constrains the transferee but also provides the transferor with the more-than-trivial benefits of knowing who has the asset, a prerequisite to repurchasing the asset, and of being able to block the asset from finding its way into the hands of a competitor for the loan customer's business or someone that the loan customer might consider an undesirable creditor. 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 with the transferor, also constrain the transferee and presumptively provide the transferor with more-than-trivial benefits.

21. However, some conditions do not constrain a transferee from pledging or exchanging the asset and therefore do not preclude a transfer subject to such a condition from being accounted for as a sale. For example, a transferor's right of first refusal on the occurrence of a bona fide offer to the transferee from a third party presumptively would not constrain a transferee, because that right in itself does not enable the transferor to compel the transferee to sell the assets and the transferee would be in a position to receive the sum offered by exchanging the asset, albeit possibly from the transferor rather than the third party. Further examples of conditions that presumptively would not constrain a transferee include (a) a requirement to obtain the transferor's permission to sell or pledge that is not to be unreasonably withheld, (b) a prohibition on sale to the transferor's competitor if other potential willing buyers exist, (c) a regulatory limitation such as on the number or nature of eligible transferees (as in the case of securities issued under Securities Act Rule 144A or debt placed privately), and (d) illiquidity, for example, the absence of an active market. Judgment is required to assess the significance of some conditions. For example, a prohibition on sale to the transferor's competitor would be a significant constraint if that competitor were the only potential willing buyer other than the transferor.

22. 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.

Transferor's Rights or Obligations to Reacquire Transferred Assets

23. Some rights or obligations to reacquire transferred assets both constrain the transferee and provide more than a trivial benefit to the transferor, thus precluding sale accounting under paragraph 7. For example, a freestanding call option written by a transferee to the transferor benefits the transferor and, if the transferred assets are not readily obtainable in the marketplace, is likely to constrain a transferee because it might have to default if the call was exercised and it had exchanged or pledged the assets. A freestanding forward purchase-sale contract between the transferor and the transferee on transferred assets not readily obtainable in the marketplace would benefit the transferor and is likely to constrain a transferee in much the same manner. Judgment is necessary to assess constraint and benefit. For example, put options written to the transferee generally do not constrain it, but a put option on a not-readily-obtainable asset may benefit the transferor and effectively constrain the transferee if the option is sufficiently deep-in-the-money when it is written that it is probable that the transferee will exercise it and the transferor will reacquire the transferred asset. In contrast, a sufficiently out-of-the-money call option held by the transferor may not constrain a transferee if it is probable when the option is written that it will not be exercised. Freestanding rights to reacquire transferred assets that are readily obtainable presumptively do not constrain the transferee from exchanging or pledging them and thus do not preclude sale accounting under paragraph 7.

24. Other rights or obligations to reacquire transferred assets, regardless of whether they constrain the transferee, may result in the transferor's maintaining effective control over the transferred assets, as discussed in paragraphs 42-46, thus precluding sale accounting under paragraph 7.

Conditions That Constrain a Holder of Beneficial Interests in a Qualifying SPE

25. The considerations in paragraphs 20-23, about conditions that may or may not constrain a transferee that is not a qualifying special-purpose entity (SPE) from pledging or exchanging the transferred assets, also extend to conditions that may or may not constrain a beneficial interest holder (BIH) from pledging or exchanging its beneficial interests in assets transferred to a qualifying SPE. For example, if BIHs agree to sell their beneficial interests in a qualifying SPE back to the transferor upon request at the price paid plus a stated return, that arrangement clearly conveys more than a trivial benefit to the transferor; sale accounting for the transfer to the qualifying SPE would be precluded if that agreement constrained a BIH from exchanging or pledging its beneficial interest.

Qualifying SPE

26. A qualifying SPE is a trust or other legal vehicle that meets all of the following conditions:

- a. It is demonstrably distinct from the transferor (paragraphs 27 and 28);
- b. Its permitted activities:
 - i. Are significantly limited;
 - ii. Were entirely specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds; and
 - iii. May be significantly changed only with the approval of the holders of at least a majority of the beneficial interests held by entities other than any transferor, its affiliates, and its agents (paragraphs 29 and 30).
- c. It shall hold only:
 - i. Financial assets transferred to it that are passive in nature (paragraph 31);
 - ii. Passive derivative financial instruments that pertain to beneficial interests (other than another derivative financial instrument) issued or sold to parties other than the transferor, its affiliates, or its agents (paragraphs 31 and 32);
 - iii. Financial assets (for example, guarantees or rights to collateral) that would reimburse it if others were to fail to adequately service financial assets transferred to it or to timely pay obligations due to it and that it entered into when it was established, when assets were transferred to it, or when beneficial interests (other than derivative financial instruments) were issued by the SPE;
 - iv. Servicing rights related to financial assets that it holds;
 - v. Temporarily, nonfinancial assets obtained in connection with the collection of financial assets that it holds (paragraph 33);
 - vi. Cash collected from assets that it holds and investments purchased with that cash pending distribution to holders of beneficial interests that are appropriate for that purpose (that is, money-market or other relatively risk-free instruments without options and with maturities no later than the expected distribution date).

- d. If it can sell or otherwise dispose of noncash financial assets, it can do so only in automatic response to one of the following conditions:
 - i. Occurrence of an event or circumstance that:
 - (a) Is specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds;
 - (b) Is outside the control of the transferor, its affiliates, or its agents; and
 - (c) Causes, or is expected at the date of transfer to cause, the fair value of those financial assets to decline by a specified degree below the fair value of those assets when the SPE obtained them (paragraphs 34 and 35.)
 - ii. Exercise by a BIH (other than the transferor, its affiliates, or its agents) of a right to put that holder's beneficial interest back to the SPE (paragraph 36);
 - iii. Exercise by the transferor of a call specified in the legal documents that established the SPE, transferred assets to the SPE, or created the beneficial interests in the transferred assets that it holds (paragraphs 42-46);
 - iv. Termination of the SPE or maturity of the beneficial interests in those financial assets on a fixed or determinable date that is specified at inception (paragraph 37).

Need to Be Demonstrably Distinct from the Transferor

27. A qualifying SPE is demonstrably distinct from the transferor only if it cannot be unilaterally dissolved by any transferor, its affiliates, or its agents and either:

- a. At least 10 percent of the fair value of its beneficial interests is held by parties other than any transferor, its affiliates, or its agents; or
- b. The transfer is a guaranteed mortgage securitization.

28. An ability to unilaterally dissolve an SPE can take many forms, including but not limited to holding sufficient beneficial interests to demand that the trustee dissolve the SPE, the right to call all the assets transferred to the SPE, and a right to call or a prepayment privilege on the beneficial interests held by other parties.

Limits on Permitted Activities

29. The powers of the SPE must be limited to those activities allowed by paragraph 26 for it to be a qualifying SPE. Many kinds of entities are not so limited. For example, any bank, insurance company, pension plan, or investment company has powers that cannot be sufficiently limited for it to be a qualifying SPE.

30. The BIHs other than any transferor, its affiliates, or its agents may have the ability to change the powers of a qualifying SPE. If the powers of a previously qualifying SPE are changed so that the SPE is no longer qualifying, unless the conditions in paragraph 7.b. are then met by the SPE itself and the conditions in paragraphs 7.a. and 7.c. continue to be met, that change would bring the transferred assets held in the SPE back under the control of the transferor (paragraph 47).

Limits on What a Qualifying SPE May Hold

31. A financial asset or derivative financial instrument is passive only if holding the asset or instrument does not involve its holder in making decisions other than the decisions inherent in servicing. An equity instrument is not passive if the qualifying SPE can exercise the voting rights and is permitted to choose how to vote. Investments are not passive if through them, either in themselves or in combination with other investments or rights, the SPE or any related entity, such as the transferor, its affiliates, or its agents, is able to exercise control, as defined in *SSAP No. 46—Investments in Subsidiary, Controlled, and Affiliated Entities* (SSAP No. 46), over the investee. A derivative financial instrument is not passive if, for example, it includes an option allowing the SPE to choose to call or put other financial instruments that would allow it and its related entities to control 10% of more of the financial instruments issuer; but other derivative financial instruments can be passive, for example, interest rate caps and swaps and forward contracts. Derivative financial instruments that result in liabilities, like other liabilities of a qualifying SPE, are a kind of beneficial interest in the qualifying SPE's assets.

32. A derivative financial instrument pertains to beneficial interests (other than another derivative financial instrument) issued only if it:

- a. Is entered into:
 - i. When the beneficial interests are issued by the qualifying SPE to parties other than the transferor, its affiliates, or its agents or sold to such other parties after being issued by the qualifying SPE to the transferor, its affiliates, or its agents; or
 - ii. When a passive derivative financial instrument needs to be replaced upon occurrence of an event or circumstance (specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds) outside the control of the transferor, its affiliates, or its agents, for example, when the counterparty to the derivative defaults or is downgraded below a specified threshold.
- b. Has a notional amount that does not initially exceed the amount of those beneficial interests and is not expected to exceed them subsequently;
- c. Has characteristics that relate to, and partly or fully but not excessively counteract, some risk associated with those beneficial interests or the related transferred assets.

33. A qualifying SPE may hold nonfinancial assets other than servicing rights only temporarily and only if those nonfinancial assets result from collecting the transferred financial assets. For example, a qualifying SPE could be permitted to temporarily hold foreclosed nonfinancial collateral. In contrast, an entity cannot be a qualifying SPE if, for example, it receives from a transferor significant secured financial assets likely to default with the expectation that it will foreclose on and profitably manage the securing nonfinancial assets.

Limits on Sales or Other Dispositions of Assets

34. Examples of requirements to sell, exchange, put, or distribute (hereinafter referred to collectively as dispose of) noncash financial assets that are permitted activities of a qualifying SPE—because they respond automatically to the occurrence of an event or circumstance that:

- a. Is specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds;
- b. Is outside the control of the transferor, its affiliates, or its agents; and

- c. Causes, or is expected to cause, the fair value of those assets to decline by a specified degree below the fair value of those assets when the qualifying SPE obtained them—include requirements to dispose of transferred assets in response to:
- i. A failure to properly service transferred assets that could result in the loss of a substantial third-party credit guarantee;
 - ii. A default by the obligor;
 - iii. A downgrade by a major rating agency of the transferred assets or of the underlying obligor to a rating below a specified minimum rating;
 - iv. The involuntary insolvency of the transferor; or
 - v. A decline in the fair value of the transferred assets to a specified value less than their fair value at the time they were transferred to the SPE.

35. The following are examples of powers or requirements to dispose of noncash financial assets that are not permitted activities of a qualifying SPE, because they do not respond automatically to the occurrence of a specified event or circumstance outside the control of the transferor, its affiliates, or its agents that causes, or is expected to cause, the fair value of those transferred assets to decline by a specified degree below the fair value of those assets when the SPE obtained them:

- a. A power that allows an SPE to choose to either dispose of transferred assets or hold them in response to a default, a downgrade, a decline in fair value, or a servicing failure;
- b. A requirement to dispose of marketable equity securities upon a specified decline from their “highest fair value” if that power could result in disposing of the asset in exchange for an amount that is more than the fair value of those assets at the time they were transferred to the SPE;
- c. A requirement to dispose of transferred assets in response to the violation of a nonsubstantive contractual provision (that is, a provision for which there is not a sufficiently large disincentive to ensure performance).

36. A qualifying SPE may dispose of transferred assets automatically to the extent necessary to comply with the exercise by a BIH (other than the transferor, its affiliates, or its agents) of its right to put beneficial interests back to the SPE in exchange for:

- a. A full or partial distribution of those assets;
- b. Cash (which may require that the SPE dispose of those assets or issue beneficial interests to generate cash to fund settlement of the put);
- c. New beneficial interests in those assets.

37. A qualifying SPE may have the power to dispose of assets to a party other than the transferor, its affiliate, or its agent on termination of the SPE or maturity of the beneficial interests, but only automatically on fixed or determinable dates that are specified at inception. For example, if an SPE is required to dispose of long-term mortgage loans and terminate itself at the earlier of (a) the specified maturity of beneficial interests in those mortgage loans or (b) the date of prepayment of a specified amount of the transferred mortgage loans, the termination date is a fixed or determinable date that was specified at inception. In contrast, if that SPE has the power to dispose of transferred assets on two

specified dates and the SPE can decide which transferred assets to sell on each date, the termination date is not a fixed or determinable date that was specified at inception.

Investments in Special-Purpose Entities

38. Reporting entities that have qualifying special-purpose entities as affiliates shall carry their investment in such entity at its underlying statutory book value in accordance with SSAP No. 46. Additionally, transactions entered involving affiliated qualifying special-purpose entities are subject to the provisions of SSAP No. 25.

Agreements That Maintain Effective Control Over Transferred Assets

39. An agreement that both entitles and obligates the transferor to repurchase or redeem transferred assets from the transferee maintains the transferor's effective control over those assets, and the transfer is therefore to be accounted for as a secured borrowing, if and only if all of the following conditions are met:

- a. The assets to be repurchased or redeemed are the same or substantially the same as those transferred (paragraph 40);
- b. The transferor is able to repurchase or redeem them on substantially the agreed terms, even in the event of default by the transferee (paragraph 41);
- c. The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price; and
- d. The agreement is entered into concurrently with the transfer.

40. To be substantially the same, the asset that was transferred and the asset that is to be repurchased or redeemed need to have all of the following characteristics:

- a. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same);
- b. Identical form and type so as to provide the same risks and rights;
- c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities have similar remaining weighted-average maturities that result in approximately the same market yield);
- d. Identical contractual interest rates;
- e. Similar assets as collateral; and
- f. The same aggregate unpaid principal amount or principal amounts within accepted good delivery standards for the type of security involved.

41. To be able to repurchase or redeem assets on substantially all of the agreed terms, even in the event of default by the transferee, a transferor must at all times during the contract term have obtained cash or other collateral sufficient to fund substantially all of the cost of purchasing replacement assets from others.

Ability to Unilaterally Cause the Return of Specific Transferred Assets

42. Some rights to reacquire transferred assets (or to acquire beneficial interests in transferred assets held by a qualifying SPE), regardless of whether they constrain the transferee, may result in the transferor's maintaining effective control over the transferred assets through the unilateral ability to cause the return of specific transferred assets. Such rights preclude sale accounting under paragraph 7. For example, an attached call in itself would not constrain a transferee who is able, by exchanging or pledging the asset subject to that call, to obtain substantially all of its economic benefits. An attached call could result, however, in the transferor's maintaining effective control over the transferred asset(s) because the attached call gives the transferor the ability to unilaterally cause whoever holds that specific asset to return it. In contrast, transfers of financial assets subject to calls embedded by the issuers of the financial instruments, for example, callable bonds or prepayable mortgage loans, do not preclude sale accounting. Such an embedded call does not result in the transferor's maintaining effective control, because it is the issuer rather than the transferor who holds the call.

43. If the transferee is a qualifying SPE, it has met the conditions in paragraph 26 and therefore must be constrained from choosing to exchange or pledge the transferred assets. In that circumstance, any call held by the transferor is effectively attached to the assets and could—depending on the price and other terms of the call—maintain the transferor's effective control over transferred assets through the ability to unilaterally cause the transferee to return specific assets. For example, a transferor's unilateral ability to cause a qualifying SPE to return to the transferor or otherwise dispose of specific transferred assets at will or, for example, in response to its decision to exit a market or a particular activity, could provide the transferor with effective control over the transferred assets.

44. A call that is attached to transferred assets maintains the transferor's effective control over those assets if, under its price and other terms, the call conveys more than a trivial benefit to the transferor. Similarly, any unilateral right to reclaim specific assets transferred to a qualifying SPE maintains the transferor's effective control over those assets if the right conveys more than a trivial benefit to the transferor. A call or other right conveys more than a trivial benefit 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. Thus, for example, a call on specific assets transferred to a qualifying SPE at a price fixed at their principal amount maintains the transferor's effective control over the assets subject to that call. Effective control over transferred assets can be present even if the right to reclaim is indirect. For example, if an embedded call allows a transferor to buy back the beneficial interests of a qualifying SPE at a fixed price, then the transferor remains in effective control of the assets underlying those beneficial interests. A cleanup call, however, is permitted as an exception to that general principle.

45. A right to reclaim specific transferred assets by paying their fair value when reclaimed generally does not maintain effective control, because it does not convey a more than trivial benefit to the transferor. However, a transferor has maintained effective control if it has such a right and also holds the residual interest in the transferred assets. For example, if a transferor can reclaim such assets at termination of the qualifying SPE by purchasing them in an auction, and thus at what might appear to be fair value, then sale accounting for the assets it can reclaim would be precluded. Such circumstances provide the transferor with a more than trivial benefit and effective control over the assets, because it can pay any price it chooses in the auction and recover any excess paid over fair value through its residual interest.

46. A transferor that has a right to reacquire transferred assets from a qualifying SPE does not maintain effective control if the reclaimed assets would be randomly selected and the amount of the assets reacquired is sufficiently limited because that would not be a right to reacquire specific assets. Nor does a transferor maintain effective control through an obligation to reacquire transferred assets from a qualifying SPE if the transfer could occur only after a specified failure of the servicer to properly service

the transferred assets that could result in the loss of a third-party guarantee (paragraph 34.c.i.) or only after a BIH other than the transferor, its affiliate, or its agent requires a qualifying SPE to repurchase that beneficial interest (paragraph 36.b.), because the transferor could not cause that reacquisition unilaterally.

Changes That Result in the Transferor's Regaining Control of Assets Sold

47. A change in law, status of the transferee as a qualifying SPE, or other circumstance may result in the transferor's regaining control of assets previously accounted for appropriately as having been sold, because one or more of the conditions in paragraph 7 are no longer met. Such a change, unless it arises solely from either the initial application of this issue paper or a change in market prices (for example, an increase in price that moves into-the-money a freestanding call that was originally sufficiently out-of-the-money that it was judged not to constrain the transferee), is accounted for in the same manner as a purchase of the assets from the former transferee(s) in exchange for liabilities assumed (paragraph 9). After that change, the transferor recognizes in its financial statements those assets together with liabilities to the former transferee(s) or BIHs in those assets (paragraph 30). The transferor initially measures those assets and liabilities at fair value on the date of the change, as if the transferor purchased the assets and assumed the liabilities on that date. The former transferee would derecognize the assets on that date, as if it had sold the assets in exchange for a receivable from the transferor. Subsequent to that date, the reporting entity shall follow statutory accounting for the assets and liabilities in accordance with the guidance in the SSAPs.

Assets Obtained and Liabilities Incurred as Proceeds

48. The proceeds from a sale of financial assets consist of the cash and any other assets obtained in the transfer less any liabilities incurred. Any asset obtained that is not an interest in the transferred asset is part of the proceeds from the sale. Any liability incurred, even if it is related to the transferred assets, is a reduction of the proceeds. Any derivative financial instrument entered into concurrently with a transfer of financial assets is either an asset obtained or a liability incurred and part of the proceeds received in the transfer. All proceeds and reductions of proceeds from a sale shall be initially measured at fair value.

Retained Interests

49. Other interests in transferred assets—those that are not part of the proceeds of the transfer—are retained interests over which the transferor has not relinquished control. They shall be measured at the date of the transfer by allocating the previous carrying amount between the assets sold, if any, and the retained interests, based on their relative fair values. That procedure shall be applied to all transfers in which interests are retained, even those that do not qualify as sales. Examples of retained interests include securities backed by the transferred assets, undivided interests, servicing assets, and cash reserve accounts and residual interests in securitization trusts. If a transferor cannot determine whether an asset is a retained interest or proceeds from the sale, the asset shall be treated as proceeds from the sale and accounted for in accordance with paragraph 48.

50. If the retained interests are subordinated to more senior interests held by others, that subordination may concentrate into the retained interests most of the risks inherent in the transferred assets and shall be taken into consideration in estimating the fair value of the retained interests. For example, if the amount of the gain recognized, after allocation, on a securitization with a subordinated retained interest is greater than the gain would have been had the entire asset been sold, the transferor needs to be able to identify why that can occur. Otherwise, it is likely that the impact of the retained interest being subordinate to a senior interest has not been adequately considered in the determination of the fair value of the subordinated retained interest.

If It Is Not Practicable to Estimate Fair Values

51. If it is not practicable to estimate the fair values of assets, the transferor shall record those assets at an allocated cost basis of zero. If it is not practicable to estimate the fair values of liabilities, the transferor shall recognize no gain on the transaction and shall record those liabilities at the greater of:

- a. The excess, if any, of (i) the fair values of assets obtained less the fair values of other liabilities incurred, over (ii) the sum of the carrying values of the assets transferred;
- b. The amount that would be recognized in accordance with SSAP No. 5.

Securitizations

52. Financial assets such as mortgage loans are assets commonly transferred in securitizations. Securitizations of mortgage loans may include pools of single-family residential mortgages or other types of real estate mortgage loans, for example, multifamily residential mortgages and commercial property mortgages. Both financial and nonfinancial assets can be securitized; life insurance policy loans, patent and copyright royalties also have been securitized. Securitizations of nonfinancial assets are outside the scope of this issue paper.

53. An originator of a typical securitization (the transferor) transfers a portfolio of financial assets to an SPE, commonly a trust. In "pass-through" and "pay-through" securitizations, receivables are transferred to the SPE at the inception of the securitization, and no further transfers are made; all cash collections are paid to the holders of beneficial interests in the SPE. In "revolving-period" securitizations, 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 SPE uses most of the cash collections to purchase additional receivables from the transferor on prearranged terms.

54. Beneficial interests in the SPE are sold to investors and the proceeds are used to pay the transferor for the assets transferred. Those beneficial interests may comprise either a single class having equity characteristics or multiple classes of interests, some having debt characteristics and others having equity characteristics. The cash collected from the portfolio is distributed to the investors and others as specified by the legal documents that established the SPE.

55. Pass-through, pay-through, and revolving-period securitizations that meet the criteria in paragraph 7 qualify for sale accounting under this issue paper. All financial assets obtained or retained and liabilities incurred by the originator of a securitization that qualifies as a sale shall be recognized and measured as provided in paragraph 9; that includes the implicit forward contract to sell new receivables during a revolving period, which may become valuable or onerous to the transferor as interest rates and other market conditions change.

Sales of Future Revenues

56. In addition to securitization of assets, some reporting entities have entered into transactions characterized as a sale of future revenues. These transactions are sometimes referred to as securitizations and are sometimes characterized as selling deferred acquisition costs. A sale of future revenues by a reporting entity shall not result in the immediate recognition of income or surplus. The proceeds of any such sale shall be established as a liability and shall be reduced as the proceeds are repaid.

Removal-of-Accounts Provisions

57. Many transfers of financial assets in securitizations empower the transferor to reclaim assets subject to certain restrictions. Such a power is sometimes called a removal-of-accounts provision (ROAP). If there is a ROAP, the transfer of assets shall not be accounted for as a sale.

Securities Lending Transactions

58. When securities are loaned, they remain assets of the reporting entity and are not removed from the accounting records. Any fees received by the transferor for loaning the securities shall be recorded as miscellaneous income. During a securities lending transaction, collateral is pledged by the transferee to the transferor that has loaned the securities. If the collateral pledged by the transferee is not available for the general use of the transferor (restricted), then the transferor shall not reflect the collateral in the transferor's balance sheet as an asset, and the transferor shall not establish a liability for the return of the collateral. However, if the collateral pledged is available for the general use of the transferor (unrestricted), then the collateral shall be recorded as an asset on the transferor's balance sheet and a separate liability shall be established on the transferor's balance sheet to record the obligation to return the collateral. The failure by the transferor to maintain sufficient collateral for the loaned securities would result in nonadmission of the undercollateralized portion. The specific collateral requirements are as follows:

- a. The reporting entity shall receive collateral having a fair value as of the transaction date at least equal to 102 percent of the fair value of the loaned securities at that date. If at any time the fair value collateral is less than 100 percent of the fair value of the loaned securities, the counterparty shall be obligated to deliver additional collateral, the fair value of which, together with the fair value of all collateral then held in connection with the transaction at least equals 102 percent of the fair value of the loaned securities;
- b. In the event that foreign securities are loaned and the denomination of the currency of the collateral is other than the denomination of the currency of the loaned foreign securities, the amount of collateral shall be at least equal to 105 percent of the fair value of the loaned securities at that date. If at any time the fair value is less than 102 percent of the fair value of the loaned securities, the reporting entity must obtain additional collateral, the fair value of which together with the fair value of all collateral then held in connection with the transaction at least equals 105 percent of the fair value of the loaned securities.

59. Securities lending transactions are generally initiated by broker-dealers and other financial institutions that need specific securities to cover a short sale or a customer's failure to deliver securities sold. Securities lending transactions typically extend less than one year. Transferees (borrowers) of securities generally are required to provide collateral to the transferor (lender) of securities, 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 transferor typically earns a return by investing that cash at rates higher than the rate paid or rebated to the transferee. If the collateral is other than cash, the transferor typically receives a fee. Securities custodians or other agents commonly carry out securities lending activities on behalf of clients. Because of the protection of collateral (typically valued daily and adjusted frequently for changes in the market price of the securities transferred) and the short terms of the transactions, most securities lending transactions in themselves do not impose significant credit risks on either party. Other risks arise from what the parties to the transaction do with the assets they receive. For example, investments made with cash collateral impose market and credit risks on the transferor.

60. Many securities lending transactions are accompanied by an agreement that entitles and obligates the transferor to repurchase or redeem the transferred assets before their maturity under which the transferor maintains effective control over those assets (paragraphs 39-41). Those transactions shall be

accounted for as secured borrowings, in which cash (or securities that the holder is permitted by contract or custom to sell or repledge) received as collateral is considered the amount borrowed, the securities loaned are considered pledged as collateral against the cash borrowed, and any rebate paid to the transferee of securities is interest on the cash the transferor is considered to have borrowed. Collateral provided in securities lending transactions that are accounted for as secured borrowings shall be reported and disclosed like other collateral, as set forth in paragraphs 14 and 58.

61. In some transactions, characterized as securities lending, all of the criteria in paragraph 7 are met, including the effective control criterion in paragraph 7.c., and consideration other than beneficial interests in the transferred assets is received. During the term of such agreements, the transferor has surrendered control over the securities transferred and the transferee has obtained control over those securities, with the ability to sell or transfer them at will. In that case, creditors of the transferor have a claim only to the collateral and the forward repurchase commitment. Those transactions shall be accounted for:

- a. By the transferor as a sale of the loaned securities, for proceeds consisting of the collateral and a forward repurchase commitment. (If the collateral is a financial asset that the holder is permitted to sell or repledge and the debtor does not have the right and ability to redeem the collateral on short notice, e.g., by substituting other collateral or terminating the contract, that financial asset is proceeds of the sale of the loaned securities. To the extent that the collateral consists of letters of credit or other financial instruments that the holder is not permitted to sell or pledge, a securities lending transaction does not satisfy the sale criteria and is accounted for as a loan of securities by the transferor to the transferee); and
- b. By the transferee as a purchase of the borrowed securities in exchange for the collateral and a forward resale commitment.

Repurchase Agreements and "Wash Sales"

62. Government securities dealers, banks, other financial institutions, and corporate investors commonly use repurchase agreements to obtain or use short-term funds. Under those agreements, the transferor ("repo party") transfers a security to a transferee ("repo counterparty" or "reverse party") in exchange for cash and concurrently agrees to reacquire that security at a future date for an amount equal to the cash exchanged plus a stipulated "interest" factor. Repurchase agreements, reverse repurchase agreements and dollar repurchase agreements meet the definition of assets as defined in SSAP No. 4 and are admitted assets to the extent they conform to the requirements of this statement.

63. Repurchase agreements can be effected in a variety of ways. Some repurchase agreements are similar to securities lending transactions in that the transferee has the right to sell or repledge the securities to a third party during the term of the repurchase agreement. In other repurchase agreements, the transferee does not have the right to sell or repledge the securities during the term of the repurchase agreement. For example, in a tri-party repurchase agreement, the transferor transfers securities to an independent third-party custodian that holds the securities during the term of the repurchase agreement. Also, many repurchase agreements are for short terms, often overnight, or have indefinite terms that allow either party to terminate the arrangement on short notice. However, other repurchase agreements are for longer terms, sometimes until the maturity of the transferred asset. Some repurchase agreements call for repurchase of securities that need not be identical to the securities transferred.

64. If the criteria in paragraph 7 are met, including the criterion in paragraph 7.c.i., the transferor shall account for the repurchase agreement as a sale of financial assets and a forward repurchase commitment, and the transferee shall account for the agreement as a purchase of financial assets and a forward resale commitment. Other transfers that are accompanied by an agreement to repurchase the transferred assets that shall be accounted for as sales include transfers with agreements to repurchase at

maturity and transfers with repurchase agreements in which the transferee has not obtained collateral sufficient to fund substantially all of the cost of purchasing replacement assets.

65. Furthermore, "wash sales" that previously were not recognized if the same financial asset was purchased within 30 days before or after the sale shall be accounted for as sales under this issue paper. Unless there is a concurrent contract to repurchase or redeem the transferred financial assets from the transferee, the transferor does not maintain effective control over the transferred assets.

66. As with securities lending transactions, under many agreements to repurchase transferred assets before their maturity the transferor maintains effective control over those assets. Repurchase agreements that do not meet all the criteria in paragraph 7 shall be treated as secured borrowings. Fixed-coupon and dollar-roll repurchase agreements, and other contracts under which the securities to be repurchased need not be the same as the securities sold, qualify as borrowings if the return of substantially the same (paragraph 40) securities as those concurrently transferred is assured. Therefore, those transactions shall be accounted for as secured borrowings by both parties to the transfer.

67. If a transferor has transferred securities to an independent third-party custodian, or to a transferee, under conditions that preclude the transferee from selling or repledging the assets during the term of the repurchase agreement (as in most tri-party repurchase agreements), the transferor has not surrendered control over those assets.

Repurchase Agreements

68. Repurchase agreements are defined as agreements under which a reporting entity purchases securities and simultaneously agrees to resell the same or substantially the same securities at a stated price on a specified date. For securities to be substantially the same, the criteria defined in paragraph 40 must be met, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.

69. For repurchase agreements that are accounted for as collateralized lendings in accordance with paragraph 66 of this statement, the underlying securities shall not be accounted for as investments owned by the reporting entity. The amount paid for the securities shall be reported as a short-term investment, and the difference between the amount paid and the amount at which the securities will be subsequently resold shall be reported as interest income, calculated on the straight-line method or the scientific interest (constant yield) method, over the term of the agreement.

70. Reporting entities generally take possession of the underlying collateral under repurchase agreements and in many cases may obtain additional collateral when the estimated fair value of such securities falls below their current contract value. However, to the extent that the current fair value of the collateral is less than the recorded amount, the shortfall shall reduce the admitted asset value of the repurchase agreement.

Reverse Repurchase Agreements

71. Reverse repurchase agreements are defined as agreements under which a reporting entity sells securities and simultaneously agrees to repurchase the same or substantially the same securities at a stated price on a specified date. For securities to be substantially the same, the criteria defined in paragraph 40 must be met, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.

72. For reverse repurchase agreements that are accounted for as collateralized borrowings in accordance with paragraph 66 of this statement, the underlying securities shall continue to be accounted

for as an investment by the reporting entity. The proceeds from the sale of the securities shall be recorded as a liability, and the difference between the proceeds and the amount at which the securities will be subsequently reacquired shall be reported as interest expense, calculated on the straight-line method or the scientific interest (constant yield) method, over the term of the agreement.

Collateral Requirements

73. The collateral requirements for repurchase and reverse repurchase agreements are as follows:

Repurchase Transaction

a. The reporting entity shall receive as collateral transferred securities having a fair value at least equal to 102 percent of the purchase price paid by the reporting entity for the securities. If at anytime the fair value of the collateral is less than 100 percent of the purchase price paid by the reporting entity, the counterparty shall be obligated to provide additional collateral, the fair value of which, together with fair value of all collateral then held in connection with the transaction, at least equals 102 percent of the purchase price.

Reverse Repurchase Transaction

b. The reporting entity shall receive collateral having a fair value as of the transaction date at least equal to 95 percent of the fair value of the securities transferred by the reporting entity in the transaction as of that date. If at anytime the fair value of the collateral is less than 95 percent of the fair value of the securities so transferred, the counterparty shall be obligated to deliver additional collateral, the fair value of which, together with the fair value of all collateral then held in connection with the transaction, at least equals 95 percent of the fair value of the transferred securities.

Dollar Repurchase Agreements

74. Dollar repurchase and dollar reverse repurchase agreements are defined as repurchase and reverse repurchase agreements involving debt instruments that are pay-through securities collateralized with Government National Mortgage Association (GNMA), Federal Home Loan Mortgage Corporation (FHLMC) and Federal National Mortgage Association (FNMA) collateral, and pass-through certificates sponsored by GNMA, mortgage participation certificates issued by the FHLMC or similar securities issued by the FNMA. Dollar repurchase agreements are also commonly referred to as dollar roll transactions. To meet the definition of dollar repurchase and dollar reverse repurchase agreements, the securities underlying the agreements must meet the criteria defined in paragraph 40, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.

75. For the seller in a dollar reverse repurchase agreement accounted for as collateralized borrowing in accordance with paragraph 66 of this statement, a liability is recorded for the amount of proceeds of the sale and the sold mortgage-backed securities are not removed from the accounting records. During the period of the agreement, interest income is recorded as if the mortgage-backed security had been held during the term of the agreement. This is offset by an equal amount of interest expense related to the proceeds received from the sale. Additional interest expense is recorded representing the difference between the sales price and the repurchase price of the mortgage-backed securities sold.

76. When the mortgage-backed securities are repurchased under the agreement, the original mortgage-backed securities sold are removed from the accounting records and the purchased mortgage-backed securities are recorded. The principal amount of the mortgage-backed securities repurchased must be in good delivery form consistent with paragraph 40.

77. If the principal amount repurchased is greater than the amount sold, the cash paid is recorded as an additional investment in the newly acquired certificates. If the principal amount repurchased is less than the amount sold, a gain or loss relating to the original certificates held is recorded.

78. For the purchaser in a dollar repurchase agreement accounted for as collateralized lending in accordance with paragraph 67 of this statement, an asset is recorded for the amount of the purchase. Upon completion of the reverse repurchase agreement, cash is received in exchange for a “substantially the same” security. The difference between the purchase and reselling price represents interest income for the lending of short-term funds.

Separate Transactions

79. Agreements to repurchase and resell securities that do not meet the definitions in paragraphs 60 and 66 of this issue paper shall be accounted for as two separate transactions, that is, as a sale and purchase or as a purchase and sale, in accordance with the relevant statutory accounting guidance. For example, sales of bonds would result in recognition of realized gains or losses.

Offsetting

80. Reporting entities may operate on both sides of the repurchase agreement market resulting in recording of liabilities and assets representing repurchase and reverse repurchase agreements, respectively.

81. Reporting entities shall offset such liabilities and assets only to the extent that one of the following occurs:

- a. A legal right of offset exists as defined in *SSAP No. 64—Offsetting and Netting of Assets and Liabilities* (SSAP No. 64); or
- b. The securities have the same settlement date, are executed with the same counterparty in accordance with a master netting arrangement, involve securities that exist in “book entry” form, and settle on securities transfer systems that have the same key elements and operating characteristics as the Fedwire Securities Transfer System.

82. Otherwise, separate assets and liabilities shall be recognized.

Loan Syndications

83. Borrowers often borrow amounts greater than any one lender is willing to lend. Therefore, it is common for groups of lenders to jointly fund those loans. That may be accomplished by a syndication under which several lenders share in lending to a single borrower, but each lender loans a specific amount to the borrower and has the right to repayment from the borrower.

84. A loan syndication is not a transfer of financial assets. Each lender in the syndication shall account for the amounts it is owed by the borrower. Repayments by the borrower may be made to a lead lender who then distributes the collections to the other lenders of the syndicate. In those circumstances, the lead lender is also functioning as a servicer and, therefore, shall only recognize its portion of the loan as an asset.

Loan Participations

85. Groups of banks or other entities also may jointly fund large borrowings through loan participations in which a single lender makes a large loan to a borrower and subsequently transfers undivided interests in the loan to other entities.

86. Transfers by the originating lender may take the legal form of either assignments or participations. 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 upon the terms of the participation agreement.

87. If the loan participation agreement gives the transferee the right to pledge or exchange those participations and the other criteria in paragraph 7 are met, the transfers to the transferee shall be accounted for by the transferor as sales of financial assets. A transferor's right of first refusal on a bona fide offer from a third party, a requirement to obtain the transferor's permission that shall not be unreasonably withheld, or a prohibition on sale to the transferor's competitor is a limitation on the transferee's rights but presumptively does not constrain a transferee from exercising its right to pledge or exchange. However, if the loan participation agreement constrains the transferees from pledging or exchanging their participations, the transferor has not relinquished control over the loan and shall account for the transfers as secured borrowings.

Factoring Arrangements

88. Factoring arrangements are a means of discounting accounts receivable on a nonrecourse, notification basis. 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. Factoring arrangements that meet the criteria in paragraph 7 shall be accounted for as sales of financial assets because the transferor surrenders control over the receivables to the factor.

Transfers of Receivables with Recourse

89. In a transfer of receivables with recourse, the transferor is obligated under the terms of the recourse provision to make payments to the transferee or to repurchase receivables sold under certain circumstances, typically for defaults up to a specified percentage. A transfer of receivables with recourse shall not be recognized as a sale but rather, as a financing. A transfer of receivables without recourse shall only be recognized if the transferor receives cash for the receivables. The sale shall be recognized when cash is received. Sales of premium receivables are addressed in *SSAP No. 42—Sale of Premium Receivables*.

Disclosures

90. A reporting entity shall disclose the following:
- a. For collateral:
 - i. If the entity has entered into repurchase agreements or securities lending transactions, its policy for requiring collateral or other security;
 - ii. If the entity has pledged any of its assets as collateral that are not reclassified and separately reported in the statement of financial position pursuant to paragraph 14.a., the carrying amount and classification of those assets as of the date of the latest statement of financial position presented;
 - iii. If the entity has accepted collateral that it is permitted by contract or custom to sell or repledge, the fair value as of the date of each statement of financial position presented of that collateral and of the portion of that collateral that it has sold or repledged, and information about the sources and uses of that collateral; and

- iv. For securities lending transactions, disclose collateral for transactions that extend beyond one year from the reporting date.
- b. If debt was considered to be extinguished by in-substance defeasance, a general description of the transaction and the amount of debt that is considered extinguished at the end of the period so long as that debt remains outstanding;
- c. If assets are set aside solely for satisfying scheduled payments of a specific obligation, a description of the nature of restrictions placed on those assets;
- d. If it is not practicable to estimate the fair value of certain assets obtained or liabilities incurred in transfers of financial assets during the period, a description of those items and the reasons why it is not practicable to estimate their fair value;
- e. For all servicing assets and servicing liabilities:
 - i. The amounts of servicing assets nonadmitted or liabilities recognized and amortized during the period; and
 - ii. The fair value of recognized servicing assets and liabilities for which it is practicable to estimate that value and the method and significant assumptions used to estimate the fair value.
- f. If the entity has securitized financial assets during any period presented and accounts for that transfer as a sale, for each major asset type (for example, mortgage loans):
 - i. Its accounting policies for initially measuring the retained interests, if any, including the methodology (whether quoted market price, prices based on sales of similar assets and liabilities, or prices based on valuation techniques) used in determining their fair value (Glossary); and
 - ii. The characteristics of securitizations (a description of the transferor's continuing involvement with the transferred assets, including, but not limited to, servicing, recourse, and restrictions on retained interests) and the gain or loss from sale of financial assets in securitizations;
 - iii. The key assumptions used in measuring the fair value of retained interests at the time of securitization (including, at a minimum, quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable financial assets, and anticipated credit losses, if applicable); and
 - iv. Cash flows between the securitization SPE and the transferor (including proceeds from new securitizations, purchases of delinquent or foreclosed loans, servicing fees, and cash flows received on interests retained.)
- g. If the entity has retained interests in securitized financial assets at the date of the latest statement of financial position presented, for each major asset type (for example, mortgage loans):
 - i. Its accounting policies for subsequently measuring those retained interests, including the methodology (whether quoted market price, prices based on sales of similar assets and liabilities, or prices based on valuation techniques) used in determining their fair value (Glossary);

- ii. The key assumptions used in subsequently measuring the fair value of those interests (including, at a minimum, quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable financial assets, and anticipated credit losses, including expected static pool losses, if applicable);
 - iii. A sensitivity analysis or stress test showing the hypothetical effect on the fair value of those interests of two or more unfavorable variations from the expected levels for each key assumption that is reported under ii. above independently from any change in another key assumption, and a description of the objectives, methodology, and limitations of the sensitivity analysis or stress test; and
 - iv. For the securitized assets and any other financial assets that the entity manages together with the retained interests¹:
 - (a) The total principal amount outstanding, the portion that has been derecognized, and the portion that continues to be recognized in each category reported in the statement of financial position, at the end of the period;
 - (b) Delinquencies at the end of the period; and
 - (c) Credit losses, net of recoveries, during the period.
 - v. Disclosure of average balances during the period is encouraged, but not required.
 - h. Description of any loaned securities, including the amount, a description of, and the policy for, requiring collateral, and whether or not the collateral is restricted;
 - i. A description of the securities underlying repurchase and reverse repurchase agreements, dollar repurchase and dollar reverse repurchase agreements, including book values and fair values, maturities, and weighted average interest rates for the following categories: (i) securities subject to reverse repurchase agreements; (ii) securities subject to repurchase agreements; (iii) securities subject to dollar repurchase agreements; and (iv) securities subject to dollar reverse repurchase agreements; and
 - j. A description of the terms of reverse repurchase agreements whose amounts are included in borrowed money.
91. Disclose any transfers of receivables with recourse.
92. A reporting entity shall disclose the following information for wash sales, as defined in paragraph 11, involving transactions for securities with a NAIC designation of 3 or below, or unrated:
- a. A description of the reporting entity's objectives regarding these transactions;
 - b. An aggregation of transactions by NAIC Designation 3 or below, or unrated;
 - c. The number of transactions involved during the reporting period;
 - d. The book value of securities sold;

¹ Excluding securitized assets that an entity continues to service but with which it has no other continuing involvement.

- e. The cost of securities repurchased; and
- f. The realized gains/losses associated with the securities involved.

93. Refer to the preamble for further discussion regarding disclosure requirements. The disclosures required by paragraph 92 shall be made for the current quarter in the quarterly statement and for the year in the annual statement.

Effective Date and Transition

94. Upon adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the *Accounting Practices and Procedures Manual* should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will be effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after January 1, 2005, and shall be applied prospectively.

95. For each servicing contract in existence before January 1, 2005, previously recognized or nonadmitted servicing rights and excess servicing receivables shall be combined, net of any previously recognized servicing obligations under that contract, as a servicing asset (nonadmitted) or liability. Thereafter, the subsequent measurement provisions of this statement shall be applied to the servicing assets (nonadmitted) or liabilities for those servicing contracts.

DISCUSSION

96. The accounting guidance in this issue paper is consistent with the guidance included in SSAP No. 18, SSAP No. 33 and SSAP No. 45, and is expanded to include issues addressed in FAS 140.

97. This statement adopts FAS 140 with the following modifications:

- a. Servicing rights assets are nonadmitted;
- b. Sales treatment is not permitted for transactions including recourse provisions or removal-of-accounts provisions on the transferred assets whereas GAAP would permit the recognition of the transfer as a sale under some circumstances;
- c. As statutory financial statements are prepared on a legal entity basis, special purpose entities shall not be consolidated in a reporting entity's statutory financial statements;
- d. Leases shall be accounted for in accordance with SSAP No. 22;
- e. Reporting entities required to maintain an IMR shall account for realized and unrealized capital gains and losses in accordance with SSAP No. 7; and
- f. The concepts of revolving-period securitizations, banker's acceptances and risk participations in banker's acceptances are not applicable for statutory accounting purposes.

98. This issue paper adopts *AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as used In Certain Audit Guides and a Statement of Position*. This statement adopts *FASB Emerging Issues Task Force No. 87-34, Sale of Mortgage Servicing Rights with a Subservicing Agreement*, *FASB Emerging Issues Task Force No. 88-11, Allocation of Recorded Investment When a Loan as Part of a Loan is Sold*, *FASB Emerging Issues Task Force No. 88-18, Sales of*

Future Revenues, FASB Emerging Issues Task Force No. 88-22, Securitization of Credit Card and Other Receivable Portfolios, FASB Emerging Issues Task Force No. 90-21, Balance Sheet Treatment of a Sale of Mortgage Servicing Rights with a Subservicing Agreement, FASB Emerging Issues Task Force No. 95-5, Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage Loan Servicing Rights and FASB Emerging Issues Task Force No. 96-19, Debtor's Accounting for a Modification or Exchange of Debt Instruments.

99. This issue paper rejects *FASB Emerging Issues Task Force No. 84-5, Sale of Marketable Securities with a Put Option*, and *FASB Emerging Issues Task Force No. 92-2, Measuring Loss Accruals by Transferors of Receivables with Recourse*.

RELEVANT STATUTORY AND GAAP GUIDANCE:

Statutory Accounting

100. SSAP No. 18 provides the following guidance:

SUMMARY CONCLUSION

3. Except as discussed in paragraph 35, a transfer of a group of financial assets, or a portion of a financial asset in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if, and only if, all of the following conditions are met:
 - a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership (see paragraphs 12 and 13);
 - b. Either (i) each transferee obtains the right, free of conditions that constrain it from taking advantage of that right (see paragraph 14), to pledge or exchange the transferred assets or (ii) the transferee is a qualifying special-purpose entity as defined in paragraph 9 of SSAP No. 33 and the holders of beneficial interests in that entity have the right, free of conditions that constrain them from taking advantage of that right (see paragraph 14), to pledge or exchange those interests; and
 - c. The transferor does not maintain effective control over the transferred assets through (i) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (see paragraphs 15-17) or (ii) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable (see paragraph 18).
4. Upon completion of any transfer of financial assets, the transferor shall:
 - a. Continue to carry in its balance sheet any retained interest in the transferred assets, including, if applicable, beneficial interests in assets transferred to a qualifying special-purpose entity in a securitization (see SSAP No. 33), and retained undivided interests (see paragraph 20); and
 - b. Allocate the previous carrying amount between the assets sold, if any, and the retained interests, if any, based on their relative fair values at the date of transfer (see paragraphs 19 and 20).
5. Upon completion of a transfer of assets that satisfies the conditions to be accounted for as a sale (see paragraph 3), the transferor (seller) shall:

- a. Eliminate the transferred assets from the balance sheet;
 - b. Allocate the previous carrying amount of the transferred assets to the securities representing beneficial interests retained by the reporting entity, if any, and the securities representing beneficial interests not retained, if any, based on the relative fair values of the transferred assets at the date of transfer;
 - c. Record in its balance sheet, the allocated carrying value of the securities representing retained beneficial interests in the assets (e.g., loan-backed securities);
 - d. Recognize all additional assets obtained (i.e., other than the securities representing retained beneficial interests which are recorded in accordance with 5 c.) and liabilities incurred in consideration as proceeds of the sale;
 - e. Initially measure such additional assets obtained and liabilities incurred in the sale at fair value; and
 - f. For reporting entities required to maintain an Interest Maintenance Reserve (IMR), the accounting for realized capital gains and losses shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*. For reporting entities not required to maintain an IMR, realized gains and losses shall be reported as net realized capital gains or losses in the statement of income.
6. The transferee shall recognize all assets obtained and any liabilities incurred, and initially measure them at fair value (in aggregate, presumptively the price paid).
 7. Repurchase agreements, reverse repurchase agreements, and dollar repurchase agreements shall meet the definition of SSAP No. 45. When an asset is sold and the proceeds are reinvested within 30 days in the same or substantially the same security, such transfers shall be considered to be wash sales and shall be accounted for as sales and disclosed as required by paragraph 37. Unless there is a concurrent contract to repurchase or redeem the transferred financial assets from the transferee, the transferor does not maintain effective control over the transferred assets.
 8. If a transfer of financial assets in exchange for cash or other consideration (other than beneficial interests in the transferred assets) (a) does not meet the criteria for a sale in paragraph 3, or (b) is a sale of receivables with recourse (see paragraph 35); the transferor and transferee shall account for the transfer as a secured borrowing with pledge of collateral (see paragraph 10).

Recognition and Measurement of Servicing Assets and Liabilities

9. Servicing rights become a distinct asset or liability only when contractually separated from the underlying assets by sale or securitization of the assets with servicing retained, or separate purchase or assumption of the servicing. If distinct servicing rights to transferred assets exist and are retained by the reporting entity, the reporting entity shall recognize a servicing asset or liability. When the servicing fees to be received exceed the cost of servicing the transferred assets, a servicing asset is recognized and nonadmitted. When the cost of servicing the transferred assets is greater than the servicing fees to be received, a liability shall be recorded for the excess to recognize this obligation. A corresponding loss shall be recorded through the Summary of Operations. The servicing asset or liability shall be amortized into income in proportion to, and over the period of estimated servicing income (if an asset) or estimated servicing loss (if a liability). A servicing asset or liability shall be assessed for impairment or increased obligation based on its fair value.

Secured Borrowings and Collateral

10. A debtor may grant a security interest in certain assets to a lender (the secured party) to serve as collateral for its obligation under a borrowing, with or without recourse to other assets of the debtor. An obligor under other kinds of current or potential obligations, for example, interest rate swaps, also may grant a security interest in certain assets to a secured party. 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 repledge (or otherwise transfer) collateral held under a pledge. The same relationships occur, under different names, in transfers documented as sales that are accounted for as secured borrowings (see paragraph 8). The accounting for collateral by the debtor (or obligor) and the secured party depends on whether the secured party has taken control over the collateral, and on the rights and obligations that result from the collateral arrangement:
 - a. If the secured party is permitted to sell or repledge the collateral, and the debtor does not have the right and ability to redeem the collateral on short notice, (e.g., by substituting other collateral or terminating the contract), then:
 - i. The debtor shall disclose the amount of such assets and the secured party's right to sell or repledge such collateral;
 - ii. The secured party shall recognize that collateral as its asset, initially measure it at fair value, and also recognize its obligation to return it.
 - b. If the secured party sells or repledges collateral on terms that do not give it the right and ability to repurchase or redeem the collateral from the transferee on short notice, the secured party shall recognize the proceeds from the sale or the asset repledged and its obligation to return the asset to the extent that it has not already recognized them. The sale or repledging of the asset is a transfer subject to the provisions of this statement;
 - c. If the debtor defaults under the terms of the secured contract and is no longer entitled to redeem the collateral, it shall derecognize the collateral. The secured party shall recognize the collateral as an asset (to the extent it has not already recognized it) and initially measure it at fair value;
 - d. Otherwise, the debtor shall continue to carry the collateral as an asset, and the secured party shall not recognize the pledged asset.

Extinguishments of Liabilities

11. A debtor shall derecognize a liability if, and only if, it has been extinguished (see SSAP No. 15). A liability has been extinguished if either of the following conditions is met:
 - a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes delivery of cash, other financial assets, goods, or services or reacquisition by the debtor of its outstanding debt securities; or
 - b. The debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor.

Isolation Beyond the Reach of the Transferor and Its Creditors

12. 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 and its creditors, either by a single transaction or a series of transactions taken as a whole—depend on the facts and circumstances. All

available evidence that either supports or questions an assertion shall be considered. That consideration includes making judgments about whether the contract or circumstances permit the transferor to revoke the transfer. It also may include making judgments about the kind of bankruptcy or other receivership into which a transferor or special-purpose entity might be placed, whether a transfer of financial assets would likely be deemed a true sale at law, whether the transferor is affiliated with the transferee, and other factors pertinent under applicable law. Derecognition of transferred assets is appropriate only if the available evidence provides reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its affiliates, except for an affiliate that is a qualifying special-purpose entity designed to make remote the possibility that it would enter bankruptcy or other receivership (see SSAP No. 33).

13. Many common financial transactions, for example, typical repurchase agreements (see SSAP No. 45) and securities lending transactions, isolate transferred assets from the transferor, although they may not meet the other criteria for surrender of control.

Conditions That Constrain a Transferee

14. Many transferor-imposed or other conditions on a transferee's contractual right to pledge or exchange a transferred asset constrain a transferee from taking advantage of that right. However, a transferor's right of first refusal on a bona fide offer from a third party, a requirement to obtain the transferor's permission to sell or pledge that shall not be unreasonably withheld, or a prohibition on sale to the transferor's competitor generally does not constrain a transferee from pledging or exchanging the asset and, therefore, presumptively does not preclude a transfer containing such a condition from being accounted for as a sale. For example, a prohibition on sale to the transferor's competitor would not constrain the transferee if it were able to sell the transferred assets to a number of other parties; however, it would be a constraint if that competitor were the only potential willing buyer.

Agreements That Maintain Effective Control Over Transferred Assets

15. An agreement that both entitles and obligates the transferor to repurchase or redeem transferred assets from the transferee maintains the transferor's effective control over those assets, and the transfer is therefore to be accounted for as a secured borrowing, if and only if all of the following conditions are met:
 - a. The assets to be repurchased or redeemed are the same or substantially the same as those transferred (see paragraph 16);
 - b. The transferor is able to repurchase or redeem them on substantially the agreed terms, even in the event of default by the transferee (see paragraph 17);
 - c. The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price; and
 - d. The agreement is entered into concurrently with the transfer.
16. To be substantially the same, the asset that was transferred and the asset that is to be repurchased or redeemed need to have all of the following characteristics:
 - a. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same);
 - b. Identical form and type so as to provide the same risks and rights;

- c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities have similar remaining weighted-average maturities that result in approximately the same market yield);
 - d. Identical contractual interest rates;
 - e. Similar assets as collateral; and
 - f. The same aggregate unpaid principal amount or principal amounts within accepted good delivery standards for the type of security involved.
17. To be able to repurchase or redeem assets on substantially all of the agreed terms, even in the event of default by the transferee, a transferor must at all times during the contract term have obtained cash or other collateral sufficient to fund substantially all of the cost of purchasing replacement assets from others.
18. A call option or forward contract that entitles the transferor to repurchase, prior to maturity, transferred assets not readily obtainable elsewhere maintains the transferor's effective control, because it would constrain the transferee from exchanging those assets, unless it is only a cleanup call.

Assets Obtained and Liabilities Incurred as Proceeds

19. The proceeds from a sale of financial assets consist of the cash and any other assets obtained in the transfer less any liabilities incurred. Any asset obtained that is not an interest in the transferred asset is part of the proceeds from the sale. Any liability incurred, even if it is related to the transferred assets, is a reduction of the proceeds. Any derivative financial instrument entered into concurrently with a transfer of financial assets is either an asset obtained or a liability incurred and part of the proceeds received in the transfer. All proceeds and reductions of proceeds from a sale shall be initially measured at fair value.

Retained Interests

20. Other interests in transferred assets—those that are not part of the proceeds of the transfer—are retained interests over which the transferor has not relinquished control. They shall be measured at the date of the transfer by allocating the previous carrying amount between the assets sold, if any, and the retained interests, based on their relative fair values. That procedure shall be applied to all transfers in which interests are retained, even those that do not qualify as sales. Examples of retained interests include securities backed by the transferred assets, undivided interests, servicing assets, and cash reserve accounts and residual interests in securitization trusts. If a transferor cannot determine whether an asset is a retained interest or proceeds from the sale, the asset shall be treated as proceeds from the sale and accounted for in accordance with paragraph 19.

Fair Value

21. The fair value of an asset (or liability) is the amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. If a quoted market price is available, the fair value is the product of the number of trading units times market price.
22. If quoted market prices are not available, the estimate of fair value shall be based on the best information available. The estimate of fair value shall consider prices for similar assets and liabilities and the results of valuation techniques to the extent available in the

circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows using a discount rate commensurate with the risks involved, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. Valuation techniques for measuring financial assets and liabilities and servicing assets and liabilities shall be consistent with the objective of measuring fair value. Those techniques shall incorporate assumptions that market participants would use in their estimates of values, future revenues, and future expenses, including assumptions about interest rates, default, prepayment, and volatility. In measuring financial liabilities and servicing liabilities at fair value by discounting estimated future cash flows, an objective is to use discount rates at which those liabilities could be settled in an arm's-length transaction.

23. Estimates of expected future cash flows, if used to estimate fair value, shall be the best estimate based on reasonable and supportable assumptions and projections. All available evidence shall be considered in developing estimates of expected future cash flows. The weight given to the evidence shall be commensurate with the extent to which the evidence can be verified objectively. If a range is estimated for either the amount or timing of possible cash flows, the likelihood of possible outcomes shall be considered in determining the best estimate of future cash flows.

If It Is Not Practicable to Estimate Fair Values

24. If it is not practicable to estimate the fair values of assets, the transferor shall record those assets at zero. If it is not practicable to estimate the fair values of liabilities, the transferor shall recognize no gain on the transaction and shall record those liabilities at the greater of:
 - a. The excess, if any, of (i) the fair values of assets obtained less the fair values of other liabilities incurred, over (ii) the sum of the carrying values of the assets transferred;
 - b. The amount that would be recognized in accordance with *SSAP No. 5—Liabilities, Contingencies and Impairments of Assets*.

Securities Lending Transactions

25. When securities are loaned, they remain assets of the reporting entity and are not removed from the accounting records. Any fees received by the transferor for loaning the securities should be recorded as miscellaneous income. During a securities lending transaction, collateral is pledged by the transferee to the transferor that has loaned the securities. If the collateral pledged by the transferee is not available for the general use of the transferor (restricted), then the transferor shall not reflect the collateral in the transferor's balance sheet as an asset, and the transferor shall not establish a liability for the return of the collateral. However, if the collateral pledged is available for the general use of the transferor (unrestricted), then the collateral shall be recorded as an asset on the transferor's balance sheet and a separate liability shall be established on the transferor's balance sheet to record the obligation to return the collateral. The failure by the transferor to maintain sufficient collateral for the loaned securities would result in nonadmission of the undercollateralized portion. The specific collateral requirements are as follows:
 - a. The reporting entity shall receive collateral having a fair value as of the transaction date at least equal to 102 percent of the fair value of the loaned securities at that date. If at any time the fair value collateral is less than 100 percent of the fair value of the loaned securities, the counterparty shall be obligated to deliver additional collateral, the fair value of which, together with the fair value of all collateral then held in connection with the transaction at least equals 102 percent of the fair value of the loaned securities.

- b. In the event that foreign securities are loaned and the denomination of the currency of the collateral is other than the denomination of the currency of the loaned foreign securities, the amount of collateral shall be at least equal to 105 percent of the fair value of the loaned securities at that date. If at any time the fair value is less than 102 percent of the fair value of the loaned securities, the reporting entity must obtain additional collateral, the fair value of which together with the fair value of all collateral then held in connection with the transaction at least equals 105 percent of the fair value of the loaned securities.
26. Securities lending transactions are generally initiated by broker-dealers and other financial institutions that need specific securities to cover a short sale or a customer's failure to deliver securities sold. Transferees (borrowers) of securities generally are required to provide collateral to the transferor (lender) of securities, 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 transferor typically earns a return by investing that cash at rates higher than the rate paid or rebated to the transferee. If the collateral is other than cash, the transferor typically receives a fee. Securities custodians or other agents commonly carry out securities lending activities on behalf of clients. Because of the protection of collateral (typically valued daily and adjusted frequently for changes in the market price of the securities transferred) and the short terms of the transactions, most securities lending transactions in themselves do not impose significant credit risks on either party. Other risks arise from what the parties to the transaction do with the assets they receive. For example, investments made with cash collateral impose market and credit risks on the transferor.
27. Securities lending transactions are accompanied by an agreement that entitles and obligates the transferor to repurchase or redeem the transferred assets before their maturity under which the transferor maintains effective control over those assets (see paragraphs 15-18). Those transactions shall be accounted for as secured borrowings, in which cash (or securities that the holder is permitted by contract or custom to sell or repledge) received as collateral is considered the amount borrowed, the securities loaned are considered pledged as collateral against the cash borrowed, and any rebate paid to the transferee of securities is interest on the cash the transferor is considered to have borrowed. Collateral provided in securities lending transactions that are accounted for as secured borrowings shall be reported and disclosed like other collateral, as set forth in paragraphs 10 and 25.
28. In some transactions, characterized as securities lending, all of the criteria in paragraph 3 are met. During the term of such agreements, the transferor has surrendered control over the securities transferred and the transferee has obtained control over those securities, with the ability to sell or transfer them at will. In that case, creditors of the transferor have a claim only to the collateral and the forward repurchase commitment. Those transactions shall be accounted for:
- a. By the transferor as a sale of the loaned securities, for proceeds consisting of the collateral and a forward repurchase commitment. (If the collateral is a financial asset that the holder is permitted to sell or repledge and the debtor does not have the right and ability to redeem the collateral on short notice, e.g., by substituting other collateral or terminating the contract, that financial asset is proceeds of the sale of the loaned securities. To the extent that the collateral consists of letters of credit or other financial instruments that the holder is not permitted to sell or pledge, a securities lending transaction does not satisfy the sale criteria and is accounted for as a loan of securities by the transferor to the transferee); and
 - b. By the transferee as a purchase of the borrowed securities in exchange for the collateral and a forward resale commitment.

Loan Syndications

29. Borrowers often borrow amounts greater than any one lender is willing to lend. Therefore, it is common for groups of lenders to jointly fund those loans. That may be accomplished by a syndication under which several lenders share in lending to a single borrower, but each lender loans a specific amount to the borrower and has the right to repayment from the borrower.
30. Each lender in the syndication shall account for the amounts it is owed by the borrower. Repayments by the borrower may be made to a lead lender who then distributes the collections to the other lenders of the syndicate. In those circumstances, the lead lender is also functioning as a servicer and, therefore, shall only recognize its portion of the loan as an asset.

Loan Participations

31. Groups of banks or other entities also may jointly fund large borrowings through loan participations in which a single lender makes a large loan to a borrower and subsequently transfers undivided interests in the loan to other entities.
32. Transfers by the originating lender may take the legal form of either assignments or participations. 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 upon the terms of the participation agreement.
33. If the loan participation agreement gives the transferee the right to pledge or exchange those participations and the other criteria in paragraph 3 are met, the transfers to the transferee shall be accounted for by the transferor as sales of financial assets. A transferor's right of first refusal on a bona fide offer from a third party, a requirement to obtain the transferor's permission that shall not be unreasonably withheld, or a prohibition on sale to the transferor's competitor is a limitation on the transferee's rights but presumptively does not constrain a transferee from exercising its right to pledge or exchange. However, if the loan participation agreement constrains the transferees from pledging or exchanging their participations, the transferor has not relinquished control over the loan and shall account for the transfers as secured borrowings.

Factoring Arrangements

34. Factoring arrangements are a means of discounting accounts receivable on a nonrecourse, notification basis. 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. Factoring arrangements that meet the criteria in paragraph 3 shall be accounted for as sales of financial assets because the transferor surrenders control over the receivables to the factor.

Transfers of Receivables with Recourse

35. In a transfer of receivables with recourse, the transferor is obligated under the terms of the recourse provision to make payments to the transferee or to repurchase receivables sold under certain circumstances, typically for defaults up to a specified percentage. A transfer of receivables with recourse shall not be recognized as a sale but rather, as a financing. A transfer of receivables without recourse shall only be recognized if the transferor receives cash for the receivables. The sale shall be recognized when cash is received. Sales of premium receivables are addressed in SSAP No. 42.

Disclosures

36. A reporting entity shall disclose the following:
- a. If it is not practicable to estimate the fair value of certain assets obtained or liabilities incurred in transfers of financial assets during the period, a description of those items and the reasons why it is not practicable to estimate their fair value;
 - b. Description of any loaned securities, including the amount, a description of, and the policy for, requiring collateral, and whether or not the collateral is restricted; and
 - c. For all servicing assets and servicing liabilities:
 - i. The amounts of servicing assets nonadmitted or liabilities recognized and amortized during the period; and
 - ii. The fair value of servicing liabilities for which it is practicable to estimate that value and the method and significant assumptions used to estimate the fair value.
37. A reporting entity shall disclose the following information for wash sales, as defined in paragraph 7, involving transactions for securities with a NAIC designation of 3 or below, or unrated:
- a. A description of the reporting entity's objectives regarding these transactions;
 - b. An aggregation of transactions by NAIC Designation 3 or below, or unrated;
 - c. The number of transactions involved during the reporting period;
 - d. The book value of securities sold;
 - e. The cost of securities repurchased; and
 - f. The realized gains/losses associated with the securities involved.
38. Refer to the preamble for further discussion regarding disclosure requirements. The disclosures required by paragraph 37 shall be made for the current quarter in the quarterly statement and for the year in the annual statement.

Relevant Literature

39. This statement adopts FAS 125 with modification to paragraphs 9, 10.a., 11.d., 13, 15-17, 35-41, and 68. Additionally, paragraphs 14, 59-60, 77-81, and 83 are rejected. The modifications to FAS 125 primarily relate to (a) the nonadmission of servicing rights assets, (b) the accounting for repurchase agreements, reverse repurchase agreements, and dollar repurchase agreements, (c) the accounting for realized gains and losses for reporting entities required to maintain an IMR, (d) the accounting for financial assets subject to prepayment, (e) the accounting for assets pledged as collateral, (f) the accounting for leases in accordance with *SSAP No. 22—Leases*, and (g) the accounting for sales of receivables with recourse. Paragraphs 77-81 are rejected because they are not applicable to the insurance industry.
40. This statement adopts AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as used In Certain Audit Guides and a Statement of Position. This statement adopts FASB Emerging Issues Task Force

No. 87-34, Sale of Mortgage Servicing Rights with a Subservicing Agreement, FASB Emerging Issues Task Force No. 88-11, Allocation of Recorded Investment When a Loan as Part of a Loan is Sold, FASB Emerging Issues Task Force No. 88-18, Sales of Future Revenues, FASB Emerging Issues Task Force No. 88-22, Securitization of Credit Card and Other Receivable Portfolios, FASB Emerging Issues Task Force No. 90-21, Balance Sheet Treatment of a Sale of Mortgage Servicing Rights with a Subservicing Agreement, FASB Emerging Issues Task Force No. 95-5, Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage Loan Servicing Rights and FASB Emerging Issues Task Force No. 96-19, Debtor's Accounting for a Modification or Exchange of Debt Instruments.

41. This statement rejects FASB Statement No. 127, Deferral of the Effective Date of Certain Provisions of FASB Statement No. 125, an amendment of FASB Statement No. 125, FASB Emerging Issues Task Force No. 84-5, Sale of Marketable Securities with a Put Option, FASB Emerging Issues Task Force No. 92-2, Measuring Loss Accruals by Transferors of Receivables with Recourse, and FASB Emerging Issues Task Force No. 96-20, Impact of FASB Statement No. 125 on Consolidation of Special-Purpose Entities.

Effective Date and Transition

42. This statement shall be effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after January 1, 2001, and shall be applied prospectively.
43. For each servicing contract in existence before January 1, 2001, previously recognized or nonadmitted servicing rights and excess servicing receivables shall be combined, net of any previously recognized servicing obligations under that contract, as a servicing asset (nonadmitted) or liability. Thereafter, the subsequent measurement provisions of this statement shall be applied to the servicing assets (nonadmitted) or liabilities for those servicing contracts.

101. SSAP No. 33 provides the following guidance:

Accounting for Securitizations of Financial Assets

3. A financial asset shall be defined as cash, evidence of an ownership interest in an entity, or a contract that both
- a. Imposes on one entity a contractual obligation (i) to deliver cash or another financial instrument to a second entity or (ii) to exchange other financial instruments on potentially unfavorable terms with the second entity; and
 - b. Conveys to that second entity a contractual right (i) to receive cash or another financial instrument from the first entity or (ii) to exchange other financial instruments on potentially favorable terms with the first entity.
4. A securitization in which the transferor surrenders control over the financial asset transferred shall be accounted for as a sale, with recognition of proceeds and measurement of a gain or loss only to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The portion of the securitization for which beneficial interests in the transferred assets are received shall not be accounted for as a sale, but shall be treated as an exchange of assets with no measurement of a gain or loss. All other securitizations shall be accounted for as secured borrowings in accordance with paragraph 11.
5. The transferor has surrendered control if, and only if, all of the following conditions are met:

- a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership;
 - b. The transferee is a qualifying special-purpose entity and the holders of beneficial interests in that entity have the right—free of transferor-imposed conditions that constrain them from taking advantage of that right—to pledge or exchange those interests; and
 - c. The transferor does not maintain effective control over the transferred assets through (i) an agreement that entitles and obligates the transferor to repurchase or redeem them before their maturity, or (ii) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable.
6. A beneficial interest shall be defined as the right to receive all or portions of specified cash inflows to a trust or other entity, including senior and subordinated shares of interest or principal inflows to be “passed through” or “paid through,” premiums due guarantors, and residual interests. Residual interests are interests in the cash flows of the trust or other entity, after the cash flows of structured securities issued by the trust are met.
7. Upon completion of the securitization of financial assets meeting the criteria for sales treatment required by paragraph 5, the transferor shall:
- a. Eliminate the transferred assets from the statement of financial position;
 - b. Allocate the previous carrying amount of the transferred assets to the securities representing beneficial interests retained by the reporting entity, if any, and the securities representing beneficial interests not retained, if any, based on the relative fair values of the transferred assets at the date of transfer;
 - c. Record in its statement of financial position, the allocated carrying value of the securities representing retained beneficial interests in the assets (e.g., loan-backed securities);
 - d. Recognize all additional assets obtained (i.e., other than the securities representing retained beneficial interests which are recorded in accordance with 7 c.) and liabilities incurred in consideration as proceeds of the sale;
 - e. Initially measure such additional assets obtained and liabilities incurred in the sale at fair value; and
 - f. For reporting entities required to maintain an Interest Maintenance Reserve (IMR), the accounting for realized capital gains and losses shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*. For reporting entities not required to maintain an IMR, realized gains and losses shall be reported as net realized capital gains or losses line in the Investment Income section of the Underwriting and Investment Exhibit.
8. The successor (transferee) shall recognize all assets obtained and any liabilities incurred and initially measure them at fair value.
9. A qualifying special-purpose entity (including a CMO special-purpose entity) as used in this statement must meet all of the following conditions:
- a. It is a trust, corporation, or other legal vehicle whose activities are permanently limited by the legal documents establishing the special-purpose entity to:

- i. Holding title to transferred financial assets;
 - ii. Issuing beneficial interests (If some of the beneficial interests are in the form of debt securities or equity securities, the transfer of assets is a securitization.);
 - iii. Collecting cash proceeds from assets held, reinvesting proceeds in financial instruments pending distribution to holders of beneficial interests, and otherwise servicing the assets held; and
 - iv. Distributing proceeds to the holders of its beneficial interests.
- b. It has a standing at law distinct from the transferor. Having standing at law depends in part on the nature of the special-purpose entity. For example, generally, under U.S. law, if a transferor of assets to a special-purpose trust holds all of the beneficial interests, it can unilaterally dissolve the trust, and thereby resume control over the individual assets held in the trust, and the transferor can effectively assign its interest and its creditors can reach it. In that circumstance, the trust has no standing at law, is not distinct, and thus is not a qualified special-purpose entity. A special-purpose entity that has distinct standing at law may still be an affiliate of the transferor.

Investments in Special-Purpose Entities

10. Reporting entities that have qualifying special-purpose entities as affiliates shall carry their investment in such entity at its underlying statutory book value in accordance with *SSAP No. 46—Investments in Subsidiary, Controlled, and Affiliated Entities*. Additionally, transactions entered involving affiliated qualifying special-purpose entities are subject to the provisions of *SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties*.

Secured Obligations and Collateral

11. Securitizations of financial assets that do not meet the criteria for sale treatment set forth in paragraph 5 shall be presumed to be secured borrowings and shall be recorded as follows. Financial assets shall remain on the reporting entity's books and a liability shall be recorded to reflect the proceeds from the issuance of any type of certificate. Non-cash proceeds shall be recorded as a contra liability and netted against the liability. The liability shall be reduced as the obligation to holders of beneficial interests is repaid. Financial assets pledged as collateral shall not be offset against the liability reflecting the proceeds of the transaction.

Recognition of Servicing Rights

12. Servicing rights become a distinct asset or liability only when contractually separated from the underlying assets by sale or securitization of the assets with servicing retained or separate purchase or assumption of the servicing. If distinct servicing rights to transferred assets exist and are retained by the reporting entity, the reporting entity shall recognize a servicing asset or liability. When the servicing fees to be received exceed the cost of servicing the transferred assets, a servicing asset is recognized and nonadmitted. When the cost of servicing the transferred assets is greater than the servicing fees to be received, a liability shall be recorded for the excess to recognize this obligation. A corresponding loss shall be recorded through the Summary of Operations. The servicing asset or liability shall be amortized into income in proportion to, and over the period of estimated servicing income (if an asset) or estimated servicing loss (if a liability). The servicing asset or liability shall be measured in a manner consistent with paragraphs 13 and 35-38 of *FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 125).

Sales of Future Revenues

13. In addition to securitization of assets, some reporting entities have entered into transactions characterized as a sale of future revenues. These transactions are sometimes referred to as securitizations and are sometimes characterized as selling deferred acquisition costs. A sale of future revenues by a reporting entity shall not result in the immediate recognition of income or surplus. The proceeds of any such sale shall be established as a liability and shall be reduced as the proceeds are repaid.

Relevant Literature

14. This statement adopts portions of FAS 125, with the following modifications (FAS 125 is addressed in its entirety in *SSAP No. 18—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*):
 - a. This statement requires servicing rights assets to be nonadmitted;
 - b. This statement does not permit sales treatment for transactions where recourse provisions exist or where “call” or “put” options exist on the transferred assets whereas GAAP would permit the recognition of the transfer as a sale under some circumstances;
 - c. This statement requires debtors to provide disclosure when a secured party is permitted to sell or pledge financial assets transferred as collateral whereas FAS 125 requires the encumbered assets to be reported separately from unencumbered assets;
 - d. This statement does not address transfers of financial assets accomplished in a manner other than through securitizations whereas FAS 125 does address such transfers; and
 - e. Paragraph 14 is rejected as it is not applicable.

Effective Date and Transition

15. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

102. SSAP No. 45 provides the following guidance:

2. Repurchase agreements, reverse repurchase agreements and dollar repurchase agreements meet the definition of assets as defined in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this statement.

Repurchase Agreements

3. Repurchase agreements are defined as agreements under which a reporting entity purchases securities and simultaneously agrees to resell the same or substantially the same securities at a stated price on a specified date within 12 months of the purchase. For securities to be substantially the same, the criteria defined in paragraph 14 must be met, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.
4. Repurchase agreements shall be accounted for as collateralized lendings. The underlying securities shall not be accounted for as investments owned by the reporting entity. The amount paid for the securities shall be reported as a short-term investment, and the difference between the amount paid and the amount at which the securities will be subsequently resold shall be reported as interest income, calculated on the straight-line method or the scientific interest (constant yield) method, over the term of the agreement.
5. Reporting entities generally take possession of the underlying collateral under repurchase agreements and in many cases may obtain additional collateral when the estimated fair value of such securities falls below their current contract value. However, to the extent that the current fair value of the collateral is less than the recorded amount, the shortfall shall reduce the admitted asset value of the repurchase agreement.

Reverse Repurchase Agreements

6. Reverse repurchase agreements are defined as agreements under which a reporting entity sells securities and simultaneously agrees to repurchase the same or substantially the same securities at a stated price on a specified date within 12 months of the sale date. For securities to be substantially the same, the criteria defined in paragraph 13 must be met, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.
7. Reverse repurchase agreements shall be accounted for as collateralized borrowings (financing transactions). The underlying securities shall continue to be accounted for as an investment by the reporting entity. The proceeds from the sale of the securities shall be recorded as a liability, and the difference between the proceeds and the amount at which the securities will be subsequently reacquired shall be reported as interest expense, calculated on the straight-line method or the scientific interest (constant yield) method, over the term of the agreement. Although recording these transactions gross tends to inflate assets and liabilities, it more closely reflects the financing nature of the transactions and their associated leverage impact to the financial statements.

Collateral Requirements

8. The collateral requirements for repurchase and reverse repurchase agreements are as follows:

Repurchase Transaction

- a. The reporting entity shall receive as collateral transferred securities having a fair value at least equal to 102 percent of the purchase price paid by the reporting entity for the securities. If at any time the fair value of the collateral is less than 100 percent of the purchase price paid by the reporting entity, the counterparty shall be obligated to provide additional collateral, the fair value of which, together with fair value of all collateral then held in connection with the transaction, at least equals 102 percent of the purchase price.

Reverse Repurchase Transaction

- b. The reporting entity shall receive collateral having a fair value as of the transaction date at least equal to 95 percent of the fair value of the securities transferred by the reporting entity in the transaction as of that date. If at anytime the fair value of the collateral is less than 95 percent of the fair value of the securities so transferred, the counterparty shall be obligated to deliver additional collateral, the fair value of which, together with the fair value of all collateral then held in connection with the transaction, at least equals 95 percent of the fair value of the transferred securities.

Dollar Repurchase Agreements

9. Dollar repurchase and dollar reverse repurchase agreements are defined as repurchase and reverse repurchase agreements involving debt instruments that are pay-through securities collateralized with Government National Mortgage Association (GNMA), Federal Home Loan Mortgage Corporation (FHLMC) and Federal National Mortgage Association (FNMA) collateral, and pass-through certificates sponsored by GNMA, mortgage participation certificates issued by the FHLMC or similar securities issued by the FNMA. Dollar repurchase agreements are also commonly referred to as dollar roll transactions. To meet the definition of dollar repurchase and dollar reverse repurchase agreements, the securities underlying the agreements must meet the criteria defined in paragraph 13, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.
10. For the seller in a dollar reverse repurchase agreement, a liability is recorded for the amount of proceeds of the sale and the sold mortgage-backed securities are not removed from the accounting records. During the period of the agreement, interest income is recorded as if the mortgage-backed security had been held during the term of the agreement. This is offset by an equal amount of interest expense related to the proceeds received from the sale. Additional interest expense is recorded representing the difference between the sales price and the repurchase price of the mortgage-backed securities sold.
11. When the mortgage-backed securities are repurchased under the agreement, the original mortgage-backed securities sold are removed from the accounting records and the purchased mortgage-backed securities are recorded. The principal amount of the mortgage-backed securities repurchased must be in good delivery form consistent with paragraph 13.
12. If the principal amount repurchased is greater than the amount sold, the cash paid is recorded as an additional investment in the newly acquired certificates. If the principal amount repurchased is less than the amount sold, a gain or loss relating to the original certificates held is recorded.
13. For the purchaser in a dollar repurchase agreement, an asset is recorded for the amount of the purchase. Since the term of the agreement is limited to twelve months, it is accounted for as a short-term investment. Upon completion of the reverse repurchase agreement, cash is received in exchange for a “substantially the same” security. The

difference between the purchase and reselling price represents interest income for the lending of short-term funds.

Criteria to Meet Substantially the Same

14. For debt instruments, including mortgage-backed securities, to be substantially the same, all the following criteria must be met:
 - a. The debt instruments must have the same primary obligor, except for debt instruments guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and terms of the guarantee must be the same;
 - b. The debt instruments must be identical in form and type so as to give the same risks and rights to the holder;
 - c. The debt instruments must bear the identical contractual interest rate;
 - d. The debt instruments must have the same maturity except for mortgage-backed pass-through and pay-through securities for which the mortgages collateralizing the securities must have similar remaining weighted average maturities (WAMs) that result in approximately the same market yield;
 - e. Mortgage-backed pass-through and pay through securities must be collateralized by a similar pool of mortgages, such as single-family residential mortgages; and
 - f. The debt instruments must have the same aggregate unpaid principal amounts, except for mortgage-backed pass-through and pay-through securities, where the aggregate principal amounts of the mortgage-backed securities given up and the mortgage-backed securities reacquired must be within the accepted “good delivery” standard for the type of mortgage-backed security involved.

Separate Transactions

15. Agreements to repurchase and resell securities that do not meet the definitions in paragraph 3, 6, or 8 of this statement shall be accounted for as two separate transactions, that is, as a sale and purchase or as a purchase and sale, in accordance with the relevant statutory accounting guidance. For example, sales of bonds would result in recognition of realized gains or losses.

Offsetting

16. Reporting entities may operate on both sides of the repurchase agreement market resulting in recording of liabilities and assets representing repurchase and reverse repurchase agreements, respectively.
17. Reporting entities shall offset such liabilities and assets only to the extent that one of the following occurs:
 - a. A legal right of offset exists as defined in *SSAP No. 64—Offsetting and Netting of Assets and Liabilities* (SSAP No. 64), or
 - b. The securities have the same settlement date, are executed with the same counterparty in accordance with a master netting arrangement, involve securities that exist in “book entry” form, and settle on securities transfer systems that have the same key elements and operating characteristics as the Fedwire Securities Transfer System.

Otherwise, separate assets and liabilities shall be recognized.

Disclosures

18. The following disclosures shall be made in the financial statements:
- a. If the reporting entity has entered into repurchase agreements, its policy for requiring collateral or other security;
 - b. A description of the securities underlying the agreements, including book values and fair values, maturities, and weighted average interest rates for the following categories: (i) securities subject to reverse repurchase agreements; (ii) securities subject to repurchase agreements; (iii) securities subject to dollar repurchase agreements; and (iv) securities subject to dollar reverse repurchase agreements; and
 - c. A description of the terms of reverse repurchase agreements whose amounts are included in borrowed money.
19. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

20. This statement adopts AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used In Certain Audit Guides and a Statement of Position.
21. This statement adopts paragraphs 9-13, 15-17, 23-25, 27-30 and 66-71 of *FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 125), as they relate to repurchase agreements, reverse repurchase agreements and dollar repurchase agreements.
22. This statement adopts FASB Emerging Issues Task Force No. 84-20, GNMA Dollar Rolls. This statement is consistent with FASB Interpretation No. 39, Offsetting of Amounts Related to Certain Contracts—an interpretation of APB Opinion No. 10 and FASB Statement No. 105 (FIN 39) (as it relates to reverse repurchase and repurchase agreements) and FASB Interpretation No. 41, Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements—an interpretation of APB Opinion No. 10 and a modification of FASB Interpretation No. 39 (FIN 41). FIN 39 and FIN 41 are adopted in SSAP No. 64.
23. This statement rejects paragraph 14 of FAS 125 as it relates to the classifications of securities under *FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities* (FAS 115). FAS 115 is rejected in *SSAP No. 26—Bonds, excluding Loan-backed and Structured Securities*.

Effective Date and Transition

24. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.
103. *INT 01-31: Assets Pledged as Collateral* (INT 01-31) provides the following guidance:

INT 01-31 Issue

1. Insurers may enter into certain transactions that require the granting of a security interest in certain assets to another party to serve as collateral for their performance under a contract. The arrangement is commonly referred to as a pledge, typically accomplished by delivery of assets to the secured party or to an independent custodian. In these transactions, the pledging

insurer typically (1) continues to receive the income on the pledged collateral and (2) can remove and substitute other securities with little or no advance notice to the secured party as long as they comply with related investment quality and market value agreement provisions. Examples include collateral pledged under investment, derivative, debt obligations and policyholder transactions.

2. Specific examples of collateral pledged for derivative and investment transactions include but are not limited to: (1) securities posted with a broker as margin for futures and options transactions, (2) securities pledged to secure credit exposure with swap counterparties, (3) securities pledged under reverse repurchase agreements or securitizations that are accounted for as secured borrowing transactions and (4) securities pledged under securities lending transactions.

3. Specific examples of collateral pledged for debt obligations and policyholder transactions include but are not limited to assets pledged to secure (1) debt borrowings from or insurance contracts issued to banking entities and (2) insurance contracts issued to governmental entities such as municipalities.

4. Under these transactions, the fair value of the securities pledged as collateral may exceed the contract balance (swap fair value, advance balance, policyholder account balance, etc). For this interpretation, this excess carrying value of securities pledged over the corresponding asset or contract balance is called the "overcollateralization" amount.

5. The accounting issue is whether the assets pledged as collateral under the various transactions mentioned above should be considered admitted assets.

INT 01-31 Discussion

6. The working group reached a consensus that if the collateral had not been pledged in the examples described above, it is assumed the underlying asset would be recorded as an admitted asset under SSAP No. 4 (e.g. they are readily marketable assets available to meet both current and future policyholder obligations). In addition, it is assumed that the asset would not be considered impaired under SSAP No. 5 due to a default, market value decline, or other loss contingency.

7. Therefore, for the examples described above, the pledging insurer would record the collateral (including the overcollateralization amount) as an admitted asset until they have committed a contract default that has not been cured in accordance with the contract provisions. This accounting is in accordance with the provisions of SSAP Nos. 18, 33 and 45. This consensus of reporting collateral as an admitted asset is further supported by SSAP Nos. 4 and 5 since generally, the insurer can readily substitute pledged assets. Additionally, an insurer may typically unwind the transaction allowing the assets to be available to the pledging insurer to meet policyholder obligations. Furthermore, no event has occurred to indicate an impairment or potential loss contingency with respect to such pledged assets. The fact that some pledged assets may constitute an overcollateralization amount does not change this analysis. Accordingly, all assets pledged in support of these type transactions should also be admitted.

8. At the time of an uncured default, the provisions of paragraph 10 of SSAP No. 18 shall be used to determine the appropriate accounting treatment for the collateral. If the secured party utilizes collateral to offset all or a portion of the liability owed by the pledging insurer as a result of the default, then the collateral amount utilized to offset the liability shall be removed from the balance sheet. At the same time, the amount of the liability that was offset should be removed from the balance sheet since that obligation has been satisfied through the secured party's utilization of that collateral. To the extent that an uncured default remains without the secured party utilizing the collateral to offset the obligation, the pledging insurer should only record an admitted asset for the amount of collateral that it can redeem.

INT 01-31 Status

9. The consensus position of this interpretation is consistent with the position of the NAIC Invested Asset (E) Working Group. This interpretation will be reviewed by the FAS 140 Subgroup of the NAIC Statutory Accounting Principles (E) Working Group in conjunction of its consideration of incorporating GAAP pronouncement *FAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, a replacement of FASB Statement 125* into the statutory accounting model. As such, this interpretation is subject to amendment pending disposition of the FAS 140 Subgroup's review of collateral and FAS 140 in its entirety.

Generally Accepted Accounting Principles

104. FAS 140 provides the following guidance:

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Accounting for Transfers and Servicing of Financial Assets

9. A transfer of financial assets (or all or a portion of a financial asset) in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:

- a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership (paragraphs 27 and 28).
- b. Each transferee (or, if the transferee is a qualifying SPE (paragraph 35), each 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 holder) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor (paragraphs 29-34).
- c. The transferor does not maintain effective control over the transferred assets through either (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (paragraphs 47-49) or (2) the ability to unilaterally cause the holder to return specific assets, other than through a cleanup call (paragraphs 50-54).

10. Upon completion of any transfer of financial assets, the transferor shall:

- a. Continue to carry in its statement of financial position any retained interest in the transferred assets, including, if applicable, servicing assets (paragraphs 61-67), beneficial interests in assets transferred to a qualifying SPE in a securitization (paragraphs 73-84), and retained undivided interests (paragraphs 58 and 59)
- b. Allocate the previous carrying amount between the assets sold, if any, and the retained interests, if any, based on their relative fair values at the date of transfer (paragraphs 56-60).

11. Upon completion of a transfer of assets that satisfies the conditions to be accounted for as a sale (paragraph 9), the transferor (seller) shall:

- a. Derecognize all assets sold
- b. Recognize all assets obtained and liabilities incurred in consideration as proceeds of the sale, including cash, put or call options held or written (for example, guarantee or recourse obligations), forward commitments (for example, commitments to deliver additional receivables during the revolving periods of some securitizations), swaps (for example, provisions that convert interest rates from fixed to variable), and servicing liabilities, if applicable (paragraphs 56, 57, and 61-67)

- c. Initially measure at fair value assets obtained and liabilities incurred in a sale (paragraphs 68-70) or, if it is not practicable to estimate the fair value of an asset or a liability, apply alternative measures (paragraphs 71 and 72)
- d. Recognize in earnings any gain or loss on the sale.

The transferee shall recognize all assets obtained and any liabilities incurred and initially measure them at fair value (in aggregate, presumptively the price paid).

12. If a transfer of financial assets in exchange for cash or other consideration (other than beneficial interests in the transferred assets) does not meet the criteria for a sale in paragraph 9, the transferor and transferee shall account for the transfer as a secured borrowing with pledge of collateral (paragraph 15).

Recognition and Measurement of Servicing Assets and Liabilities

13. Each time an entity undertakes an obligation to service financial assets it shall recognize either a servicing asset or a servicing liability for that servicing contract, unless it transfers the assets to a qualifying SPE in a guaranteed mortgage securitization, retains all of the resulting securities, and classifies them as debt securities held-to-maturity in accordance with *FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities*. If the servicing asset or liability was purchased or assumed rather than undertaken in a sale or securitization of the financial assets being serviced, it shall be measured initially at its fair value, presumptively the price paid. A servicing asset or liability shall be amortized 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). A servicing asset or liability shall be assessed for impairment or increased obligation based on its fair value (paragraphs 61-64).

Financial Assets Subject to Prepayment

14. Interest-only strips, retained interests in securitizations, loans, other receivables, or other 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, except for instruments that are within the scope of Statement 133, shall be subsequently measured like investments in debt securities classified as available-for-sale or trading under Statement 115, as amended (paragraph 362).

Secured Borrowings and Collateral

15. A debtor may grant a security interest in certain assets to a lender (the secured party) to serve as collateral for its obligation under a borrowing, with or without recourse to other assets of the debtor. An obligor under other kinds of current or potential obligations, for example, interest rate swaps, also may grant a security interest in certain assets to a secured party. 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 repledge (or otherwise transfer) collateral held under a pledge. The same relationships occur, under different names, in transfers documented as sales that are accounted for as secured borrowings (paragraph 12). The accounting for noncash collateral by the debtor (or obligor) and the secured party depends on whether the secured party has the right to sell or repledge the collateral and on whether the debtor has defaulted.

- a. If the secured party (transferee) has the right by contract or custom to sell or repledge the collateral, then the debtor (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.
- b. 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 Statement.
- c. If the debtor (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,

and the secured party (transferee) shall recognize the collateral as its asset initially measured at fair value or, if it has already sold the collateral, derecognize its obligation to return the collateral.

- d. Except as provided in paragraph 15.c., the debtor (transferor) shall continue to carry the collateral as its asset, and the secured party (transferee) shall not recognize the pledged asset.

Extinguishments of Liabilities

16. A debtor shall derecognize a liability if and only if it has been extinguished. A liability has been extinguished if either of the following conditions is met:

- a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes delivery of cash, other financial assets, goods, or services or reacquisition by the debtor of its outstanding debt securities whether the securities are canceled or held as so-called treasury bonds.
- b. The debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor.

Disclosures

17. An entity shall disclose the following:

- a. For collateral:
 - (1) If the entity has entered into repurchase agreements or securities lending transactions, its policy for requiring collateral or other security
 - (2) If the entity has pledged any of its assets as collateral that are not reclassified and separately reported in the statement of financial position pursuant to paragraph 15.a., the carrying amount and classification of those assets as of the date of the latest statement of financial position presented
 - (3) If the entity has accepted collateral that it is permitted by contract or custom to sell or repledge, the fair value as of the date of each statement of financial position presented of that collateral and of the portion of that collateral that it has sold or repledged, and information about the sources and uses of that collateral
- b. If debt was considered to be extinguished by in-substance defeasance under the provisions of *FASB Statement No. 76, Extinguishment of Debt*, prior to the effective date of Statement 125, 6 a general description of the transaction and the amount of debt that is considered extinguished at the end of the period so long as that debt remains outstanding
- c. If assets are set aside after the effective date of Statement 125 solely for satisfying scheduled payments of a specific obligation, a description of the nature of restrictions placed on those assets
- d. If it is not practicable to estimate the fair value of certain assets obtained or liabilities incurred in transfers of financial assets during the period, a description of those items and the reasons why it is not practicable to estimate their fair value
- e. For all servicing assets and servicing liabilities:
 - (1) The amounts of servicing assets or liabilities recognized and amortized during the period
 - (2) The fair value of recognized servicing assets and liabilities for which it is practicable to estimate that value and the method and significant assumptions used to estimate the fair value
 - (3) The risk characteristics of the underlying financial assets used to stratify recognized servicing assets for purposes of measuring impairment in accordance with paragraph 63
 - (4) The activity in any valuation allowance for impairment of recognized servicing assets—including beginning and ending balances, aggregate additions charged and reductions credited to operations, and aggregate direct write-downs charged against the allowances—for each period for which results of operations are presented.

- f. If the entity has securitized financial assets during any period presented and accounts for that transfer as a sale, for each major asset type (for example, mortgage loans, credit card receivables, and automobile loans):
- (1) Its accounting policies for initially measuring the retained interests, if any, including the methodology (whether quoted market price, prices based on sales of similar assets and liabilities, or prices based on valuation techniques) used in determining their fair value (paragraphs 68-70)
 - (2) The characteristics of securitizations (a description of the transferor's continuing involvement with the transferred assets, including, but not limited to, servicing, recourse, and restrictions on retained interests) and the gain or loss from sale of financial assets in securitizations
 - (3) The key assumptions used in measuring the fair value of retained interests at the time of securitization (including, at a minimum, quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable financial assets, 8 and anticipated credit losses, if applicable)
 - (4) Cash flows between the securitization SPE and the transferor, unless reported separately elsewhere in the financial statements or notes (including proceeds from new securitizations, proceeds from collections reinvested in revolving-period securitizations, purchases of delinquent or foreclosed loans, servicing fees, and cash flows received on interests retained)
- g. If the entity has retained interests in securitized financial assets at the date of the latest statement of financial position presented, for each major asset type (for example, mortgage loans, credit card receivables, and automobile loans):
- (1) Its accounting policies for subsequently measuring those retained interests, including the methodology (whether quoted market price, prices based on sales of similar assets and liabilities, or prices based on valuation techniques) used in determining their fair value (paragraphs 68-70)
 - (2) The key assumptions used in subsequently measuring the fair value of those interests (including, at a minimum, quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable financial assets, and anticipated credit losses, including expected static pool losses, 9 if applicable)
 - (3) A sensitivity analysis or stress test showing the hypothetical effect on the fair value of those interests of two or more unfavorable variations from the expected levels for each key assumption that is reported under (2) above independently from any change in another key assumption, and a description of the objectives, methodology, and limitations of the sensitivity analysis or stress test
 - (4) For the securitized assets and any other financial assets that it manages together with them: 10
 - (a) The total principal amount outstanding, the portion that has been derecognized, and the portion that continues to be recognized in each category reported in the statement of financial position, at the end of the period
 - (b) Delinquencies at the end of the period
 - (c) Credit losses, net of recoveries, during the period
- Disclosure of average balances during the period is encouraged, but not required.

Implementation Guidance

18. Appendix A describes certain provisions of this Statement in more detail and describes their application to certain types of transactions. Appendix A is an integral part of the standards provided in this Statement.

Effective Date and Transition

19. Except as provided in paragraphs 20-25, this Statement shall be effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after March 31, 2001.

This Statement shall be applied prospectively, 11 except as provided in paragraphs 20, 21, 23, and 24. Earlier or retroactive application of this Statement is not permitted.

20. For each servicing contract in existence before January 1, 1997, previously recognized servicing rights and “excess servicing” receivables that do not exceed contractually specified servicing fees shall be combined, net of any previously recognized servicing obligations under that contract, as a servicing asset or liability. Previously recognized servicing receivables that exceed contractually specified servicing fees shall be reclassified as interest-only strips receivable. Thereafter, the subsequent measurement provisions of this Statement shall be applied to the servicing assets or liabilities for those servicing contracts (paragraph 63) and to the interest-only strips receivable (paragraph 14).

21. The provisions of paragraph 14 and the amendment to Statement 115 (paragraph 362) shall be effective for financial assets held on or acquired after January 1, 1997.

22. Paragraphs 17.f. and 17.g. shall be effective for financial statements for fiscal years ending after December 15, 2000. The information required to be disclosed about securitizations of financial assets during the period that are accounted for as sales need not be reported for periods ending on or before December 15, 2000, for which an income statement is presented for comparative purposes.

23. Collateral previously recognized in financial statements in accordance with the requirements of paragraphs 15.a.ii. and 15.b. of Statement 125 that is no longer to be recognized in accordance with paragraph 15 of this Statement shall no longer be recognized in financial statements for fiscal years ending after December 15, 2000, and financial statements for previous periods presented for comparative purposes shall be restated accordingly. The requirements for reclassification of certain assets in paragraph 15.a. of this Statement and for disclosure about collateral pledged and accepted in paragraphs 17.a.(2) and 17.a.(3) shall be effective for financial statements for fiscal years ending after December 15, 2000; that information need not be reported for periods ending on or before December 15, 2000, for which a statement of financial position is presented for comparative purposes.

24. Assets transferred on or before March 31, 2001, and transfers of assets after that date required by commitments made before that date to transferees or beneficial interest holders (BIHs) other than the transferor, its affiliates, 12 or its agents shall continue to be accounted for under the previous accounting standards for transfers of assets that applied when the transferor made or committed to those transfers. Transfers of assets after that date, unless required by commitments made before that date to transferees or BIHs unrelated to the transferor, shall be subject to all the provisions of this Statement.

25. A formerly qualifying SPE that fails to meet one or more conditions for being a qualifying SPE under this Statement shall continue to be considered a qualifying SPE if it maintains its qualifying status under previous accounting standards, does not issue new beneficial interests after the effective date, and does not receive assets it was not committed to receive (through a commitment to BIHs unrelated to the transferor) before the effective date. Otherwise, the formerly qualifying SPE and assets transferred to it shall be subject to other consolidation policy standards and guidance and to all the provisions of this Statement.

Appendix A: IMPLEMENTATION GUIDANCE

Introduction

26. This appendix describes certain provisions of this Statement in more detail and describes how they apply to certain types of transactions. This appendix discusses generalized situations. Facts and circumstances and specific contracts need to be considered carefully in applying this Statement. This appendix is an integral part of the standards provided in this Statement.

Isolation beyond the Reach of the Transferor and Its Creditors

27. 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 and its creditors, either by a single transaction or a series of transactions taken as a whole—depend on the facts and circumstances. All available evidence that either supports or questions an assertion shall be considered. That consideration includes making judgments about whether the contract or circumstances permit the transferor to revoke the transfer. It also may include making judgments about the kind of bankruptcy or other receivership into which a transferor or SPE might be placed, whether a transfer of financial assets would likely be deemed a true sale at law, whether the transferor is affiliated with the transferee, and other factors pertinent under applicable law. Derecognition of transferred assets is appropriate only if the available evidence provides reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any consolidated affiliate of the transferor that is not a special-purpose corporation or other entity designed to make remote the possibility that it would enter bankruptcy or other receivership (paragraph 83.c.).

28. Whether securitizations isolate transferred assets may depend on such factors as whether the securitization is accomplished in one step or two steps (paragraphs 80-84). Many common financial transactions, for example, typical repurchase agreements and securities lending transactions, isolate transferred assets from the transferor, although they may not meet the other criteria for surrender of control.

Conditions That Constrain a Transferee

29. Sale accounting is allowed under paragraph 9.b. only if each transferee has the right to pledge, or the right to exchange, the transferred assets or beneficial interests it received, but constraints on that right also matter. Many transferor-imposed or other conditions on a transferee's right to pledge or exchange a transferred asset both constrain a transferee from pledging or exchanging the transferred assets and, through that constraint, provide more than a trivial benefit to the transferor. For example, a provision in the transfer contract that prohibits selling or pledging a transferred loan receivable not only constrains the transferee but also provides the transferor with the more-than-trivial benefits of knowing who has the asset, a prerequisite to repurchasing the asset, and of being able to block the asset from finding its way into the hands of a competitor for the loan customer's business or someone that the loan customer might consider an undesirable creditor. 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 with the transferor, also constrain the transferee and presumptively provide the transferor with more-than-trivial benefits.

30. However, some conditions do not constrain a transferee from pledging or exchanging the asset and therefore do not preclude a transfer subject to such a condition from being accounted for as a sale. For example, a transferor's right of first refusal on the occurrence of a bona fide offer to the transferee from a third party presumptively would not constrain a transferee, because that right in itself does not enable the transferor to compel the transferee to sell the assets and the transferee would be in a position to receive the sum offered by exchanging the asset, albeit possibly from the transferor rather than the third party. Further examples of conditions that presumptively would not constrain a transferee include (a) a requirement to obtain the transferor's permission to sell or pledge that is not to be unreasonably withheld, (b) a prohibition on sale to the transferor's competitor if other potential willing buyers exist, (c) a regulatory limitation such as on the number or nature of eligible transferees (as in the case of securities issued under Securities Act Rule 144A or debt placed privately), and (d) illiquidity, for example, the absence of an active market. Judgment is required to assess the significance of some conditions. For example, a prohibition on sale to the transferor's competitor would be a significant constraint if that competitor were the only potential willing buyer other than the transferor.

31. 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.

Transferor's Rights or Obligations to Reacquire Transferred Assets

32. Some rights or obligations to reacquire transferred assets both constrain the transferee and provide more than a trivial benefit to the transferor, thus precluding sale accounting under paragraph 9.b. For example, a freestanding call option written by a transferee to the transferor benefits the transferor and, if the transferred assets are not readily obtainable in the marketplace, is likely to constrain a transferee because it might have to default if the call was exercised and it had exchanged or pledged the assets. A freestanding forward purchase-sale contract between the transferor and the transferee on transferred assets not readily obtainable in the marketplace would benefit the transferor and is likely to constrain a transferee in much the same manner. Judgment is necessary to assess constraint and benefit. For example, put options written to the transferee generally do not constrain it, but a put option on a not-readily-obtainable asset may benefit the transferor and effectively constrain the transferee if the option is sufficiently deep-in-the-money when it is written that it is probable that the transferee will exercise it and the transferor will reacquire the transferred asset. In contrast, a sufficiently out-of-the-money call option held by the transferor may not constrain a transferee if it is probable when the option is written that it will not be exercised. Freestanding rights to reacquire transferred assets that are readily obtainable presumptively do not constrain the transferee from exchanging or pledging them and thus do not preclude sale accounting under paragraph 9.b.

33. Other rights or obligations to reacquire transferred assets, regardless of whether they constrain the transferee, may result in the transferor's maintaining effective control over the transferred assets, as discussed in paragraphs 50-54, thus precluding sale accounting under paragraph 9.c.(2).¹⁵

Conditions That Constrain a Holder of Beneficial Interests in a Qualifying SPE

34. The considerations in paragraphs 29-32, about conditions that may or may not constrain a transferee that is not a qualifying SPE from pledging or exchanging the transferred assets, also extend to conditions that may or may not constrain a BIH from pledging or exchanging its beneficial interests in assets transferred to a qualifying SPE. For example, if BIHs agree to sell their beneficial interests in a qualifying SPE back to the transferor upon request at the price paid plus a stated return, that arrangement clearly conveys more than a trivial benefit to the transferor; sale accounting for the transfer to the qualifying SPE would be precluded if that agreement constrained a BIH from exchanging or pledging its beneficial interest.

Qualifying SPE

35. A qualifying SPE 16 is a trust or other legal vehicle that meets all of the following conditions:

- a. It is demonstrably distinct from the transferor (paragraph 36).
- b. Its permitted activities (1) are significantly limited, (2) were entirely specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds, and (3) may be significantly changed only with the approval of the holders of at least a majority of the beneficial interests held by entities other than any transferor, its affiliates, and its agents (paragraphs 37 and 38).
- c. It may hold only:
 - (1) Financial assets transferred to it that are passive in nature (paragraph 39)

- (2) Passive derivative financial instruments that pertain to beneficial interests (other than another derivative financial instrument) issued or sold to parties other than the transferor, its affiliates, or its agents (paragraphs 39 and 40)
 - (3) Financial assets (for example, guarantees or rights to collateral) that would reimburse it if others were to fail to adequately service financial assets transferred to it or to timely pay obligations due to it and that it entered into when it was established, when assets were transferred to it, or when beneficial interests (other than derivative financial instruments) were issued by the SPE
 - (4) Servicing rights related to financial assets that it holds
 - (5) Temporarily, nonfinancial assets obtained in connection with the collection of financial assets that it holds (paragraph 41)
 - (6) Cash collected from assets that it holds and investments purchased with that cash pending distribution to holders of beneficial interests that are appropriate for that purpose (that is, money-market or other relatively risk-free instruments without options and with maturities no later than the expected distribution date).
- d. If it can sell or otherwise dispose of noncash financial assets, it can do so only in automatic response to one of the following conditions:
- (1) Occurrence of an event or circumstance that (a) is specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds; (b) is outside the control of the transferor, its affiliates, or its agents; and (c) causes, or is expected at the date of transfer to cause, the fair value of those financial assets to decline by a specified degree below the fair value of those assets when the SPE obtained them (paragraphs 42 and 43)
 - (2) Exercise by a BIH (other than the transferor, its affiliates, or its agents) of a right to put that holder's beneficial interest back to the SPE (paragraph 44)
 - (3) Exercise by the transferor of a call or ROAP specified in the legal documents that established the SPE, transferred assets to the SPE, or created the beneficial interests in the transferred assets that it holds (paragraphs 51-54 and 85-88)
 - (4) Termination of the SPE or maturity of the beneficial interests in those financial assets on a fixed or determinable date that is specified at inception (paragraph 45).

Need to Be Demonstrably Distinct from the Transferor

36. A qualifying SPE is demonstrably distinct from the transferor only if it cannot be unilaterally dissolved by any transferor, its affiliates, or its agents and either (a) at least 10 percent of the fair value of its beneficial interests is held by parties other than any transferor, its affiliates, or its agents or (b) the transfer is a guaranteed mortgage securitization. 17 An ability to unilaterally dissolve an SPE can take many forms, including but not limited to holding sufficient beneficial interests to demand that the trustee dissolve the SPE, the right to call all the assets transferred to the SPE, and a right to call or a prepayment privilege on the beneficial interests held by other parties.

Limits on Permitted Activities

37. The powers of the SPE must be limited to those activities allowed by paragraph 35 for it to be a qualifying SPE. Many kinds of entities are not so limited. For example, any bank, insurance company, pension plan, or investment company has powers that cannot be sufficiently limited for it to be a qualifying SPE.

38. The BIHs other than any transferor, its affiliates, or its agents may have the ability to change the powers of a qualifying SPE. If the powers of a previously qualifying SPE are changed

so that the SPE is no longer qualifying, unless the conditions in paragraph 9.b. are then met by the SPE itself and the conditions in paragraphs 9.a. and 9.c. continue to be met, that change would bring the transferred assets held in the SPE back under the control of the transferor (paragraph 55).

Limits on What a Qualifying SPE May Hold

39. A financial asset or derivative financial instrument is passive only if holding the asset or instrument does not involve its holder in making decisions other than the decisions inherent in servicing (paragraph 61). An equity instrument is not passive if the qualifying SPE can exercise the voting rights and is permitted to choose how to vote. Investments are not passive if through them, either in themselves or in combination with other investments or rights, the SPE or any related entity, such as the transferor, its affiliates, or its agents, is able to exercise control or significant influence (as defined in generally accepted accounting principles for consolidation policy and for the equity method, respectively) over the investee. A derivative financial instrument is not passive if, for example, it includes an option allowing the SPE to choose to call or put other financial instruments; but other derivative financial instruments can be passive, for example, interest rate caps and swaps and forward contracts. Derivative financial instruments that result in liabilities, like other liabilities of a qualifying SPE, are a kind of beneficial interest in the qualifying SPE's assets.

40. A derivative financial instrument pertains to beneficial interests (other than another derivative financial instrument) issued only if it:

- a. Is entered into (1) when the beneficial interests are issued by the qualifying SPE to parties other than the transferor, its affiliates, or its agents or sold to such other parties after being issued by the qualifying SPE to the transferor, its affiliates, or its agents or (2) when a passive derivative financial instrument needs to be replaced upon occurrence of an event or circumstance (specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds) outside the control of the transferor, its affiliates, or its agents, for example, when the counterparty to the derivative defaults or is downgraded below a specified threshold
- b. Has a notional amount that does not initially exceed the amount of those beneficial interests and is not expected to exceed them subsequently
- c. Has characteristics that relate to, and partly or fully but not excessively counteract, some risk associated with those beneficial interests or the related transferred assets.

41. A qualifying SPE may hold nonfinancial assets other than servicing rights only temporarily and only if those nonfinancial assets result from collecting the transferred financial assets. For example, a qualifying SPE could be permitted to temporarily hold foreclosed nonfinancial collateral. In contrast, an entity cannot be a qualifying SPE if, for example, it receives from a transferor significant secured financial assets likely to default with the expectation that it will foreclose on and profitably manage the securing nonfinancial assets. A qualifying SPE also may hold the residual value of a sales-type or a direct financing lease only to the extent that it is guaranteed at the inception of the lease either by the lessee or by a third party financially capable of discharging the obligations that may arise from the guarantee (paragraph 89).

Limits on Sales or Other Dispositions of Assets

42. Examples of requirements to sell, exchange, put, or distribute (hereinafter referred to collectively as dispose of) noncash financial assets that are permitted activities of a qualifying SPE—because they respond automatically to the occurrence of an event or circumstance that (a) is specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds; (b) is outside the control of the transferor, its affiliates, or its agents; and (c) causes, or is expected to cause, the fair value of those assets to decline by a specified degree below the fair value of those assets when the qualifying SPE obtained them—include requirements to dispose of transferred assets in response to:

- a. A failure to properly service transferred assets that could result in the loss of a substantial third-party credit guarantee
- b. A default by the obligor
- c. A downgrade by a major rating agency of the transferred assets or of the underlying obligor to a rating below a specified minimum rating
- d. The involuntary insolvency of the transferor
- e. A decline in the fair value of the transferred assets to a specified value less than their fair value at the time they were transferred to the SPE.

43. The following are examples of powers or requirements to dispose of noncash financial assets that are not permitted activities of a qualifying SPE, because they do not respond automatically to the occurrence of a specified event or circumstance outside the control of the transferor, its affiliates, or its agents that causes, or is expected to cause, the fair value of those transferred assets to decline by a specified degree below the fair value of those assets when the SPE obtained them:

- a. A power that allows an SPE to choose to either dispose of transferred assets or hold them in response to a default, a downgrade, a decline in fair value, or a servicing failure
- b. A requirement to dispose of marketable equity securities upon a specified decline from their "highest fair value" if that power could result in disposing of the asset in exchange for an amount that is more than the fair value of those assets at the time they were transferred to the SPE
- c. A requirement to dispose of transferred assets in response to the violation of a nonsubstantive contractual provision (that is, a provision for which there is not a sufficiently large disincentive to ensure performance).

44. A qualifying SPE may dispose of transferred assets automatically to the extent necessary to comply with the exercise by a BIH (other than the transferor, its affiliates, or its agents) of its right to put beneficial interests back to the SPE in exchange for:

- a. A full or partial distribution of those assets
- b. Cash (which may require that the SPE dispose of those assets or issue beneficial interests to generate cash to fund settlement of the put)
- c. New beneficial interests in those assets.

45. A qualifying SPE may have the power to dispose of assets to a party other than the transferor, its affiliate, or its agent on termination of the SPE or maturity of the beneficial interests, but only automatically on fixed or determinable dates that are specified at inception. For example, if an SPE is required to dispose of long-term mortgage loans and terminate itself at the earlier of (a) the specified maturity of beneficial interests in those mortgage loans or (b) the date of prepayment of a specified amount of the transferred mortgage loans, the termination date is a fixed or determinable date that was specified at inception. In contrast, if that SPE has the power to dispose of transferred assets on two specified dates and the SPE can decide which transferred assets to sell on each date, the termination date is not a fixed or determinable date that was specified at inception.

Qualifying SPEs and Consolidated Financial Statements

46. A qualifying SPE shall not be consolidated in the financial statements of a transferor or its affiliates.

Maintaining Effective Control over Transferred Assets

Agreement to Repurchase or Redeem Transferred Assets

47. An agreement that both entitles and obligates the transferor to repurchase or redeem transferred assets from the transferee maintains the transferor's effective control over those assets under paragraph 9.c.(1), and the transfer is therefore to be accounted for as a secured borrowing, if and only if all of the following conditions are met:

- a. The assets to be repurchased or redeemed are the same or substantially the same as those transferred (paragraph 48).
 - b. The transferor is able to repurchase or redeem them on substantially the agreed terms, even in the event of default by the transferee (paragraph 49).
 - c. The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price.
 - d. The agreement is entered into concurrently with the transfer.
48. To be substantially the same, the asset that was transferred and the asset that is to be repurchased or redeemed need to have all of the following characteristics:
- a. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same)
 - b. Identical form and type so as to provide the same risks and rights
 - 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)
 - d. Identical contractual interest rates
 - e. Similar assets as collateral
 - f. The same aggregate unpaid principal amount or principal amounts within accepted “good delivery” standards for the type of security involved.
49. To be able to repurchase or redeem assets on substantially the agreed terms, even in the event of default by the transferee, a transferor must at all times during the contract term have obtained cash or other collateral sufficient to fund substantially all of the cost of purchasing replacement assets from others.

Ability to Unilaterally Cause the Return of Specific Transferred Assets

50. Some rights to reacquire transferred assets (or to acquire beneficial interests in transferred assets held by a qualifying SPE), regardless of whether they constrain the transferee, may result in the transferor’s maintaining effective control over the transferred assets through the unilateral ability to cause the return of specific transferred assets. Such rights preclude sale accounting under paragraph 9.c.(2). For example, an attached call in itself would not constrain a transferee who is able, by exchanging or pledging the asset subject to that call, to obtain substantially all of its economic benefits. An attached call could result, however, in the transferor’s maintaining effective control over the transferred asset(s) because the attached call gives the transferor the ability to unilaterally cause whoever holds that specific asset to return it. In contrast, transfers of financial assets subject to calls embedded by the issuers of the financial instruments, for example, callable bonds or prepayable mortgage loans, do not preclude sale accounting. Such an embedded call does not result in the transferor’s maintaining effective control, because it is the issuer rather than the transferor who holds the call.

51. If the transferee is a qualifying SPE, it has met the conditions in paragraph 35.d. and therefore must be constrained from choosing to exchange or pledge the transferred assets. In that circumstance, any call held by the transferor is effectively attached to the assets and could—depending on the price and other terms of the call—maintain the transferor’s effective control over transferred assets through the ability to unilaterally cause the transferee to return specific assets. For example, a transferor’s unilateral ability to cause a qualifying SPE to return to the transferor or otherwise dispose of specific transferred assets at will or, for example, in response to its decision to exit a market or a particular activity, could provide the transferor with effective control over the transferred assets.

52. A call that is attached to transferred assets maintains the transferor’s effective control over those assets if, under its price and other terms, the call conveys more than a trivial benefit to the transferor. Similarly, any unilateral right to reclaim specific assets transferred to a qualifying SPE maintains the transferor’s effective control over those assets if the right conveys more than a trivial benefit to the transferor. A call or other right conveys more than a trivial benefit 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. Thus, for example, a call on specific assets transferred to a qualifying SPE at a price fixed at their principal amount maintains the transferor's effective control over the assets subject to that call. Effective control over transferred assets can be present even if the right to reclaim is indirect. For example, if an embedded call allows a transferor to buy back the beneficial interests of a qualifying SPE at a fixed price, then the transferor remains in effective control of the assets underlying those beneficial interests. A cleanup call, however, is permitted as an exception to that general principle.

53. A right to reclaim specific transferred assets by paying their fair value when reclaimed generally does not maintain effective control, because it does not convey a more than trivial benefit to the transferor. However, a transferor has maintained effective control if it has such a right and also holds the residual interest in the transferred assets. For example, if a transferor can reclaim such assets at termination of the qualifying SPE by purchasing them in an auction, and thus at what might appear to be fair value, then sale accounting for the assets it can reclaim would be precluded. Such circumstances provide the transferor with a more than trivial benefit and effective control over the assets, because it can pay any price it chooses in the auction and recover any excess paid over fair value through its residual interest.

54. A transferor that has a right to reacquire transferred assets from a qualifying SPE does not maintain effective control if the reclaimed assets would be randomly selected and the amount of the assets reacquired is sufficiently limited (paragraph 87.a.), because that would not be a right to reacquire specific assets. Nor does a transferor maintain effective control through an obligation to reacquire transferred assets from a qualifying SPE if the transfer could occur only after a specified failure of the servicer to properly service the transferred assets that could result in the loss of a third-party guarantee (paragraph 42.a.) or only after a BIH other than the transferor, its affiliate, or its agent requires a qualifying SPE to repurchase that beneficial interest (paragraph 44.b.), because the transferor could not cause that reacquisition unilaterally.

Changes That Result in the Transferor's Regaining Control of Assets Sold

55. A change in law, status of the transferee as a qualifying SPE, or other circumstance may result in the transferor's regaining control of assets previously accounted for appropriately as having been sold, because one or more of the conditions in paragraph 9 are no longer met. Such a change, unless it arises solely from either the initial application of this Statement or a change in market prices (for example, an increase in price that moves into-the-money a freestanding call that was originally sufficiently out-of-the-money that it was judged not to constrain the transferee), is accounted for in the same manner as a purchase of the assets from the former transferee(s) in exchange for liabilities assumed (paragraph 11). After that change, the transferor recognizes in its financial statements those assets together with liabilities to the former transferee(s) or BIHs in those assets (paragraph 38). The transferor initially measures those assets and liabilities at fair value on the date of the change, as if the transferor purchased the assets and assumed the liabilities on that date. The former transferee would derecognize the assets on that date, as if it had sold the assets in exchange for a receivable from the transferor.

Measurement of Interests Held after a Transfer of Financial Assets

Assets Obtained and Liabilities Incurred as Proceeds

56. The proceeds from a sale of financial assets consist of the cash and any other assets obtained in the transfer less any liabilities incurred. Any asset obtained that is not an interest in the transferred asset is part of the proceeds from the sale. Any liability incurred, even if it is related to the transferred assets, is a reduction of the proceeds. Any derivative financial instrument entered into concurrently with a transfer of financial assets is either an asset obtained or a liability incurred and part of the proceeds received in the transfer. All proceeds and reductions of proceeds from a sale shall be initially measured at fair value, if practicable.

Illustration—Recording Transfers with Proceeds of Cash, Derivatives, and Other Liabilities

57. Company A sells loans with a fair value of \$1,100 and a carrying amount of \$1,000. Company A retains no servicing responsibilities but obtains an option to purchase from the transferee loans similar to the loans sold (which are readily obtainable in the marketplace) and assumes a limited recourse obligation to repurchase delinquent loans.

Company A agrees to provide the transferee a return at a floating rate of interest even though the contractual terms of the loan are fixed rate in nature (that provision is effectively an interest rate swap).

Fair Values

Cash proceeds	\$1,050
Interest rate swap	40
Call option	70
Recourse obligation	60

Net Proceeds

Cash received	\$1,050
Plus: Call option	70
Interest rate swap	40
Less: Recourse obligation	<u>(60)</u>
Net proceeds	<u>\$1,100</u>

Gain on Sale

Net proceeds	\$1,100
Carrying amount of loans sold	<u>1,000</u>
Gain on sale	<u>\$ 100</u>

Journal Entry

Cash	1,050	
Interest rate swap	40	
Call option	70	
Loans		1,000
Recourse obligation		60
Gain on sale		100
To record transfer		

Retained Interests

58. Other interests in transferred assets—those that are not part of the proceeds of the transfer—are retained interests over which the transferor has not relinquished control. They shall be measured at the date of the transfer by allocating the previous carrying amount between the assets sold, if any, and the retained interests, based on their relative fair values. Allocation procedures shall be applied to all transfers in which interests are retained, even those that do not qualify as sales. Examples of retained interests include securities backed by the transferred assets, undivided interests, servicing assets, and cash reserve accounts and residual interests in securitization trusts. If a transferor cannot determine whether an asset is a retained interest or proceeds from the sale, the asset shall be treated as proceeds from the sale and accounted for in accordance with paragraph 56.

59. If the retained interests are subordinated to more senior interests held by others, that subordination may concentrate into the retained interests most of the risks inherent in the transferred assets and shall be taken into consideration in estimating the fair value of the retained interests. For example, if the amount of the gain recognized, after allocation, on a securitization

with a subordinated retained interest is greater than the gain would have been had the entire asset been sold, the transferor needs to be able to identify why that can occur. Otherwise, it is likely that the impact of the retained interest being subordinate to a senior interest has not been adequately considered in the determination of the fair value of the subordinated retained interest.

Illustration—Recording Transfers of Partial Interests

60. Company B sells a pro rata nine-tenths interest in loans with a fair value of \$1,100 and a carrying amount of \$1,000. There is no servicing asset or liability, because Company B estimates that the benefits of servicing are just adequate to compensate it for its servicing responsibilities.

Fair values	
Cash proceeds for nine-tenths sold	\$990
One-tenth interest retained $[(\$990 \div 9/10) \times 1/10]$	110

Carrying Amount Based on Relative Fair Values

	<u>Fair Value</u>	<u>Percentage Of Total Fair Value</u>	<u>Allocated Carrying Amount</u>
Nine-tenths interest sold	\$ 990	90	\$ 900
One-tenth interest retained	110	10	100
Total	<u>\$ 1,100</u>	<u>100</u>	<u>\$ 1,000</u>

Gain on Sale

Net proceeds	\$ 990
Carrying amount of loans sold	<u>900</u>
Gain on sale	<u>\$ 90</u>

Journal Entry

Cash	990	
Loans		900
Gain on sale		90
To record transfer		

Servicing Assets and Liabilities

61. Servicing of mortgage loans, credit card receivables, or other financial assets commonly includes, but is not limited to, collecting principal, interest, and escrow payments from borrowers; paying taxes and insurance from escrowed funds; monitoring delinquencies; executing foreclosure if necessary; temporarily investing funds pending distribution; remitting fees to guarantors, trustees, and others providing services; and accounting for and remitting principal and interest payments to the holders of beneficial interests in the financial assets. Servicing is inherent in all financial assets; it becomes a distinct asset or liability only when contractually separated from the underlying assets by sale or securitization of the assets with servicing retained or separate purchase or assumption of the servicing.

62. An entity that undertakes a contract to service financial assets shall recognize either a servicing asset or a servicing liability, with only one exception. (That exception is if the transferor transfers the assets in a guaranteed mortgage securitization, retains all of the resulting securities, and classifies them as debt securities held-to-maturity in accordance with Statement 115, in which case the servicing asset or liability may be reported together with the asset being serviced.) Each sale or securitization with servicing retained or separate purchase or assumption of servicing results in a servicing contract. A servicer of financial assets commonly receives the benefits of servicing—revenues from contractually specified servicing fees, late charges, and other ancillary sources, including “float,” all of which it is entitled to receive only if it performs the

servicing—and incurs the costs of servicing the assets. Each servicing contract results in a servicing asset or servicing liability. 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. (A servicing asset may become a servicing liability, or vice versa, if circumstances change, and the initial measure for servicing may be zero if the benefits of servicing are just adequate to compensate the servicer for its servicing responsibilities.)

63. A servicer that recognizes a servicing asset or servicing liability shall account for the contract to service financial assets separately from those assets, as follows:

- a. Report servicing assets separately from servicing liabilities in the statement of financial position (paragraph 13).
- b. Initially measure servicing assets retained in a sale or securitization of the assets being serviced at their allocated previous carrying amount based on relative fair values, if practicable, at the date of the sale or securitization (paragraphs 10, 58-60, and 68-72).
- c. Initially measure servicing assets purchased or servicing liabilities assumed at fair value (paragraph 13).
- d. Initially measure servicing liabilities undertaken in a sale or securitization at fair value, if practicable (paragraphs 11.b., 11.c., and 68-72).
- e. Account separately for rights to future interest income from the serviced assets that exceeds 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 14 of this Statement.
- f. Subsequently measure servicing assets by amortizing the amount recognized in proportion to and over the period of estimated net servicing income—the excess of servicing revenues over servicing costs (paragraph 13).
- g. Subsequently evaluate and measure impairment of servicing assets as follows:
 - (1) Stratify servicing assets 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.
 - (2) Recognize impairment through a valuation allowance for an individual stratum. The amount of impairment recognized 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.
 - (3) Adjust the valuation allowance to reflect changes in the measurement of impairment subsequent to the initial measurement of impairment. Fair value in excess of the carrying amount of servicing assets for that stratum, however, shall not be recognized. This Statement does not address when an entity should record a direct write-down of recognized servicing assets (paragraph 13).
- h. Subsequently measure servicing liabilities by amortizing the amount recognized in proportion to and over the period of estimated net servicing loss—the excess of servicing costs over servicing revenues. However, 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 from the cash flows previously projected, the servicer shall revise its earlier estimates and recognize the increased obligation as a loss in earnings (paragraph 13).

64. As indicated above, transferors sometimes agree to take on servicing responsibilities when the future benefits of servicing are not expected to adequately compensate them for performing that servicing. In that circumstance, the result is a servicing liability rather than a servicing asset. For example, if in the transaction illustrated in paragraph 57 the transferor had agreed to service the loans without explicit compensation and it estimated the fair value of that

servicing obligation at \$50, net proceeds would be reduced to \$1,050, gain on sale would be reduced to \$50, and the transferor would report a servicing liability of \$50.

Illustration—Sale of Receivables with Servicing Retained

65. Company C originates \$1,000 of loans that yield 10 percent interest income for their estimated lives of 9 years. Company C sells the \$1,000 principal plus the right to receive interest income of 8 percent to another entity for \$1,000. Company C will continue to service the loans, and the contract stipulates that its compensation for performing the servicing is the right to receive half of the interest income not sold. The remaining half of the interest income not sold is considered an interest-only strip receivable. At the date of the transfer, the fair value of the loans, including servicing, is \$1,100. The fair value of the servicing asset is \$40.

Fair values

Cash proceeds	\$1,000
Servicing asset	40
Interest-only strip receivable	60

Carrying Amount Based on Relative Fair Values

	<u>Fair Value</u>	<u>Percentage Of Total Fair Value</u>	<u>Allocated Carrying Amount</u>
Loans sold	\$ 1,000	91.0	\$ 910
Servicing asset	40	3.6	36
Interest-only strip receivable	60	5.4	54
Total	<u>\$ 1,100</u>	<u>100.0</u>	<u>\$ 1,000</u>

Gain on Sale

Net proceeds	\$ 1000
Carrying amount of loans sold	<u>910</u>
Gain on sale	<u>\$ 90</u>

Journal Entries

Cash	1000	
Loans		910
Gain on sale		90
To record transfer		
Servicing asset	36	
Interest-only strip receivable	54	
Loans		90
To record servicing asset and interest-only strip receivable		
Interest-only strip receivable	6	
Equity		6
To begin to subsequently measure interest-only strip receivable like an available-for-sale security (paragraph 14)		

66. The previous illustration demonstrates how a transferor would account for a simple sale or securitization in which servicing is retained. Company C might instead transfer the financial assets to a corporation or a trust that is a qualifying SPE. The qualifying SPE then securitizes the loans by selling beneficial interests to the public. The qualifying SPE pays the cash proceeds to the original transferor, which accounts for the transfer as a sale and derecognizes the financial

assets assuming that the criteria in paragraph 9 are met. Securitizations often combine the elements shown in paragraphs 57, 60, and 65, as illustrated below.

Illustration—Recording Transfers of Partial Interests with Proceeds of Cash, Derivatives, Other Liabilities, and Servicing

67. Company D originates \$1,000 of prepayable loans that yield 10 percent interest income for their 9-year expected lives. Company D sells nine-tenths of the principal plus interest of 8 percent to another entity. Company D will continue to service the loans, and the contract stipulates that its compensation for performing the servicing is the 2 percent of the interest income not sold. Company D obtains an option to purchase from the transferee loans similar to the loans sold (which are readily obtainable in the marketplace) and incurs a limited recourse obligation to repurchase delinquent loans.

<u>Fair values</u>		
Cash proceeds		\$900
Call option		70
Recourse obligation		60
Servicing asset		90
One-tenth interest retained		100
 <u>Net Proceeds</u>		
Cash received		\$900
Plus: Call option		70
Less: Recourse obligation		<u>(60)</u>
Net proceeds		<u>\$910</u>

Carrying Amount Based on Relative Fair Values

	<u>Fair Value</u>	<u>Percentage Of Total Fair Value</u>	<u>Allocated Carrying Amount</u>
Interest sold	\$ 910	83	\$ 830
Servicing asset	90	8	80
One-tenth interest retained	<u>100</u>	<u>9</u>	<u>90</u>
Total	<u>\$ 1,100</u>	<u>100</u>	<u>\$ 1,000</u>

Gain on Sale

Net proceeds	\$ 910
Carrying amount of loans sold	<u>830</u>
Gain on sale	<u>\$ 80</u>

Journal Entries

Cash	900	
Call option	70	
Loans		830
Recourse obligation		60
Gain on sale		80
To record transfer		
 Servicing asset	 80	
Loans		80
To record servicing asset		

At the time of the transfer, Company D reports its one-tenth retained interest in the loans at its allocated carrying amount of \$90.

Fair Value

68. The fair value of an asset (or liability) is the amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. If a quoted market price is available, the fair value is the product of the number of trading units times that market price.

69. If quoted market prices are not available, the estimate of fair value shall be based on the best information available in the circumstances. The estimate of fair value shall consider prices for similar assets and liabilities and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated future cash flows,²⁰ option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. Valuation techniques for measuring financial assets and liabilities and servicing assets and liabilities shall be consistent with the objective of measuring fair value. Those techniques shall incorporate assumptions that market participants would use in their estimates of values, future revenues, and future expenses, including assumptions about interest rates, default, prepayment, and volatility.²¹ In measuring financial liabilities and servicing liabilities at fair value, the objective is to estimate the value of the assets required currently to (a) settle the liability with the holder or (b) transfer a liability to an entity of comparable credit standing.

70. Estimates of expected future cash flows, if used to estimate fair value, shall be based on reasonable and supportable assumptions and projections. All available evidence shall be considered in developing estimates of expected future cash flows. The weight given to the evidence shall be commensurate with the extent to which the evidence can be verified objectively. If a range is estimated for either the amount or timing of possible cash flows, the likelihood of possible outcomes shall be considered either directly, if applying an expected cash flow approach, or indirectly through the risk-adjusted discount rate, if determining the best estimate of future cash flows.

If It Is Not Practicable to Estimate Fair Values

71. If it is not practicable to estimate the fair values of assets, the transferor shall record those assets at zero. If it is not practicable to estimate the fair values of liabilities, the transferor shall recognize no gain on the transaction and shall record those liabilities at the greater of:

- a. The excess, if any, of (1) the fair values of assets obtained less the fair values of other liabilities incurred, over (2) the sum of the carrying values of the assets transferred
- b. The amount that would be recognized in accordance with *FASB Statement No. 5, Accounting for Contingencies*, as interpreted by *FASB Interpretation No. 14, Reasonable Estimation of the Amount of a Loss*.

Illustration—Recording Transfers If It Is Not Practicable to Estimate a Fair Value

72. Company E sells loans with a carrying amount of \$1,000 to another entity for cash plus a call option to purchase loans similar to the loans sold (which are readily obtainable in the marketplace) and incurs a limited recourse obligation to repurchase any delinquent loans. Company E undertakes to service the transferred assets for the other entity. In Case 1, Company E finds it impracticable to estimate the fair value of the servicing contract, although it is confident that servicing revenues will be more than adequate compensation for performing the servicing. In Case 2, Company E finds it impracticable to estimate the fair value of the recourse obligation.

<u>Fair Values</u>	<u>Case 1</u>	<u>Case 2</u>
Cash proceeds	\$1,050	\$1,050
Servicing asset	XX*	40

Call option	70	70
Recourse obligation	<u>60</u>	<u>XX*</u>
Fair value of loans transferred	1,100	1,100

* Not practicable to estimate fair value

<u>Net Proceeds</u>	<u>Case 1</u>	<u>Case 2</u>
Cash received	\$1,050	\$1,050
Plus: Call option	70	70
Less: Recourse obligation	<u>(60)</u>	<u>XX</u>
Net proceeds	<u>\$1,060</u>	<u>\$1,120</u>

Carrying Amount Based on Relative Fair Values (Case 1)

	<u>Fair Value</u>	<u>Percentage Of Total Fair Value</u>	<u>Allocated Carrying Amount</u>
Loans sold	\$ 1,060	100	\$ 1,000
Servicing asset	<u>0</u>	<u>0</u>	<u>0</u>
Total	<u>\$ 1,060</u>	<u>100</u>	<u>\$ 1,000</u>

Carrying Amount Based on Relative Fair Values (Case 2)

	<u>Fair Value</u>	<u>Percentage Of Total Fair Value</u>	<u>Allocated Carrying Amount</u>
Loans sold	\$ 1,120	97	\$ 970
Servicing asset	<u>40</u>	<u>3</u>	<u>30</u>
Total	<u>\$ 1,160</u>	<u>100</u>	<u>\$ 1,000</u>

Journal Entries

	<u>Case 1</u>		<u>Case 2</u>
Cash	1,050		1,050
Servicing asset	0*		30
Call option	70		70
Loans		1,000	1,000
Recourse obligation		60	150†
Gain on sale		60	0
To record transfer			

* Assets shall be recorded at zero if an estimate of the fair value of the assets is not practicable.

† The amount recorded as a liability in this example equals the sum of the known assets less the fair value of the known liabilities, that is, the amount that results in no gain or loss.

Securitizations

73. Financial assets such as mortgage loans, automobile loans, trade receivables, credit card receivables, and other revolving charge accounts are assets commonly transferred in securitizations. Securitizations of mortgage loans may include pools of single-family residential mortgages or other types of real estate mortgage loans, for example, multifamily residential mortgages and commercial property mortgages. Securitizations of loans secured by chattel mortgages on automotive vehicles as well as other equipment (including direct financing or sales-type leases) also are common. Both financial and nonfinancial assets can be securitized; life insurance policy loans, patent and copyright royalties, and even taxi medallions also have been securitized. But securitizations of nonfinancial assets are outside the scope of this Statement.

74. An originator of a typical securitization (the transferor) transfers a portfolio of financial assets to an SPE, commonly a trust. In "pass-through" and "pay-through" securitizations,

receivables are transferred to the SPE at the inception of the securitization, and no further transfers are made; all cash collections are paid to the holders of beneficial interests in the SPE. In "revolving-period" securitizations, 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 SPE uses most of the cash collections to purchase additional receivables from the transferor on prearranged terms.

75. Beneficial interests in the SPE are sold to investors and the proceeds are used to pay the transferor for the assets transferred. Those beneficial interests may comprise either a single class having equity characteristics or multiple classes of interests, some having debt characteristics and others having equity characteristics. The cash collected from the portfolio is distributed to the investors and others as specified by the legal documents that established the SPE.

76. Pass-through, pay-through, and revolving-period securitizations that meet the criteria in paragraph 9 qualify for sale accounting under this Statement. All financial assets obtained or retained and liabilities incurred by the originator of a securitization that qualifies as a sale shall be recognized and measured as provided in paragraph 11; that includes the implicit forward contract to sell new receivables during a revolving period, which may become valuable or onerous to the transferor as interest rates and other market conditions change.

Revolving-Period Securitizations

77. 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.

78. Gain or loss recognition for revolving-period receivables sold to a securitization trust is limited to receivables that exist and have been sold. Recognition of servicing assets or liabilities for revolving-period receivables is similarly limited to the servicing for the receivables that exist and have been transferred. As new receivables are sold, rights to service them become assets or liabilities and are recognized.

79. Revolving-period securitizations may use either a discrete trust, used for a single securitization, or a master trust, used for many securitizations. To achieve another securitization using an existing master trust, a transferor first transfers additional receivables to the trust and then sells additional ownership interests in the trust to investors. Adding receivables to a master trust, in itself, is neither a sale nor a secured borrowing under paragraph 9, because that transfer only increases the transferor's beneficial interest in the trust's assets. A sale or secured borrowing does not occur until the transferor receives consideration other than beneficial interests in the transferred assets. Transfers that result in an exchange of cash, that is, either transfers that in essence replace previously transferred receivables that have been collected or sales of beneficial interests to outside investors, are transfers in exchange for consideration other than beneficial interests in the transferred assets and thus are accounted for as sales (if they satisfy all the criteria in paragraph 9) or as secured borrowings.

Isolation of Transferred Assets in Securitizations

80. A securitization carried out in one transfer or a series of transfers may or may not isolate the transferred assets beyond the reach of the transferor 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 and interest rate risks, the availability of other assets, and the powers of bankruptcy courts or other receivers.

81. In certain securitizations, a corporation that, if it failed, would be subject to the U.S. Bankruptcy Code transfers financial assets to a special-purpose trust in exchange for cash. The trust raises that cash by issuing to investors beneficial interests that pass through all cash received from the financial assets, and the transferor has no further involvement with the trust or the transferred assets. The Board understands that those securitizations generally would be judged as having isolated the assets, because in the absence of any continuing involvement there would be reasonable assurance that the transfer would be found to be a true sale at law that places the assets beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.

82. In other securitizations, a similar corporation transfers financial assets to an SPE in exchange for cash and beneficial interests in the transferred assets. That entity raises the cash by issuing to investors commercial paper that gives them a senior interest in cash received from the financial assets. The beneficial interests retained by the transferring corporation represent a junior interest to be reduced by any credit losses on the financial assets in trust. The commercial paper interests are highly rated by credit rating agencies only if both (a) the credit enhancement from the junior interest is sufficient and (b) the transferor is highly rated. Depending on facts and circumstances, the Board understands that those “single-step” securitizations often would be judged in the United States as not having isolated the assets, because the nature of the continuing involvement may make it difficult to obtain reasonable assurance that the transfer would be found to be a true sale at law that places the assets beyond the reach of the transferor and its creditors in U.S. bankruptcy (paragraph 113). If the transferor fell into bankruptcy and the transfer was found not to be a true sale at law, investors in the transferred assets might be subjected to an automatic stay that would delay payments due them, and they might have to share in bankruptcy expenses and suffer further losses if the transfer was recharacterized as a secured loan.

83. Still other securitizations use two transfers intended to isolate transferred assets beyond the reach of the transferor and its creditors, even in bankruptcy. In those “two-step” structures:

- a. First, the corporation transfers financial assets to a special-purpose corporation that, although wholly owned, is so designed that the possibility that the transferor or its creditors could reclaim the assets is remote. This first transfer is designed to be judged to be a true sale at law, in part because the transferor does not provide “excessive” credit or yield protection to the special-purpose corporation, and the Board understands that transferred assets are likely to be judged beyond the reach of the transferor or the transferor's creditors even in bankruptcy.
- b. Second, the special-purpose corporation transfers the assets to a trust or other legal vehicle with a sufficient increase in the credit or yield protection on the second transfer (provided by a junior retained beneficial interest or other means) to merit the high credit rating sought by third-party investors who buy senior beneficial interests in the trust. Because of that aspect of its design, that second transfer might not be judged to be a true sale at law and, thus, the transferred assets could at least in theory be reached by a bankruptcy trustee for the special-purpose corporation.
- c. However, the special-purpose corporation is designed to make remote the possibility that it would enter bankruptcy, either by itself or by substantive consolidation into a bankruptcy of its parent should that occur. For example, its charter forbids it from undertaking any other business or incurring any liabilities, so that there can be no creditors to petition to place it in bankruptcy. Furthermore, its dedication to a single purpose is intended to make it extremely unlikely, even if it somehow entered bankruptcy, that a receiver under the U.S. Bankruptcy Code could reclaim the transferred assets because it has no other assets to substitute for the transferred assets.

The Board understands that the "two-step" securitizations described above, taken as a whole, generally would be judged under present U.S. law as having isolated the assets beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.

84. The powers of receivers for entities not subject to the U.S. Bankruptcy Code (for example, banks subject to receivership by the 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 assets from a transferor subject to such a receiver and its creditors even though it is accomplished by only one transfer directly to an SPE 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 assets have been isolated need to be made in relation to the powers of bankruptcy courts or trustees, conservators, or receivers in those jurisdictions.

Removal-of-Accounts Provisions

85. Many transfers of financial assets in securitizations empower the transferor to reclaim assets subject to certain restrictions. Such a power is sometimes called a removal-of-accounts provision (ROAP). Whether a ROAP precludes sale accounting depends on whether the ROAP results in the transferor's maintaining effective control over specific transferred assets (paragraphs 9.c.(2) and 51-54).

86. The following are examples of ROAPs that preclude transfers from being accounted for as sales:

- a. An unconditional ROAP or repurchase agreement that allows the transferor to specify the assets that may be removed, because such a provision allows the transferor unilaterally to remove specific assets
- b. A ROAP conditioned on a transferor's decision to exit some portion of its business, 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 (for example, geographic) portion of the transferor's business, such a provision allows the transferor unilaterally to remove specific assets.

87. The following are examples of ROAPs that do not preclude transfers from being accounted for as sales:

- a. A ROAP for random removal of excess assets, if the ROAP is sufficiently limited so that the transferor cannot remove specific transferred assets, for example, by limiting removals to the amount of the transferor's retained interest and to one removal per month
- b. A ROAP for defaulted receivables, because the removal would be allowed only after a third party's action (default) and could not be caused unilaterally by the transferor
- c. A ROAP conditioned on a third-party cancellation, or expiration without renewal, of an affinity or private-label arrangement, 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.

88. A ROAP that can be exercised only in response to a third party's action that has not yet occurred does not maintain the transferor's effective control over assets potentially subject to that ROAP. However, when a third party's action (such as default or cancellation) or decision not to act (expiration) occurs that allows removal of assets to be initiated solely by the transferor, the transferor must recognize any assets subject to the ROAP, whether the ROAP is exercised or not. If the ROAP is exercised, the assets are recognized because the transferor has reclaimed the assets. If the ROAP is not exercised, the assets are recognized because the transferor now

can unilaterally cause the qualifying SPE to return those specific assets and, therefore, the transferor once again has effective control over those transferred assets (paragraph 55).

Securities Lending Transactions

91. Securities lending transactions are initiated by broker-dealers and other financial institutions that need specific securities to cover a short sale or a customer's failure to deliver securities sold. Transferees ("borrowers") of securities generally are required to provide "collateral" to the transferor ("lender") of securities, 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 transferor typically earns a return by investing that cash at rates higher than the rate paid or "rebated" to the transferee. If the "collateral" is other than cash, the transferor typically receives a fee. Securities custodians or other agents commonly carry out securities lending activities on behalf of clients. Because of the protection of "collateral" (typically valued daily and adjusted frequently for changes in the market price of the securities transferred) and the short terms of the transactions, most securities lending transactions in themselves do not impose significant credit risks on either party. Other risks arise from what the parties to the transaction do with the assets they receive. For example, investments made with cash "collateral" impose market and credit risks on the transferor.

92. In some securities lending transactions, the criteria in paragraph 9 are met, including the effective control criterion in paragraph 9.c., and consideration other than beneficial interests in the transferred assets is received. Those transactions shall be accounted for (a) by the transferor as a sale of the "loaned" securities for proceeds consisting of the cash "collateral" and a forward repurchase commitment and (b) by the transferee as a purchase of the "borrowed" securities in exchange for the "collateral" and a forward resale commitment. During the term of that agreement, the transferor has surrendered control over the securities transferred and the transferee has obtained control over those securities with the ability to sell or transfer them at will. In that case, creditors of the transferor have a claim only to the "collateral" and the forward repurchase commitment.

93. However, many securities lending transactions are accompanied by an agreement that entitles and obligates the transferor to repurchase or redeem the transferred assets before their maturity under which the transferor maintains effective control over those assets (paragraphs 47-49). Those transactions shall be accounted for as secured borrowings, in which cash (or securities that the holder is permitted by contract or custom to sell or repledge) received as "collateral" is considered the amount borrowed, the securities "loaned" are considered pledged as collateral against the cash borrowed and reclassified as set forth in paragraph 15.a., and any "rebate" paid to the transferee of securities is interest on the cash the transferor is considered to have borrowed.

94. The transferor of securities being "loaned" accounts for cash received in the same way whether the transfer is accounted for as a sale or a secured borrowing. The cash received shall be recognized as the transferor's asset—as shall investments made with that cash, even if made by agents or in pools with other securities lenders—along with the obligation to return the cash. If securities that may be sold or repledged are received, the transferor of the securities being "loaned" accounts for those securities in the same way as it would account for cash received.
Illustration—Securities Lending Transaction Treated as a Secured Borrowing

95. The following example illustrates the accounting for a securities lending transaction treated as a secured borrowing, in which the securities borrower sells the securities upon receipt and later buys similar securities to return to the securities lender:

Facts

Transferor's carrying amount and fair value of security loaned	\$1,000
Cash "collateral"	1,020
Transferor's return from investing cash collateral at a 5 percent annual rate	5
Transferor's rebate to the securities borrower at a 4 percent annual rate	4

For simplicity, the fair value of the security is assumed not to change during the 35-day term of the transaction.

Journal Entries for the Transferor

At inception:

Cash	1,020	
Payable under securities loan agreements		1,020
To record the receipt of cash collateral		

Securities pledged to creditors	1,000	
Securities		1,000
To reclassify loaned securities that the secured party has the right to sell or repledge		

Money market instrument	1,020	
Cash		1,020
To record investment of cash collateral		

At conclusion:

Cash	1,025	
Interest		5
Money market instrument		1,020
To record results of investment		

Securities	1,000	
Securities pledged to creditors		1,000
To record return of security		

Payable under securities loan agreements	1,020	
Interest ("rebate")	4	
Cash		1,024
To record repayment of cash collateral plus interest		

Journal Entries for the Transferee

At inception:

Receivable under securities loan agreements	1,020	
Cash		1,020
To record transfer of cash collateral		

Cash	1,000	
Obligation to return borrowed securities		1,000
To record sale of borrowed securities to a third party and the resulting obligation to return securities that it no longer holds		

At conclusion:

Obligation to return borrowed securities	1,000	
Cash		1,000
To record the repurchase of securities borrowed		

Cash	1,024	
Receivable under securities loan agreements		1,020
Interest revenue ("rebate")		4
To record the receipt of cash collateral and rebate interest		

Repurchase Agreements and "Wash Sales"

96. Government securities dealers, banks, other financial institutions, and corporate investors commonly use repurchase agreements to obtain or use short-term funds. Under those agreements, the transferor ("repo party") transfers a security to a transferee ("repo counterparty" or "reverse party") in exchange for cash and concurrently agrees to reacquire that security at a future date for an amount equal to the cash exchanged plus a stipulated "interest" factor.

97. Repurchase agreements can be effected in a variety of ways. Some repurchase agreements are similar to securities lending transactions in that the transferee has the right to sell or repledge the securities to a third party during the term of the repurchase agreement. In other repurchase agreements, the transferee does not have the right to sell or repledge the securities during the term of the repurchase agreement. For example, in a tri-party repurchase agreement, the transferor transfers securities to an independent third-party custodian that holds the securities during the term of the repurchase agreement. Also, many repurchase agreements are for short terms, often overnight, or have indefinite terms that allow either party to terminate the arrangement on short notice. However, other repurchase agreements are for longer terms, sometimes until the maturity of the transferred asset. Some repurchase agreements call for repurchase of securities that need not be identical to the securities transferred.

98. If the criteria in paragraph 9 are met, including the criterion in paragraph 9.c.(1), the transferor shall account for the repurchase agreement as a sale of financial assets and a forward repurchase commitment, and the transferee shall account for the agreement as a purchase of financial assets and a forward resale commitment. Other transfers that are accompanied by an agreement to repurchase the transferred assets that shall be accounted for as sales include transfers with agreements to repurchase at maturity and transfers with repurchase agreements in which the transferee has not obtained collateral sufficient to fund substantially all of the cost of purchasing replacement assets.

99. Furthermore, "wash sales" that previously were not recognized if the same financial asset was purchased soon before or after the sale shall be accounted for as sales under this Statement. Unless there is a concurrent contract to repurchase or redeem the transferred financial assets from the transferee, the transferor does not maintain effective control over the transferred assets.

100. As with securities lending transactions, under many agreements to repurchase transferred assets before their maturity the transferor maintains effective control over those assets. Repurchase agreements that do not meet all the criteria in paragraph 9 shall be treated as secured borrowings. Fixed-coupon and dollar-roll repurchase agreements, and other contracts under which the securities to be repurchased need not be the same as the securities sold, qualify as borrowings if the return of substantially the same (paragraph 48) securities as those concurrently transferred is assured. Therefore, those transactions shall be accounted for as secured borrowings by both parties to the transfer.

101. If a transferor has transferred securities to an independent third-party custodian, or to a transferee, under conditions that preclude the transferee from selling or repledging the assets during the term of the repurchase agreement (as in most tri-party repurchase agreements), the transferor has not surrendered control over those assets.

Loan Syndications

102. Borrowers often borrow amounts greater than any one lender is willing to lend. Therefore, it is common for groups of lenders to jointly fund those loans. That may be accomplished by a syndication under which several lenders share in lending to a single borrower, but each lender loans a specific amount to the borrower and has the right to repayment from the borrower.

103. A loan syndication is not a transfer of financial assets. Each lender in the syndication shall account for the amounts it is owed by the borrower. Repayments by the borrower may be made to a lead lender that then distributes the collections to the other lenders of the syndicate. In those

circumstances, the lead lender is simply functioning as a servicer and, therefore, shall not recognize the aggregate loan as an asset.

Loan Participations

104. Groups of banks or other entities also may jointly fund large borrowings through loan participations in which a single lender makes a large loan to a borrower and subsequently transfers undivided interests in the loan to other entities.

105. Transfers by the originating lender may take the legal form of either assignments or participations. 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 upon the terms of the participation agreement.

106. If the loan participation agreement gives the transferee the right to pledge or exchange those participations and the other criteria in paragraph 9 are met, the transfers to the transferee shall be accounted for by the transferor as sales of financial assets. A transferor's right of first refusal on a bona fide offer from a third party, a requirement to obtain the transferor's permission that shall not be unreasonably withheld, or a prohibition on sale to the transferor's competitor if other potential willing buyers exist is a limitation on the transferee's rights but presumptively does not constrain a transferee from exercising its right to pledge or exchange. However, if the loan participation agreement constrains the transferees from pledging or exchanging their participations, the transferor presumptively receives a more than trivial benefit, has not relinquished control over the loan, and shall account for the transfers as secured borrowings.

Factoring Arrangements

112. Factoring arrangements are a means of discounting accounts receivable on a nonrecourse, notification basis. 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. Factoring arrangements that meet the criteria in paragraph 9 shall be accounted for as sales of financial assets because the transferor surrenders control over the receivables to the factor.

Transfers of Receivables with Recourse

113. In a transfer of receivables with recourse, the transferor provides the transferee with full or limited recourse. The transferor is obligated under the terms of the recourse provision to make payments to the transferee or to repurchase receivables sold under certain circumstances, typically for defaults up to a specified percentage. The effect of a recourse provision on the application of paragraph 9 may vary by jurisdiction. In some jurisdictions, transfers with full recourse may not place transferred assets beyond the reach of the transferor and its creditors, but transfers with limited recourse may. A transfer of receivables with recourse shall be accounted for as a sale, with the proceeds of the sale reduced by the fair value of the recourse obligation, if the criteria in paragraph 9 are met. Otherwise, a transfer of receivables with recourse shall be accounted for as a secured borrowing.

Extinguishments of Liabilities

114. If a creditor releases a debtor from primary obligation on the condition that a third party assumes the obligation and that the original debtor becomes secondarily liable, that release extinguishes the original debtor's liability. However, in those circumstances, whether or not explicit consideration was paid for that guarantee, the original debtor becomes a guarantor. As a guarantor, it shall recognize a guarantee obligation in the same manner as would a guarantor that had never been primarily liable to that creditor, with due regard for the likelihood that the third party will carry out its obligations. The guarantee obligation shall be initially measured at fair value, and that amount reduces the gain or increases the loss recognized on extinguishment.

RELEVANT LITERATURE

Statutory Accounting

- *SSAP No. 18—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
- *SSAP No. 33—Securitization*
- *SSAP No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements*
- *Purposes and Procedures Manual of the NAIC Securities Valuation Office*

Generally Accepted Accounting Principles

- *FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
- *AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as used In Certain Audit Guides and a Statement of Position*
- *FASB Emerging Issues Task Force No. 87-34, Sale of Mortgage Servicing Rights with a Subservicing Agreement*
- *FASB Emerging Issues Task Force No. 88-11, Allocation of Recorded Investment When a Loan as Part of a Loan is Sold*
- *FASB Emerging Issues Task Force No. 88-18, Sales of Future Revenues*
- *FASB Emerging Issues Task Force No. 88-22, Securitization of Credit Card and Other Receivable Portfolios*
- *FASB Emerging Issues Task Force No. 90-21, Balance Sheet Treatment of a Sale of Mortgage Servicing Rights with a Subservicing Agreement*
- *FASB Emerging Issues Task Force No. 95-5, Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage Loan Servicing Rights*
- *FASB Emerging Issues Task Force No. 96-19, Debtor's Accounting for a Modification or Exchange of Debt Instruments*

EXHIBIT A - GLOSSARY**Asset Securitization**

An asset securitization is the process of converting assets which would normally serve as collateral for a loan into securities. The largest category of securitized assets is real estate mortgage loans, which serve as collateral for mortgage-backed securities.

Beneficial Interests

Rights to receive all or portions of specified cash inflows to a trust or other entity, including senior and subordinated shares of interest, principal, or other cash inflows to be passed-through or paid-through, premiums due to guarantors, commercial paper obligations and residual interests, whether in the form of debt or equity.

Beneficial Interest Holder (“BIH”)

Holder of beneficial interests

Cleanup Call

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

Collateral

Personal or real property in which a security interest has been given.

Derecognize

Remove previously recognized assets or liabilities from the balance sheet.

Derivative Financial Instrument

A derivative instrument (as defined in *SSAP No. 86—Accounting for Derivative Instruments and Hedging, Income Generation, and Replication (Synthetic Asset) Transactions*) that is a financial instrument (refer to *SSAP No. 27*, paragraph 2).

Embedded Call (See Issue Paper on FAS 140 paragraphs 50 and 52)

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.

Financial Asset

Cash, evidence of an ownership interest in an entity, or a contract that conveys to a second entity a contractual right (a) to receive cash or another financial instrument from a first entity or (b) to exchange other financial instruments on potentially favorable terms with the first entity.

Financial Liability

A contract that imposes on one entity a contractual obligation (a) to deliver cash or another financial instrument to a second entity or (b) to exchange other financial instruments on potentially unfavorable terms with the second entity.

Guaranteed Mortgage Securitization

A securitization of mortgage loans which includes a substantive guarantee by a third party.

Proceeds

Cash, derivatives, or other assets that are obtained in a transfer of financial assets, less any liabilities incurred.

Recourse

The right of a transferee of receivables to receive payment from the transferor of those receivables for (a) failure of debtors to pay when due, (b) the effects of prepayments, or (c) adjustments resulting from defects in the eligibility of the transferred receivables.

Residual

Residuals are a class of retained or purchased beneficial interests that have rights to the last cash flows from the pool of securitized assets and are not rated by a NRSRO. Residuals are to be carried at fair value with the difference between fair value and the allocated cost basis recognized as an unrealized gain or loss.

Securitization

The process by which financial assets are transformed into securities.

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.

Servicing Asset

A contract to service financial assets under which the estimated future revenues from contractually specified servicing fees, late charges, and other ancillary revenues are expected to more than adequately compensate the servicer for performing the servicing. A servicing contract is either (a) undertaken in conjunction with selling or securitizing the financial assets being serviced or (b) purchased or assumed separately.

Servicing Liability

A contract to service financial assets under which the estimated future revenues from stated servicing fees, late charges, and other ancillary revenues are not expected to adequately compensate the servicer for performing the servicing.

Transfer

The conveyance of a noncash financial asset by and to someone other than the issuer of that financial asset. Thus, a transfer includes selling a receivable, putting it into a securitization trust, or posting it as collateral but excludes the origination of that receivable, the settlement of that receivable, or the restructuring of that receivable into a security in a troubled debt restructuring.

Transferee

An entity that receives a financial asset, a portion of a financial asset, or a group of financial assets from a transferor.

Transferor

An entity that transfers a financial asset, a portion of a financial asset, or a group of financial assets that it controls to another entity.

Undivided Interest

Partial legal or beneficial ownership of an asset as a tenant in common with others. The proportion owned may be pro rata, for example, the right to receive 50 percent of all cash flows from a security, or non-pro rata, for example, the right to receive the interest from a security while another has the right to the principal.

Unrestricted Collateral

Securities received that may be sold or repledged and which were obtained under agreements that are not subject to repurchase or redemption on short notice, for example, by substitution of other collateral or termination of the contract.

Unilateral Ability (See Issue Paper on FAS 140 paragraphs 50 and 51)

A capacity for action not dependent on the actions (or failure to act) of any other party.

EXHIBIT B - ILLUSTRATIONS

1. Illustration—Recording Transfers with Proceeds of Cash, Derivatives, and Other Liabilities

Company A sells loans with a fair value of \$1,100 and a carrying amount of \$1,000. Company A retains no servicing responsibilities but obtains an option to purchase from the transferee loans similar to the loans sold (which are readily obtainable in the marketplace) and assumes a limited recourse obligation to repurchase delinquent loans.

Company A agrees to provide the transferee a return at a floating rate of interest even though the contractual terms of the loan are fixed rate in nature (that provision is effectively an interest rate swap).

Fair Values

Cash proceeds	\$1,050
Interest rate swap	40
Call option	70
Recourse obligation	60

Net Proceeds

Cash received	\$1,050
Plus: Call option	70
Interest rate swap	40
Less: Recourse obligation	<u>(60)</u>
Net proceeds	<u>\$1,100</u>

Gain on Sale

Net proceeds	\$1,100
Carrying amount of loans sold	<u>1,000</u>
Gain on sale	<u>\$ 100</u>

Journal Entry

Cash	1,050	
Interest rate swap	40	
Call option	70	
Loans		1,000
Recourse obligation		60
Gain on sale		100

To record transfer

2. Illustration—Recording Transfers of Partial Interests

Company B sells a pro rata nine-tenths interest in loans with a fair value of \$1,100 and a carrying amount of \$1,000. There is no servicing asset or liability, because Company B estimates that the benefits of servicing are just adequate to compensate it for its servicing responsibilities.

Fair values	
Cash proceeds for nine-tenths sold	\$990
One-tenth interest retained $[(\$990 \div 9/10) \times 1/10]$	110

Carrying Amount Based on Relative Fair Values

	<u>Fair Value</u>	<u>Percentage Of Total Fair Value</u>	<u>Allocated Carrying Amount</u>
Nine-tenths interest sold	\$ 990	90	\$ 900
One-tenth interest retained	<u>110</u>	<u>10</u>	<u>100</u>
Total	<u>\$ 1,100</u>	<u>100</u>	<u>\$ 1,000</u>

Gain on Sale

Net proceeds	\$ 990
Carrying amount of loans sold	<u>900</u>
Gain on sale	<u>\$ 90</u>

Journal Entry

Cash	990	
Loans		900
Gain on sale		90
<i>To record transfer</i>		

3. Illustration—Sale of Receivables with Servicing Retained

Company C originates \$1,000 of loans that yield 10 percent interest income for their estimated lives of 9 years. Company C sells the \$1,000 principal plus the right to receive interest income of 8 percent to another entity for \$1,000. Company C will continue to service the loans, and the contract stipulates that its compensation for performing the servicing is the right to receive half of the interest income not sold. The remaining half of the interest income not sold is considered an interest-only strip receivable. At the date of the transfer, the fair value of the loans, including servicing, is \$1,100. The fair value of the servicing asset is \$40.

Fair Values

Cash proceeds	\$1,000
Servicing asset	40
Interest-only strip receivable	60

Carrying Amount Based on Relative Fair Values

	<u>Fair Value</u>	<u>Percentage Of Total Fair Value</u>	<u>Allocated Carrying Amount</u>
Loans sold	\$ 1,000	91.0	\$ 910
Servicing asset	40	3.6	36
Interest-only strip receivable	<u>60</u>	<u>5.4</u>	<u>54</u>
Total	<u>\$ 1,100</u>	<u>100.0</u>	<u>\$ 1,000</u>

Gain on Sale

Net proceeds	\$ 1000
Carrying amount of loans sold	<u>910</u>
Gain on sale	<u>\$ 90</u>

Journal Entries

Cash	1000	
Loans		910
Gain on sale		90
<i>To record transfer</i>		
Servicing asset	36	
Interest-only strip receivable	54	
Loans		90
<i>To record servicing asset and interest-only strip receivable</i>		
Interest-only strip receivable	6	
Equity		6
<i>To begin to subsequently measure interest-only strip receivable like an available-for-sale security (FAS 140 paragraph 14)</i>		

4. Illustration—Recording Transfers of Partial Interests with Proceeds of Cash, Derivatives, Other Liabilities, and Servicing

Company D originates \$1,000 of prepayable loans that yield 10 percent interest income for their 9-year expected lives. Company D sells nine-tenths of the principal plus interest of 8 percent to another entity. Company D will continue to service the loans, and the contract stipulates that its compensation for performing the servicing is the 2 percent of the interest income not sold. Company D obtains an option to purchase from the transferee loans similar to the loans sold (which are readily obtainable in the marketplace) and incurs a limited recourse obligation to repurchase delinquent loans.

Fair Values

Cash proceeds	\$900
Call option	70
Recourse obligation	60
Servicing asset	90
One-tenth interest retained	100

Net Proceeds

Cash received	\$900
Plus: Call option	70
Less: Recourse obligation	<u>(60)</u>
Net proceeds	<u>\$910</u>

Carrying Amount Based on Relative Fair Values

	<u>Fair Value</u>	<u>Percentage Of Total Fair Value</u>	<u>Allocated Carrying Amount</u>
Interest sold	\$ 910	83	\$ 830
Servicing asset	90	8	80
One-tenth interest retained	<u>100</u>	<u>9</u>	<u>90</u>
Total	<u>\$ 1,100</u>	<u>100</u>	<u>\$ 1,000</u>

Gain on Sale

Net proceeds		\$ 910
Carrying amount of loans sold		<u>830</u>
Gain on sale		<u>\$ 80</u>

Journal Entries

Cash	900	
Call option	70	
Loans		830
Recourse obligation		60
Gain on sale		80
<i>To record transfer</i>		
Servicing asset	80	
Loans		80
<i>To record servicing asset</i>		

At the time of the transfer, Company D reports its one-tenth retained interest in the loans at its allocated carrying amount of \$90.

5. Illustration—Recording Transfers If It Is Not Practicable to Estimate a Fair Value

Company E sells loans with a carrying amount of \$1,000 to another entity for cash plus a call option to purchase loans similar to the loans sold (which are readily obtainable in the marketplace) and incurs a limited recourse obligation to repurchase any delinquent loans. Company E undertakes to service the transferred assets for the other entity. In Case 1, Company E finds it impracticable to estimate the fair value of the servicing contract, although it is confident that servicing revenues will be more than adequate compensation for performing the servicing. In Case 2, Company E finds it impracticable to estimate the fair value of the recourse obligation.

<u>Fair Values</u>	<u>Case 1</u>	<u>Case 2</u>
Cash proceeds	\$1,050	\$1,050
Servicing asset	XX*	40
Call option	70	70
Recourse obligation	<u>60</u>	<u>XX*</u>
Fair value of loans transferred	\$1,100	\$1,100

* Not practicable to estimate fair value

<u>Net Proceeds</u>	<u>Case 1</u>	<u>Case 2</u>
Cash received	\$1,050	\$1,050
Plus: Call option	70	70
Less: Recourse obligation	<u>(60)</u>	<u>XX</u>
Net proceeds	<u>\$1,060</u>	<u>\$1,120</u>

Carrying Amount Based on Relative Fair Values (Case 1)

	<u>Fair Value</u>	<u>Percentage Of Total Fair Value</u>	<u>Allocated Carrying Amount</u>
Loans sold	\$ 1,060	100	\$ 1,000
Servicing asset	<u>0</u>	<u>0</u>	<u>0</u>
Total	<u>\$ 1,060</u>	<u>100</u>	<u>\$ 1,000</u>

Carrying Amount Based on Relative Fair Values (Case 2)

	<u>Fair Value</u>	<u>Percentage Of Total Fair Value</u>	<u>Allocated Carrying Amount</u>
Loans sold	\$ 1,120	97	\$ 970
Servicing asset	<u>40</u>	<u>3</u>	<u>30</u>
Total	<u>\$ 1,160</u>	<u>100</u>	<u>\$ 1,000</u>

Journal Entries

	<u>Case 1</u>		<u>Case 2</u>	
Cash	1,050		1,050	
Servicing asset	0*		30	
Call option	70		70	
Loans		1,000		1,000
Recourse obligation		60		150†
Gain on sale		60		0
<i>To record transfer</i>				

* Assets shall be recorded at zero if an estimate of the fair value of the assets is not practicable.

† The amount recorded as a liability in this example equals the sum of the known assets less the fair value of the known liabilities, that is, the amount that results in no gain or loss.

6. The following example illustrates the accounting for a securities lending transaction treated as a secured borrowing, in which the securities borrower sells the securities upon receipt and later buys similar securities to return to the securities lender:

Facts

Transferor's carrying amount and fair value of security loaned	\$1,000
Cash "collateral"	1,020
Transferor's return from investing cash collateral at a 5 percent annual rate	5
Transferor's rebate to the securities borrower at a 4 percent annual rate	4

For simplicity, the fair value of the security is assumed not to change during the 35-day term of the transaction.

Journal Entries for the Transferor

At inception:

Cash	1,020	
Payable under securities loan agreements		1,020

To record the receipt of cash collateral

IP No. 122	Issue Paper		
Securities pledged to creditors	1,000		
Securities			1,000
<i>To reclassify loaned securities that the secured party has the right to sell or repledge</i>			
Money market instrument	1,020		
Cash			1,020
<i>To record investment of cash collateral</i>			
<i>At conclusion:</i>			
Cash	1,025		
Interest			5
Money market instrument			1,020
<i>To record results of investment</i>			
Securities	1,000		
Securities pledged to creditors			1,000
<i>To record return of security</i>			
Payable under securities loan agreements	1,020		
Interest (“rebate”)	4		
Cash			1,024
<i>To record repayment of cash collateral plus interest</i>			
 <u>Journal Entries for the Transferee</u>			
<i>At inception:</i>			
Receivable under securities loan agreements	1,020		
Cash			1,020
<i>To record transfer of cash collateral</i>			
Cash	1,000		
Obligation to return borrowed securities			1,000
<i>To record sale of borrowed securities to a third party and the resulting obligation to return securities that it no longer holds</i>			
<i>At conclusion:</i>			
Obligation to return borrowed securities	1,000		
Cash			1,000
<i>To record the repurchase of securities borrowed</i>			
Cash	1,024		
Receivable under securities loan agreements			1,020
Interest revenue (“rebate”)			4
<i>To record the receipt of cash collateral and rebate interest</i>			