

Statement of Financial Accounting Standards No. 140

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

(a replacement of FASB Statement No. 125)

September 2000



Financial Accounting Standards Board
of the Financial Accounting Foundation
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Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities

a replacement of FASB Statement No. 125

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FAS 140: Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities

a replacement of FASB Statement 125

FAS 140 Summary

This Statement replaces FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. It revises the standards for accounting for securitizations and other transfers of financial assets and collateral and requires certain disclosures, but it carries over most of Statement 125's provisions without reconsideration.

This Statement provides accounting and reporting standards for transfers and servicing of financial assets and extinguishments of liabilities. Those standards are based on consistent application of a *financial-components approach* that focuses on control. Under that approach, after a transfer of financial assets, an entity recognizes the financial and servicing assets it controls and the liabilities it has incurred, derecognizes financial assets when control has been surrendered, and derecognizes liabilities when extinguished. This Statement provides consistent standards for distinguishing transfers of financial assets that are sales from transfers that are secured borrowings.

A transfer of financial assets in which the transferor surrenders control over those assets is 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.
- b. Each transferee (or, if the transferee is a qualifying special-purpose entity (SPE), 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.
- 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 or (2) the ability to unilaterally cause the holder to return specific assets, other than through a cleanup call.

This Statement requires that liabilities and derivatives incurred or obtained by transferors as part of a transfer of financial assets be initially measured at fair value, if practicable. It also

requires that servicing assets and other retained interests in the transferred assets be measured by allocating the previous carrying amount between the assets sold, if any, and retained interests, if any, based on their relative fair values at the date of the transfer.

This Statement requires that servicing assets and liabilities be subsequently measured by (a) amortization in proportion to and over the period of estimated net servicing income or loss and (b) assessment for asset impairment or increased obligation based on their fair values.

This Statement requires that a liability be derecognized if and only if either (a) the debtor pays the creditor and is relieved of its obligation for the liability or (b) the debtor is legally released from being the primary obligor under the liability either judicially or by the creditor. Therefore, a liability is not considered extinguished by an in-substance defeasance.

This Statement provides implementation guidance for assessing isolation of transferred assets, conditions that constrain a transferee, conditions for an entity to be a qualifying SPE, accounting for transfers of partial interests, measurement of retained interests, servicing of financial assets, securitizations, transfers of sales-type and direct financing lease receivables, securities lending transactions, repurchase agreements including "dollar rolls," "wash sales," loan syndications and participations, risk participations in banker's acceptances, factoring arrangements, transfers of receivables with recourse, and extinguishments of liabilities. This Statement also provides guidance about whether a transferor has retained effective control over assets transferred to qualifying SPEs through removal-of-accounts provisions, liquidation provisions, or other arrangements.

This Statement requires a debtor to (a) reclassify financial assets pledged as collateral and report those assets in its statement of financial position separately from other assets not so encumbered if the secured party has the right by contract or custom to sell or repledge the collateral and (b) disclose assets pledged as collateral that have not been reclassified and separately reported in the statement of financial position. This Statement also requires a secured party to disclose information about collateral that it has accepted and is permitted by contract or custom to sell or repledge. The required disclosure includes the fair value at the end of the period 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.

This Statement requires an entity that has securitized financial assets to disclose information about accounting policies, volume, cash flows, key assumptions made in determining fair values of retained interests, and sensitivity of those fair values to changes in key assumptions. It also requires that entities that securitize assets disclose for the securitized assets and any other financial assets it manages together with them (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 during the period.

In addition to replacing Statement 125 and rescinding FASB Statement No. 127, *Deferral of the Effective Date of Certain Provisions of FASB Statement No. 125*, this Statement carries forward the actions taken by Statement 125. Statement 125 superseded FASB Statements No. 76, *Extinguishment of Debt*, and No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse*. Statement 125 amended FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, to clarify that a debt security may not be classified as

held-to-maturity if it can be prepaid or otherwise settled in such a way that the holder of the security would not recover substantially all of its recorded investment. Statement 125 amended and extended to all servicing assets and liabilities the accounting standards for mortgage servicing rights now in FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, and superseded FASB Statement No. 122, *Accounting for Mortgage Servicing Rights*. Statement 125 also superseded FASB Technical Bulletins No. 84-4, *In-Substance Defeasance of Debt*, and No. 85-2, *Accounting for Collateralized Mortgage Obligations (CMOs)*, and amended FASB Technical Bulletin No. 87-3, *Accounting for Mortgage Servicing Fees and Rights*.

Statement 125 was effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after December 31, 1996, and on or before March 31, 2001, except for certain provisions. Statement 127 deferred until December 31, 1997, the effective date (a) of paragraph 15 of Statement 125 and (b) for repurchase agreement, dollar-roll, securities lending, and similar transactions, of paragraphs 9–12 and 237(b) of Statement 125.

This Statement is effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after March 31, 2001. This Statement is effective for recognition and reclassification of collateral and for disclosures relating to securitization transactions and collateral for fiscal years ending after December 15, 2000. Disclosures about securitization and collateral accepted need not be reported for periods ending on or before December 15, 2000, for which financial statements are presented for comparative purposes.

This Statement is to be applied prospectively with certain exceptions. Other than those exceptions, earlier or retroactive application of its accounting provisions is not permitted.

INTRODUCTION AND SCOPE

1. The Board added a project on financial instruments and off-balance-sheet financing to its agenda in May 1986. The project is intended to develop standards to aid in resolving existing financial accounting and reporting issues and other issues likely to arise in the future about various financial instruments and related transactions. The November 1991 FASB Discussion Memorandum, *Recognition and Measurement of Financial Instruments*, describes the issues to be considered. This Statement focuses on the issues of accounting for **transfers**¹ and servicing of **financial assets** and extinguishments of liabilities.

2. Transfers of financial assets take many forms. Accounting for transfers in which the **transferor** has no continuing involvement with the transferred assets or with the **transferee** has not been controversial. However, transfers of financial assets often occur in which the transferor has some continuing involvement either with the assets transferred or with the transferee. Examples of continuing involvement are **recourse**, servicing, agreements to reacquire, options written or held, and pledges of **collateral**. Transfers of financial assets with continuing involvement raise issues about the circumstances under which the transfers should be considered as sales of all or part of the assets or as secured borrowings and about how transferors and transferees should account for sales and secured borrowings. This Statement establishes

standards for resolving those issues.

3. An entity may settle a liability by transferring assets to the creditor or otherwise obtaining an unconditional release. Alternatively, an entity may enter into other arrangements designed to set aside assets dedicated to eventually settling a liability. Accounting for those arrangements has raised issues about when a liability should be considered extinguished. This Statement establishes standards for resolving those issues.

4. This Statement does not address transfers of custody of financial assets for safekeeping, contributions, ² transfers of ownership interests that are in substance sales of real estate, exchanges of equity method investments for similar productive assets, or investments by owners or distributions to owners of a business enterprise. This Statement does not address subsequent measurement of assets and liabilities, except for (a) **servicing assets** and **servicing liabilities** and (b) **interest-only strips**, securities, 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 and that are not within the scope of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. This Statement does not change the accounting for employee benefits subject to the provisions of FASB Statement No. 87, *Employers' Accounting for Pensions*, No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, or No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*. This Statement does not change the provisions relating to leveraged leases in FASB Statement No. 13, *Accounting for Leases*, or money-over-money and wrap lease transactions involving nonrecourse debt subject to the provisions of FASB Technical Bulletin No. 88-1, *Issues Relating to Accounting for Leases*. This Statement does not address transfers of nonfinancial assets, for example, servicing assets, or transfers of unrecognized financial assets, for example, minimum lease payments to be received under operating leases.

5. The Board concluded that an objective in accounting for transfers of financial assets is for each entity that is a party to the transaction to recognize only assets it controls and liabilities it has incurred, to **derecognize** assets only when control has been surrendered, and to derecognize liabilities only when they have been extinguished. Sales and other transfers frequently result in a disaggregation of financial assets and liabilities into components, which become separate assets and liabilities. For example, if an entity sells a portion of a financial asset it owns, the portion retained becomes an asset separate from the portion sold and from the assets obtained in exchange.

6. The Board concluded that another objective is that recognition of financial assets and liabilities should not be affected by the sequence of transactions that result in their acquisition or incurrence unless the effect of those transactions is to maintain effective control over a transferred financial asset. For example, if a transferor sells financial assets it owns and at the same time writes an “at-the-money” put option (such as a guarantee or recourse obligation) on those assets, it should recognize the put obligation in the same manner as would another

unrelated entity that writes an identical put option on assets it never owned. Similarly, a creditor may release a debtor on the condition that a third party assumes the obligation and that the original debtor becomes secondarily liable. In those circumstances, the original debtor becomes a guarantor and should recognize a guarantee obligation in the same manner as would a third-party guarantor that had never been primarily liable to that creditor, whether or not explicit consideration was paid for that guarantee. However, certain agreements to repurchase or redeem transferred assets maintain effective control over those assets and should therefore be accounted for differently than agreements to acquire assets never owned.

7. Before FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, accounting standards generally required that a transferor account for financial assets transferred as an inseparable unit that had been either entirely sold or entirely retained. Those standards were difficult to apply and produced inconsistent and arbitrary results. For example, whether a transfer "purported to be a sale" was sufficient to determine whether the transfer was accounted for and reported as a sale of receivables under one accounting standard or as a secured borrowing under another. After studying many of the complex developments that have occurred in financial markets during recent years, the Board concluded that previous approaches that viewed each financial asset as an indivisible unit do not provide an appropriate basis for developing consistent and operational standards for dealing with transfers and servicing of financial assets and extinguishments of liabilities. To address those issues adequately and consistently, the Board decided to adopt as the basis for this Statement a *financial-components approach* that focuses on control and recognizes that financial assets and liabilities can be divided into a variety of components.

8. The Board issued Statement 125 in June 1996. After the issuance of that Statement, several parties called for reconsideration or clarification of certain provisions. Matters the Board was asked to reconsider or clarify included:

- 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 an 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 Statement 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
- i. The accounting for and disclosure about collateral that can be sold or repledged.

The Board concluded that those requests to reconsider certain provisions of Statement 125 were appropriate and added a project to amend Statement 125 to its agenda in March 1997. This Statement is the result. To present the amended accounting standards for transfers of financial assets more clearly, this Statement replaces Statement 125. However, most of the provisions of Statement 125 have been carried forward without reconsideration.

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 ³ 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 ⁴ 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 ⁵ 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 ⁷ 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.

**The provisions of this Statement need
not be applied to immaterial items.**

This Statement was adopted by the affirmative votes of five members of the Financial Accounting Standards Board. Mr. Crooch abstained. Mr. Foster dissented.

Mr. Foster dissents from the issuance of this Statement [*Statement 140*] because he believes its amendments to Statement 125 negate the rationale in that Statement [*Statement 125*] that underlies the accounting for transfers of financial assets to certain qualifying SPEs. Furthermore, he believes the amendments made by this Statement to the accounting for collateral conflict with the underlying concept that an entity recognizes assets that it controls.

A principal requirement for transfers of financial assets to be accounted for as sales pursuant to Statement 125 is that the transferor surrenders control of those assets. The Board reasoned that in most situations, excepting transactions involving repurchase agreements and similarly structured arrangements, the transferor had not surrendered control unless the transferee had unconstrained rights to pledge or exchange the transferred assets. However, if that criterion was applied to securitization transactions, very few would be accounted for as sales, because, in those transactions, SPEs to which the financial assets have been transferred are generally limited by their governing documents in their ability to pledge or exchange the transferred assets. The Board believes that many securitization transactions are, in substance, sales. Consequently, the Board developed a separate rationale for determining which transfers to SPEs (which are primarily securitization transactions) could qualify as sales.

In securitization transactions, assets are transferred to an SPE, which holds the assets on behalf of the BIHs. As discussed in paragraph 173 of this Statement, the Board developed a notion that in a qualifying SPE, the BIHs are the ultimate holders of the transferred assets. That notion is based on the premise that because the powers of a qualifying SPE are essentially limited to holding the transferred assets and collecting and distributing the cash flows that arise from the transferred assets, the BIHs effectively have undivided interests in the transferred

assets. The Board observed that “the effect of establishing the qualifying SPE is to merge the contractual rights in the transferred assets and to *allocate undivided interests in them*—the beneficial interests” (Statement 125, paragraph 127; paragraph 173 of this Statement; emphasis added). Accordingly, the Board concluded that if the BIHs can pledge or exchange their beneficial interests without constraint (and if the other criteria in paragraph 9 are met), the transferor has surrendered control over the transferred assets.

Mr. Foster believes it is clear that if an SPE can pledge or exchange its assets, the BIHs do not have undivided interests in the assets initially transferred to that SPE. Rather, they have undivided interests in an undefined pool of assets, and having the ability to freely pledge or exchange their beneficial interests is not tantamount to being able to transfer undivided interests in those assets that were transferred to the SPE. It is the ability to pledge or exchange undivided interests in the transferred assets that underlies the conclusion that transfers of financial assets to qualifying SPEs be accounted for as sales. For that conclusion to be valid, Mr. Foster believes qualifying SPEs should not be permitted to pledge or exchange assets under any circumstances and particularly so when the exchanges occur at the behest and on behalf of the transferor/servicer. When transferred assets can be pledged or exchanged by the SPE, the ability of BIHs to transfer their beneficial interests in the SPE has no bearing on whether the transferor has surrendered control over those assets. Yet, this Statement offers no other rationale for why control over assets transferred to an SPE having the expanded powers provided by this amendment is considered to be surrendered.

Mr. Foster dissented from the issuance of Statement 125 (see previous dissent included below) in part because he believes that in securitizations having a revolving-period agreement, effective control over the assets has not been surrendered. He believes the existence of and the need for ROAPs that enable the transferor to reclaim specific transferred receivables in securitizations having a revolving-period agreement are further evidence that the receivables transferred in those securitizations continue to be effectively controlled by the transferor and that those securitization transactions are, therefore, secured borrowings. (He notes that, in addition to the transferor’s ability to reclaim specific receivables from the SPE, the transferor generally continues to collect the cash from the transferred receivables, commingles that cash with its own cash, invests the cash for its own benefit, and uses the cash to buy additional receivables from itself that it selects. Furthermore, the transferor, within fairly wide latitude, has the power to change the interest rate on already transferred receivables.)

Statement 125, prior to amendment by this Statement, provides that for a sale to occur a transferor of financial assets to a qualifying SPE cannot maintain effective control over those assets. That notion that a transferor cannot recognize a sale if it maintains effective control through an option to reclaim the transferred assets is carried forward in this Statement in paragraph 9(c)(2). However, the notion is modified in this Statement to make a distinction between call options that are unilaterally exercisable by the transferor and options for which the exercise by the transferor is conditioned upon an event outside its control. The effect of this modification is that if the transferor can only reclaim the receivable upon the occurrence of an event outside its control, it is not considered to have retained effective control. Mr. Foster believes that effective control is maintained by any option to reclaim transferred assets that is held by the transferor, but even more so in the case where the transferor holds a call on a specific

receivable transferred to an SPE for which it has previously issued a call on that same receivable to another party (such as in the case of an affinity relationship described in paragraph 87(c)). In that case, the transferor has already promised that if that other party calls the receivable, it will deliver it. Consequently, if it transfers the receivable, it must control it through a ROAP that enables it to reclaim it—the transferor cannot surrender control of the receivable because it would be unable to perform in the event that specific receivable is called by that other party. Mr. Foster does not understand why control is deemed to have been surrendered in circumstances that *require* that a transferor have the ability to reclaim a transferred receivable when control is deemed not to have been surrendered in circumstances that enable a transferor to reclaim transferred receivables at its discretion.

A fundamental tenet of Statement 125 is that a transferor has surrendered control over an asset only if the transferee can exchange or pledge that transferred asset. The transferee then can control the asset, because it is free to sell, pledge, or do anything else it desires with the asset. **13** An entity that holds collateral in the form of a financial asset that it can pledge or exchange likewise can control that collateral. Statement 125, prior to amendment by this Statement, required that an entity that holds collateral that can be sold or repledged recognize that collateral as its asset unless the transferor can redeem the pledged collateral on short notice. This Statement amends Statement 125 to require that collateral not be recognized by the entity that holds it, even in circumstances in which it can be sold or repledged. Only after cash is received in exchange for collateral that is subsequently sold is the fact that the holder of the collateral had an asset acknowledged. Mr. Foster believes that the amendment related to collateral also is inconsistent with the concepts underlying Statement 125.

Members of the Financial Accounting Standards Board:

Edmund L. Jenkins, *Chairman*
Anthony T. Cope
G. Michael Crooch
John M. Foster
Gaylen N. Larson
Gerhard G. Mueller
Edward W. Trott

Statement 125 was adopted in June 1996 by the affirmative votes of six members of the Financial Accounting Standards Board. Mr. Foster dissented.

Mr. Foster dissents from the issuance of Statement 125 because he believes that the notion of effective control that is applied to repurchase agreements, including dollar rolls, and securities lending transactions should be applied consistently to other transfers of financial assets, including securitization transactions. Furthermore, he believes that in those instances where the financial-components approach is applied, all rights (assets) and obligations (liabilities) that are recognized by the transferor after a sale or securitization has occurred should be measured at fair value.

Under paragraphs 9(a) and 9(b) of Statement 125, control is deemed to have been surrendered if the transferred assets have been legally isolated from the transferor and the transferee has the right to pledge or exchange the transferred assets. That notion of control is the

cornerstone of the financial-components approach. However, the Board considered that approach inappropriate to account for certain transactions, such as those involving repurchase agreements, including dollar rolls, and securities lending transactions, where legal control over the assets has been surrendered, but where the Board believes that effective control still exists. For those transactions, paragraph 9(c) of Statement 125 was specifically crafted to override the criteria for transfers of legal control in paragraphs 9(a) and 9(b) of Statement 125. Paragraph 9(c), however, was designed to provide an exception only for certain transactions resulting in inconsistent application of the control notion: one set of transfers of financial assets—securitizations—is accounted for using a narrow, legal definition of control while others are accounted for using a broad notion of effective control. Mr. Foster favors an approach that encompasses the broader notion of effective control. He questions why, if the financial-components approach is inappropriate to account for all transfers of financial assets, it is appropriate to apply it to securitizations. He believes that if the entirety of the arrangement is considered, certain securitization transactions, such as those having a revolving-period agreement, also result in effective control being retained by the transferor and accordingly those transactions should be accounted for as secured borrowings.

In securitizations having a revolving-period agreement, which are described in paragraphs 130–133 of Statement 125 [paragraphs 192–195 of this Statement], the transferor generally continues to collect the cash from the transferred receivables, commingles that cash with its own cash, invests the cash for its own benefit, and uses the cash to buy additional receivables from itself that it selects. As a result of those features, the future benefits of the receivables (the cash flows to be received from them) that inure to the transferor are little different, if at all, from the future benefits that the transferor would obtain from receivables that it holds for its own account. Mr. Foster believes that in those transactions effective control of the receivables has not been surrendered and that the transferred receivables continue to be assets of the transferor.

Paragraph 26 of FASB Concepts Statement No. 6, *Elements of Financial Statements*, states, "An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others' access to it, and (c) the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred." Mr. Foster believes that in securitizations having revolving-period agreements, the transferred receivables meet each of those criteria from the perspective of the transferor. The transferred receivables directly or indirectly contribute to the transferor's cash inflows—it generally receives and retains all of the cash inflows during the term of the arrangement subject only to payment of what amounts to interest on the investment of the holders of beneficial interests—and the transferor can and does obtain and control others' access to both the receivables and the cash inflows by its structuring of the transaction and retention of most of the cash flows until termination of the arrangement. Paragraph 131 of Statement 125 [paragraph 193 of this Statement] asserts that the cash obtained by the transferor in those securitizations is received in exchange for new receivables and is not obtained as a benefit attributable to its previous ownership of the transferred receivables. In substance, however, the transfer of new receivables is little different from the substitution of collateral prevalent in many secured loan arrangements. In short, the transferred receivables have all of the attributes of

assets controlled by the transferor.

As described below, the principal criteria cited in the basis for conclusions for treating repurchase agreements and securities lending transactions as secured borrowings apply equally to many securitizations, particularly those having a revolving-period agreement.

The inability of the transferor in a transfer with a revolving-period agreement to sell new receivables elsewhere because it has contracted to sell those new receivables on prearranged terms at times that it does not determine or have much influence over is asserted to be significant in paragraph 131 of Statement 125 [paragraph 193 of this Statement]. However, within fairly wide latitude, the transferor in those circumstances has retained the right to change the interest rate (the price) on both the previously transferred receivables and receivables to be transferred in the future. Mr. Foster believes that that right substantially diminishes any disadvantage of not being able to sell the receivables elsewhere and substantially negates any effect, favorable or onerous, on the transferor as a result of changes in market conditions as asserted in paragraph 50 of Statement 125 [paragraph 76 of this Statement]. In fact, any effects on the transferor result solely from having financed the receivables at whatever rate is paid the beneficial owners of the securities. Furthermore, the transferor of assets transferred under repurchase agreements or in securities lending transactions cannot sell those assets elsewhere.

Two reasons advanced in support of the treatment of repurchase agreements and securities lending transactions as secured borrowings are that (a) those transactions are difficult to characterize because they have attributes of both borrowings and sales and (b) supporting arguments can be found for accounting for those transactions as borrowings or sales. Those two reasons are equally applicable to securitization transactions having a revolving-period agreement—they are treated as sales for purposes of marketing to investors and as borrowings for tax purposes, and legal opinions and the prospectuses for those transactions acknowledge that their treatment as sales may not be sustained in a legal dispute.

The only supporting arguments cited for the treatment of repurchase agreements and securities lending transactions as secured borrowings that are not equally applicable to certain securitizations are that (a) forward contracts that are fully secured should be treated differently than those that are unsecured and (b) making a change in existing accounting practice would have a substantial impact on the reported financial position of certain entities and on the markets in which they participate. Mr. Foster does not believe that the existence of security in support of a transaction should determine its accounting treatment and notes that extension of the reasoning in paragraph 141 of Statement 125 [paragraph 207 of this Statement] would lead to lenders not recognizing loans receivable that are unsecured. While it may be necessary to consider prior accounting treatment and the effect a change in accounting practice would have on certain entities, Mr. Foster believes that those factors should carry relatively little weight in determining what is an appropriate accounting standard.

Paragraph 18 of Opinion 29 states, "The Board concludes that in general accounting for nonmonetary transactions should be based on the fair values of the assets (or services) involved which is the same basis as that used in monetary transactions. Thus, the cost of a nonmonetary asset acquired in exchange for another nonmonetary asset is the fair value of the asset surrendered to obtain it . . ." (footnote reference omitted). The conclusion embodied in that language is that the accounting for both monetary and nonmonetary transactions acquired in an

exchange should be based on the fair values of the assets (or services) involved. Mr. Foster believes that in securitization transactions in which control is deemed under this Statement to be surrendered and in partial sales of financial assets, assets (or rights) are surrendered in exchange for cash and other rights and obligations, all of which are new. ¹⁴ The new assets (rights) received are part of the proceeds of the exchange, and any liabilities (obligations) incurred are a reduction of the proceeds. As such, those new assets and liabilities should be measured at their fair values as they are in all other exchange transactions.

Statement 125 contends that in those transactions certain components of the original assets have not been exchanged. If that is one's view, however, it is clear that a transaction of sufficient significance to result in the derecognition of assets has occurred. Furthermore, the event of securitization results in a change in the form and value of assets—securities are generally more easily sold or used as collateral and thus are more valuable than receivables. Mr. Foster believes that a securitization transaction, like the initial recognition of an asset or liability and derecognition of assets and liabilities where it is clear an exchange has occurred, is also sufficiently significant that the resulting, or remaining components of, assets and liabilities should be recorded at fair value.

Mr. Foster also notes, as described in paragraphs 182–184 of Statement 125 [paragraphs 271–273 of this Statement], that the distinctions made in paragraphs 10 and 11 between (a) assets retained and (b) assets obtained and liabilities incurred are arbitrary. For example, one could easily argue that beneficial interests acquired in a transfer of receivables have different rights and obligations than the receivables and accordingly should be accounted for not as retained assets, but as new and different assets, and, arguably, the rights inherent in derivatives arising in a securitization transaction, which are considered new rights (assets) in Statement 125, were embedded, albeit in an obscure form, in the transferred assets and could be as readily identified as retained portions of them. That the Board needed to make those distinctions arbitrarily begs for a consistent measurement attribute—fair value—for all of the rights and obligations held by the transferor subsequent to the transfer.

Members of the Financial Accounting Standards Board, June 1996:

Dennis R. Beresford, *Chairman*

Joseph V. Anania

Anthony T. Cope

John M. Foster

James J. Leisenring

Robert H. Northcutt

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Appendix A

IMPLEMENTATION GUIDANCE

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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, ¹⁸ 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 interest 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
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, **19** 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	<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	\$1,000
Carrying amount of loans sold	<u>910</u>
Gain on sale	<u>\$ 90</u>

Journal Entries

Cash	1,000	
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.

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
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	60	XX*
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		

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).

Sales-Type and Direct Financing Lease Receivables

89. Sales-type and direct financing receivables secured by leased equipment, referred to as gross investment in lease receivables, are made up of two components: minimum lease payments and residual values. Minimum lease payments are requirements for lessees to pay cash to lessors and meet the definition of a financial asset. Thus, transfers of minimum lease payments are subject to the requirements of this Statement. Residual values represent the lessor's estimate of the "salvage" value of the leased equipment at the end of the lease term and may be either guaranteed or unguaranteed; residual values meet the definition of financial assets *to the extent that they are guaranteed at the inception of the lease*. Thus, transfers of residual values guaranteed at inception also are subject to the requirements of this Statement. Unguaranteed residual values do not meet the definition of financial assets, nor do residual values guaranteed after inception, and transfers of them are not subject to the requirements of this Statement. Transfers of residual values not guaranteed at inception continue to be subject to Statement 13, as amended. Because residual values guaranteed at inception are financial assets, increases to their estimated value over the life of the related lease are recognized. Entities selling or securitizing lease financing receivables shall allocate the gross investment in receivables between minimum lease payments, residual values guaranteed at inception, and residual values not guaranteed at inception using the individual carrying amounts of those components at the date of transfer. Those entities also shall record a servicing asset or liability in accordance with paragraphs 10 and 13, if appropriate.

Illustration—Recording Transfers of Lease Financing Receivables with Residual Values

90. At the beginning of the second year in a 10-year sales-type lease, Company F sells for \$505 a nine-tenths interest in the minimum lease payments and retains a one-tenth interest in the minimum lease payments and a 100 percent interest in the unguaranteed residual value of leased equipment. Company F receives no explicit compensation for servicing, but it estimates that the other benefits of servicing are just adequate to compensate it for its servicing responsibilities and hence initially records no servicing asset or liability. The carrying amounts and related gain computation are as follows:

Carrying Amounts

Minimum lease payments		\$ 540
Unearned income related to minimum lease payments		<u>370</u>
Gross investment in minimum lease payments		910
Unguaranteed residual value	\$ 30	
Unearned income related to residual value	<u>60</u>	
Gross investment in residual value		<u>90</u>

Total gross investment in financing lease receivable		<u>\$1,000</u>
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Gain on Sale

Cash received		\$ 505
Nine-tenths of carrying amount of gross investment in minimum lease payments	\$819	
Nine-tenths of carrying amount of unearned income related to minimum lease payments	<u>333</u>	
Net carrying amount of minimum lease payments sold		<u>486</u>
Gain on sale		<u>\$ 19</u>

Journal Entry

Cash	505	
Unearned income	333	
Lease receivable		819
Gain on sale		19

To record sale of nine-tenths of the minimum lease payments at the beginning of year 2

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" ²² 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		
<i>At conclusion:</i>		
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 ²³ 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.

Banker's Acceptances and Risk Participations in Them

107. Banker's acceptances provide a way for a bank to finance a customer's purchase of goods from a vendor for periods usually not exceeding six months. Under an agreement between the bank, the customer, and the vendor, the bank agrees to pay the customer's liability to the vendor upon presentation of specified documents that provide evidence of delivery and acceptance of the purchased goods. The principal document is a draft or bill of exchange drawn by the customer that the bank stamps to signify its "acceptance" of the liability to make payment on the draft on its due date.

108. Once the bank accepts a draft, the customer is liable to repay the bank at the time the draft matures. The bank recognizes a receivable from the customer and a liability for the acceptance it has issued to the vendor. The accepted draft becomes a negotiable financial instrument. The vendor typically sells the accepted draft at a discount either to the accepting bank or in the marketplace.

109. A risk participation is a contract between the accepting bank and a participating bank in

which the participating bank agrees, in exchange for a fee, to reimburse the accepting bank in the event that the accepting bank's customer fails to honor its liability to the accepting bank in connection with the banker's acceptance. The participating bank becomes a guarantor of the credit of the accepting bank's customer.

110. An accepting bank that obtains a risk participation shall not derecognize the liability for the banker's acceptance, because the accepting bank is still primarily liable to the holder of the banker's acceptance even though it benefits from a guarantee of reimbursement by a participating bank. The accepting bank shall not derecognize the receivable from the customer because it has not transferred the receivable: it controls the benefits inherent in that receivable and it is still entitled to receive payment from the customer. The accepting bank shall, however, record the guarantee purchased, and the participating bank shall record a liability for the guarantee issued.

Illustration—Banker's Acceptance with a Risk Participation

111. An accepting bank assumes a liability to pay a customer's vendor and obtains a risk participation from another bank. The details of the banker's acceptance are provided below:

Facts

Face value of the draft provided to vendor	\$1,000
Term of the draft provided to vendor	90 days
Commission with an annual rate of 10 percent	25
Fee paid for risk participation	10

Journal Entries for Accepting Bank

At issuance of acceptance:

Receivable from customer	1,000	
Cash	25	
Time draft payable to vendor		1,000
Deferred acceptance commission revenue		25

At purchase of risk participation from a participating bank:

Guarantee purchased	10	
Cash		10

Upon presentation of the accepted time draft:

Time draft payable to vendor	1,000	
Deferred acceptance commission revenue	25	
Cash		1,000
Acceptance commission revenue		25

Upon collection from the customer (or the participating bank, if the customer defaults):

Cash	1,000	
Guarantee expense	10	
Receivable from customer		1,000
Guarantee purchased		10

Journal Entries for Participating Bank

Upon issuing the risk participation:

Cash	10	
Guarantee liability		10

Upon payment by the customer to the accepting bank:

Guarantee liability	10	
Guarantee revenue		10

OR:

In the event of total default by the customer:

Guarantee loss	990	
Guarantee liability	10	
Cash (paid to accepting bank)		1,000

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.

Appendix B

BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

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Appendix B: BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

Introduction

115. This appendix summarizes considerations that were deemed significant by Board members in reaching the conclusions in this Statement. It also summarizes the considerations that were deemed significant by Board members in reaching the conclusions in Statement 125. Most of those conclusions and considerations are carried forward without reconsideration. It includes reasons for accepting certain approaches and rejecting others. Individual Board members gave greater weight to some factors than to others.

Background to Statement 125

116. In recent years, transfers of financial assets in which the transferor has some continuing involvement with the transferred assets or with the transferee have grown in volume, variety, and complexity. Those transfers raise the issues of whether transferred financial assets should be considered to be sold and a related gain or loss recorded, whether the assets should be considered to be collateral for borrowings, or whether the transfer should not be recognized.

117. A transferor may sell financial assets and receive in exchange cash or other assets that are unrelated to the assets sold so that the transferor has no continuing involvement with the assets sold. Alternatively, an entity may borrow money and pledge financial assets as collateral, or a transferor may engage in any of a variety of transactions that transfer financial assets to another entity with the transferor having some continuing involvement with the assets transferred. Examples of continuing involvement are recourse or guarantee obligations, servicing, agreements to repurchase or redeem, retained subordinated interests, and put or call options on the assets transferred.

118. Many transactions disaggregate financial assets into separate components by creating undivided interests in pools of financial assets that frequently reflect multiple participations (often referred to as tranches) in a single pool. The components created may later be recombined to restore the original assets or may be combined with other financial assets to create still different assets.

119. An entity also may enter into transactions that change the characteristics of an asset that the entity continues to hold. An entity may sell part of an asset, or an undivided interest in the asset, and retain part of the asset. In some cases, it was not always clear what the accounting should have been.

120. An entity may settle a liability by transferring assets to a creditor and obtaining an unconditional release from the obligation. Alternatively, an entity may arrange for others to settle or set aside assets to settle a liability later. Those alternative arrangements have raised issues about when a liability is extinguished.

121. The Board previously provided guidance for two specific types of transfers of financial assets in FASB Statement No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse*, and in FASB Technical Bulletin No. 85-2, *Accounting for Collateralized Mortgage Obligations (CMOs)*. Confusion and inconsistency in accounting practices developed because the provisions of those two pronouncements provided seemingly conflicting guidance. In practice, if an entity sold financial assets to an SPE that issued debt securities, the guidance under Technical Bulletin 85-2 would be applied, and if any of those securities were obtained by the seller, the transaction would be accounted for as a borrowing. However, if the interests issued by the SPE were designated as participations instead of debt securities, the guidance in Statement 77 would be applied, and the transaction would be accounted for as a sale even if the seller retained recourse on some of the participations. Further, accounting for other types of transfers, whether developed by analogy to Statement 77 or Technical Bulletin 85-2, in industry practices codified in various AICPA audit and accounting Guides, in consensuses of the Emerging Issues Task Force (EITF), or in other ways, added to the confusion and inconsistency.

122. FASB Statement No. 76, *Extinguishment of Debt*, established accounting practices that (a) treat liabilities that are not fully settled as if they had been extinguished and (b) derecognize assets transferred to a trust even though the assets continue to benefit the transferor. Some criticized Statement 76 as being inconsistent with Statement 77; others disagreed.

123. The Board decided that it was necessary to reconsider Statements 76 and 77, Technical Bulletin 85-2, and other guidance and to develop new standards for transfers of financial assets and extinguishments of liabilities.

124. The Board added a project to its agenda in May 1986 to address those and other problems in accounting for financial instruments and off-balance-sheet financing. Statement 125 and this Statement, as part of that project, focus on accounting for transfers and servicing of financial assets and extinguishments of liabilities. The Financial Instruments Task Force, which was formed in January 1989, assisted in the preparation of a Discussion Memorandum on those issues and advised the Board in its deliberations. The FASB Discussion Memorandum, *Recognition and Measurement of Financial Instruments*, was issued in November 1991. The Board received 96 comment letters on the Discussion Memorandum. During 1994 and 1995, the Board discussed issues about transfers and servicing of financial assets and extinguishments of liabilities at numerous public meetings. The Financial Instruments Task Force reviewed drafts of the proposed Statement and discussed it with the Board at a public meeting in February 1995. The Financial Accounting Standards Advisory Council discussed a draft of the proposed Statement and advised the Board at public meetings. The Board also received requests from

constituents to discuss issues about credit card securitizations and securities lending transactions and repurchase agreements. The Board met with constituents interested in those issues at public meetings in November 1994 and April 1995.

125. In October 1995, the Board issued an Exposure Draft, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. The Board received 112 comment letters on the Exposure Draft, and 24 individuals and organizations presented their views at a public hearing held in February 1996. In addition, 10 enterprises participated in limited field-testing of the provisions of the Exposure Draft. The comments and test results were considered by the Board during its redeliberations of the issues addressed by the Exposure Draft in public meetings in 1996. The Financial Instruments Task Force reviewed a draft of the final Statement. Statement 125 was a result of those Board meetings and deliberations.

Background to This Statement

126. Statement 125 was issued in June 1996 and as issued was effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after December 31, 1996. In December 1996, the Board considered constituents' concerns about their ability to apply certain provisions of Statement 125 by that date, including (a) making the changes to information and accounting systems needed to apply the newly established accounting requirements and (b) effectively tracking supporting data. The Board noted those concerns and issued Statement 127 to defer for one year the effective date of paragraph 15 (addressing secured borrowings and collateral) for all transactions and paragraphs 9–12 (addressing transfers of financial assets) only for transfers of financial assets that are part of repurchase agreement, dollar-roll, securities lending, and similar transactions.

127. In December 1996, after considering other constituent concerns, the Board added to its agenda a project to interpret or possibly amend Statement 125. The project initially focused on the effect of EITF Issue No. 90-18, "Effect of a 'Removal of Accounts' Provision on the Accounting for a Credit Card Securitization," on accounting for credit card securitizations under Statement 125 and whether a removal-of-accounts provision (ROAP) maintains a transferor's effective control over transferred assets by entitling it to repurchase or redeem transferred assets that are not readily obtainable. The Board subsequently decided that the project also should consider several other issues concerning whether transfers of financial assets are accounted for as sales, including (a) the impact on isolation of transferred assets of the powers of the FDIC as receiver for a failed institution, (b) a transferee's right to sell or pledge transferred assets and the effect of conditions that constrain the transferee, (c) circumstances in which an SPE with some ability to sell transferred financial assets can be considered qualifying under the criteria in paragraph 26 of Statement 125, (d) the conditions for deciding whether assets transferred to a qualifying SPE and beneficial interests in those assets should appear in the consolidated financial statements of the transferor, and (e) a transferor's right to call a transferred financial asset that is not readily obtainable. In response to other concerns expressed by constituents, the Board also decided to consider (1) possible changes to the collateral provisions of paragraph 15 of

Statement 125, (2) possible enhanced disclosures for securitizations involving financial assets, and (3) possible exclusion of transfers of financial assets measured using the equity method of accounting from the scope of Statement 125. The Board concluded that resolution of those issues would require an amendment, rather than an interpretation, of Statement 125.

128. In June 1999, the Board issued an Exposure Draft, *Accounting for Transfers of Financial Assets*. The Board received 40 comment letters on the Exposure Draft. In addition, four enterprises and members of the Bond Market Association participated in limited field-testing of certain provisions of the Exposure Draft. The comment letters and test results were considered by the Board during its redeliberations of the issues addressed by the Exposure Draft in 16 public meetings in 1999 and 2000. The Board concluded that it could reach an informed decision on the basis of existing information without a public hearing. The Board decided to issue a final Statement that replaces, rather than amends, Statement 125 after some commentators suggested that that would improve the readability and usefulness of the Statement. The Financial Instruments Task Force and other interested parties reviewed a draft of the final Statement for clarity and operationality. This Statement is a result of those Board meetings and deliberations.

Benefits and Costs

129. The Board's mission statement charges the Board to determine that a proposed standard will fill a significant need and that the costs it imposes will be justified in relation to the overall benefits.

130. Previous practices in accounting for transfers of financial assets were inconsistent about the circumstances that distinguish sales from secured borrowings. The result was confusion on the part of both users and preparers of financial statements. Statement 125 and this Statement eliminate that inconsistency and reduce that confusion by distinguishing sales from secured borrowings based on the underlying contractual commitments and customs that determine substance. Much of the information needed to implement the accounting required by Statement 125 and carried forward without reconsideration in this Statement is substantially the same as that required for previous accounting and, therefore, should be available. Some of the information may not have been collected in accounting systems but is commonly obtained by sellers and buyers for use in negotiating transactions. Although there will be one-time costs for systems changes needed to apply the accounting required by this Statement, the benefits in terms of more credible, consistent, and understandable information will be ongoing.

131. In addition, in developing Statement 125 and this Statement, the Board considered how the costs incurred to implement their requirements could be minimized by, for example, (a) not requiring retroactive application of the initial measurement provisions of Statement 125 to existing servicing rights and excess servicing receivables, (b) carrying over without change the subsequent measurement (amortization and impairment) provisions of FASB Statement No. 122, *Accounting for Mortgage Servicing Rights*, (c) not requiring allocation of previous carrying amounts of assets partially sold based on relative fair values at acquisition, but rather at the date

of transfer, and (d) eliminating the requirement to recognize collateral because the limited benefits do not justify the burden of preparing the information. This Statement requires additional disclosures for securitizations, because events since the issuance of Statement 125 convinced the Board that the need of investors and creditors for better information justifies the costs other entities will incur in developing and reporting that information. Furthermore, many of those disclosures are already being made voluntarily by some entities. The Board is confident that the benefits derived from the accounting and disclosure required by Statement 125 and this Statement will outweigh the costs of implementation.

Approaches Considered in Developing Statement 125

132. The Board noted that the most difficult questions about accounting for transfers of financial assets concern the circumstances in which it is appropriate to remove previously recognized financial assets from the statement of financial position and to recognize gain or loss. One familiar approach to those questions views each financial asset as a unit that should not be derecognized until the risks and rewards that are embodied in that asset have been surrendered. Variations on that approach attempt to choose which risks and rewards are most critical and whether all or some major portion of those risks and rewards must be surrendered to allow derecognition.

133. In addition to reviewing U.S. accounting literature, the Board reviewed the approach described by the International Accounting Standards Committee (IASC) in its proposed International Accounting Standard, *Financial Instruments*, Exposure Draft E40 (1992), later revised as Exposure Draft E48 (1994). In E40, derecognition of financial assets and liabilities would have been permitted only upon the transfer to others of the underlying risks and rewards, presumably all risks and rewards. That approach could have resulted in an entity's continuing to recognize assets even though it had surrendered control over the assets to a successor entity. The approach in E40 was similar to that taken in Technical Bulletin 85-2. The Board concluded that the approaches proposed in E40 and provided in Technical Bulletin 85-2 were unsatisfactory because the result does not faithfully represent the effects of the transfer of assets and because of the potential for inconsistencies.

134. In response to comments received on E40, the IASC proposal was revised in E48 to require the transfer of *substantially all* risks and rewards. That modification did not overcome the inconsistency noted in paragraphs 130 and 133 of this Statement and would have added the prospect of difficulties in application because of the need to identify, measure, and weigh in the balance each of possibly many and varied risks and rewards embodied in a particular financial asset. The number of different risks and rewards would have varied depending on the definitions used. Questions would have arisen about whether each identified risk and reward should be substantially surrendered to allow derecognition, whether all risks should be aggregated separately from all rewards, and whether risks and rewards should somehow be offset and then combined for evaluation. That modification also might have led to wide variations in practice depending on how various entities interpreted *substantially all* in the necessarily subjective

evaluation of the aggregated, offset, and combined risks and rewards. Moreover, viewing each financial asset as an indivisible unit is contrary to the growing practice in financial markets of disaggregating individual financial assets or pools of financial assets into components. The IASC was still studying that issue in its financial instruments project when Statement 125 was issued.

135. In March 1997, the IASC issued jointly with the Canadian Institute of Chartered Accountants a comprehensive Discussion Paper, *Accounting for Financial Assets and Financial Liabilities*. Later in 1997, the IASC Board decided to pursue its financial instruments project along two paths. It joined with national standard setters, including the FASB, in a Joint Working Group to develop, integrate, and harmonize international accounting standards on financial instruments, building on the March 1997 Joint Discussion Paper. At the same time, the IASC decided to complete an interim international standard to serve until the integrated comprehensive standard is completed. In December 1998, the IASC issued that interim standard, IAS 39, *Financial Instruments: Recognition and Measurement*. The provisions for derecognition of a financial asset in that interim standard continue to focus on whether the transferor has retained, or the transferee has taken on, substantially all of the risks and rewards of ownership. The Joint Working Group has reached tentative conclusions on issues about transfers of financial assets that resemble the conclusions in Statement 125 in some respects, with less focus on risks and rewards, but that differ significantly in other respects. However, that group has yet to reach conclusions on certain issues and its work is still in progress. The tentative conclusions have not yet been exposed for public comment. Because (a) the comprehensive international project is still in that early stage, (b) the project has a broad scope including many other issues likely to prove controversial, and (c) the FASB project to amend Statement 125 was limited in scope and urgently needed, the Board did not consider in this project whether to replace the fundamental principles of Statement 125 with the principles being developed internationally. The Board plans to join the other members of the Joint Working Group in circulating that group's document for public comment, after which the Board expects to consider what further steps it should take.

136. In developing Statement 125, the Board noted that application of a risks-and-rewards approach for derecognizing financial assets would be highly dependent on the sequence of transactions leading to their acquisition. For example, if Entity A initially acquired an undivided subordinated interest in a pool of financial assets, it would recognize that subordinated interest as a single asset. If, on the other hand, Entity B initially acquired a pool of financial assets identical to the pool in which Entity A participates, then sold a senior interest in the pool and continued to hold a subordinated interest identical to the undivided interest held by Entity A, Entity B might be judged under a risks-and-rewards approach to have retained substantially all the risks of the entire pool. Thus, Entity B would carry in its statement of financial position the entire pool of financial assets as well as an obligation equal to the proceeds from the sale of the undivided senior interest, while Entity A would report its identical position quite differently. Those accounting results would disregard one of the fundamental tenets of the Board's conceptual framework; that is, ". . . accountants must not disguise real differences nor create false differences." ²⁴

137. The Board also considered the approach required by the United Kingdom's Accounting Standards Board in Financial Reporting Standard No. 5, *Reporting the Substance of Transactions*, a variation of the risks-and-rewards approach that requires the surrender of substantially all risks and rewards for derecognition of financial assets but permits, in limited circumstances, the use of a *linked presentation*. Use of the linked presentation is restricted to circumstances in which an entity borrows funds to be repaid from the proceeds of pledged financial assets, any excess proceeds go to the borrower, and the lender has no recourse to other assets of the borrower. In those circumstances, the pledged assets remain on the borrower's statement of financial position, but the unpaid borrowing is reported as a deduction from the pledged assets rather than as a liability; no gain or loss is recognized. That approach had some appeal to the Board because it would have highlighted significant information about transactions that many believe have characteristics of both sales and secured borrowings. The Board observed, however, that the linked presentation would not have dealt with many of the problems created by the risks-and-rewards approach. Further, the Board concluded that it is not appropriate for an entity to offset restricted assets against a liability or to derecognize a liability merely because assets are dedicated to its repayment, as discussed in paragraphs 309–312.

138. Statement 77 based the determination of whether to derecognize receivables on transfer of control instead of on evaluation of risks and rewards. Statement 125 and this Statement take a similar approach. However, Statement 77 was narrowly focused on sales of receivables with recourse and did not address other transfers of financial assets. Also, the derecognition of receivables under that Statement could depend on the sequence of transactions that led to their acquisition or on whether any options were involved. The Board concluded that simply superseding Technical Bulletin 85-2 and allowing Statement 77 to remain in effect would not have dealt adequately with the issues about transfers of financial assets.

139. Statement 76 followed a risks-and-rewards approach in requiring that (a) it be probable that a debtor would not be required to make future payments with respect to the debt under any guarantees and (b) an in-substance defeasance trust be restricted to owning only monetary assets that are risk free with cash flows that approximately coincide, as to timing and amount, with the scheduled interest and principal payments on the debt being extinguished. The Board concluded that that approach was inconsistent with the financial-components approach that focuses on control developed in this Statement (paragraphs 309–312). As a result, the Board decided to supersede Statement 76 but to carry forward those of its criteria that could be modified to conform to the financial-components approach.

140. The considerations discussed in paragraphs 132–139 led the Board to seek an alternative to the risks-and-rewards approach and variations to that approach.

Objectives of the Financial-Components Approach

141. The Board concluded in Statement 125 that it was necessary to develop an approach that

would be responsive to current developments in the financial markets to achieve consistent accounting for transfers and servicing of financial assets and extinguishments of liabilities. That approach—the financial-components approach—is designed to:

- a. Be consistent with the way participants in the financial markets deal with financial assets, including the combination and separation of components of those assets
- b. Reflect the economic consequences of contractual provisions underlying financial assets and liabilities
- c. Conform to the FASB conceptual framework.

142. The approach analyzes a transfer of a financial asset by examining the component assets (controlled economic benefits) and liabilities (present obligations for probable future sacrifices of economic benefits) that exist after the transfer. Each party to the transfer recognizes the assets and liabilities that it controls after the transfer and no longer recognizes the assets and liabilities that were surrendered or extinguished in the transfer. That approach has some antecedents in existing accounting guidance, for example, in EITF Issue No. 88-11, "Allocation of Recorded Investment When a Loan or Part of a Loan Is Sold." The Board identified the concepts set forth in paragraphs 143–145 as an appropriate basis for the financial-components approach.

Conceptual Basis for the Financial-Components Approach

143. FASB Concepts Statement No. 6, *Elements of Financial Statements*, states the following about assets:

Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. [Paragraph 25, footnote reference omitted.]

Every asset is an asset of some entity; moreover, no asset can simultaneously be an asset of more than one entity, although a particular physical thing or other agent [for example, contractual rights and obligations] that provides future economic benefit may provide separate benefits to two or more entities at the same time. . . . To have an asset, an entity must control future economic benefit to the extent that it can benefit from the asset and generally can deny or regulate access to that benefit by others, for example, by permitting access only at a price.

Thus, *an asset of an entity is the future economic benefit that the entity can control and thus can, within limits set by the nature of the benefit or the entity's right to it, use as it pleases.* The entity having an asset is the one that can exchange it, use it to produce goods or services, exact a price for others' use of it, use it to settle liabilities, hold it, or perhaps distribute it to owners.

The definition of assets focuses primarily on the future economic benefit to which an entity has access and only secondarily on the physical things and other agents that provide future economic benefits. *Many physical things and other*

agents are in effect bundles of future economic benefits that can be unbundled in various ways, and two or more entities may have different future economic benefits from the same agent at the same time or the same continuing future economic benefit at different times. For example, two or more entities may have undivided interests in a parcel of land. Each has a right to future economic benefit that may qualify as an asset under the definition in paragraph 25, even though the right of each is subject at least to some extent to the rights of the other(s). Or, one entity may have the right to the interest from an investment, while another has the right to the principal. [Paragraphs 183–185; emphasis added.]

144. Concepts Statement 6 states the following about liabilities:

Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. [Paragraph 35, footnote references omitted.]

Most liabilities are obligations of only one entity at a time. Some liabilities are shared—for example, two or more entities may be "jointly and severally liable" for a debt or for the unsatisfied liabilities of a partnership. But most liabilities bind a single entity, and those that bind two or more entities are commonly ranked rather than shared. For example, *a primary debtor and a guarantor may both be obligated for a debt, but they do not have the same obligation—the guarantor must pay only if the primary debtor defaults and thus has a contingent or secondary obligation*, which ranks lower than that of the primary debtor.

Secondary, and perhaps even lower ranked, obligations may qualify as liabilities under the definition in paragraph 35, but recognition considerations are highly significant in deciding whether they should formally be included in financial statements because of the effects of uncertainty (paragraphs 44–48). For example, the probability that a secondary or lower ranked obligation will actually have to be paid must be assessed to apply the definition. [Paragraphs 204 and 205; emphasis added.]

145. Financial assets and liabilities are assets and liabilities that qualify as financial instruments as defined in paragraph 3 of FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*:

A financial instrument is defined as cash, evidence of an ownership interest in an entity, or a contract that both:

- a. Imposes on one entity a contractual obligation (1) to deliver cash or another financial instrument to a second entity or (2) to exchange other financial

instruments on potentially unfavorable terms with the second entity

- b. Conveys to that second entity a contractual right (1) to receive cash or another financial instrument from the first entity or (2) to exchange other financial instruments on potentially favorable terms with the first entity. [Footnote references omitted.]

146. Based on the concepts and definitions cited in paragraphs 143–145, the Board concluded that the key to applying the financial-components approach can be summarized as follows:

- a. The economic benefits provided by a financial asset (generally, the right to future cash flows) are derived from the contractual provisions that underlie that asset, and the entity that controls those benefits should recognize them as its asset.
- b. A financial asset should be considered sold and therefore should be derecognized if it is transferred and control is surrendered.
- c. A transferred financial asset should be considered pledged as collateral to secure an obligation of the transferor (and therefore should not be derecognized) if the transferor has not surrendered control of the financial asset.
- d. Each liability should be recognized by the entity that is primarily liable and, accordingly, an entity that guarantees another entity's obligation should recognize only its obligation to perform on the guarantee.
- e. The recognition of financial assets and liabilities should not be affected by the sequence of transactions that led to their existence unless as a result of those transactions the transferor maintains effective control over a transferred asset.
- f. Transferors and transferees should account symmetrically for transfers of financial assets.

147. Most respondents to the Exposure Draft of Statement 125 generally supported the financial-components approach, especially as it applies to securitization transactions.

148. The concepts underlying the financial-components approach could be applied by analogy to accounting for transfers of nonfinancial assets and thus could result in accounting that differs significantly from that required by existing standards and practices. However, the Board believes that financial and nonfinancial assets have significantly different characteristics, and it is not clear to what extent the financial-components approach is applicable to nonfinancial assets. Nonfinancial assets have a variety of operational uses, and management skill plays a considerable role in obtaining the greatest value from those assets. In contrast, financial assets have no operational use. They may facilitate operations, and financial assets may be the principal “product” offered by some entities. However, the promise embodied in a financial asset is governed by contract. Once the contract is established, management skill plays a limited role in the entity’s ability to realize the value of the instrument. Furthermore, the Board believes that attempting to extend Statement 125 and this Statement to transfers of nonfinancial assets would unduly delay resolving the issues for transfers of financial assets, because of the significant differences between financial assets and nonfinancial assets and because of the significant unresolved recognition and measurement issues posed by those differences. For

those reasons, the Board concluded that existing accounting practices for transfers of nonfinancial assets should not be changed at this time. The Board further concluded that transfers of servicing assets and transfers of property subject to operating leases are not within the scope of Statement 125 and this Statement because they are nonfinancial assets.

149. The following paragraphs discuss the application of the concepts and principles described in paragraphs 143–148, both as the concepts and principles were applied initially in Statement 125 and as they are, in some cases, applied differently in this Statement. First, circumstances that require derecognition of transferred assets and recognition of assets and liabilities received in exchange are discussed in the paragraphs about sales of financial assets, transfers to SPEs, and other transfers (paragraphs 150–264). Then, the measurement of assets controlled and liabilities incurred (paragraphs 265–305) and subsequent measurement (paragraphs 306–308) are discussed. Finally, extinguishments of liabilities are discussed (paragraphs 309–315).

Sales of Financial Assets

150. If an entity transfers financial assets, surrenders control of those assets to a successor entity, and has no continuing involvement with those assets, accounting for the transaction as a sale and derecognizing the assets and recognizing the related gain or loss is not controversial. However, accounting for transfers of financial assets has been controversial and inconsistent in circumstances in which an entity transfers only a partial interest in a financial asset or has some other continuing involvement with the transferred asset or the transferee.

151. Under the financial-components approach, the accounting for a transfer is based on whether a transferor surrenders control of financial assets. Paragraph 3 of Statement 77 states, “This Statement establishes standards of financial accounting and reporting by transferors for transfers of receivables with recourse that *purport to be sales* of receivables” (emphasis added). The Board believes that, while it may have some significance at law, a more exacting test than whether a transaction purports to be a sale is needed to conclude that control has been surrendered in a manner that is consistent with the definitions in Concepts Statement 6. The Board concluded that a sale occurs only if control has been surrendered to another entity or group of entities and that surrender of control depends on whether (a) transferred assets have been isolated from the transferor, (b) transferees have obtained the right to pledge or exchange either the transferred assets or beneficial interests in the transferred assets, and (c) the transferor does not maintain effective control over the transferred assets through an agreement to repurchase or redeem them before their maturity or through the ability to unilaterally cause the holder to return specific assets.

Isolation beyond the Reach of the Transferor, Even in Bankruptcy or Other Receivership

152. The Board developed its criterion that transferred assets must be isolated—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership (paragraph 9(a))—in large part with reference to securitization practices. Credit

rating agencies and investors in securitized assets pay close attention to (a) the possibility of bankruptcy or other receivership of the transferor, its affiliates, or the SPE, even though that possibility may seem unlikely given the present credit standing of the transferor, and (b) what might happen in such a receivership, because those are major areas of risk for them. If certain receivers can reclaim securitized assets, investors will suffer a delay in payments due them and may be forced to accept a pro rata settlement. Credit rating agencies and investors commonly demand transaction structures that minimize those possibilities and sometimes seek assurances from attorneys about whether entities can be forced into receivership, what the powers of a receiver might be, and whether the transaction structure would withstand receivers' attempts to reach the securitized assets in ways that would harm investors. Unsatisfactory structures or assurances commonly result in credit ratings that are no higher than those for the transferor's liabilities and in lower prices for transferred assets.

153. Because legal isolation of transferred assets has substance, the Board decided that it could and should serve as an important part of the basis for determining whether a sale should be recognized. Some constituents expressed concern about the feasibility of an accounting standard based on those legal considerations, but the Board concluded that having to consider only the evidence available should make that requirement workable.

154. Respondents to the Exposure Draft of Statement 125 raised several questions about the application of the isolation criterion in paragraph 9(a) to existing securitization structures. The questions included whether it was necessary to consider separately the accounting by the first-tier SPE, whose transfer to the second-tier trust taken by itself might not satisfy the isolation test. After considering those comments and consulting with respondents who specialize in the structure of securitization transactions, the Board concluded that related language in Appendix A should be revised to explain that that criterion can be satisfied either by a single transaction or by a series of transactions considered as a whole. As discussed in paragraphs 80–84, the Board understands that the series of transactions in a typical two-tier structure taken as a whole may satisfy the isolation test because the design of the structure achieves isolation.

155. The Board understands that a one-tier structure with significant continuing involvement by a transferor subject to the U.S. Bankruptcy Code might not satisfy the isolation test, because a trustee in bankruptcy has substantial powers that could alter amounts that investors might receive and thus it may be difficult to conclude that control has been relinquished. Some respondents argued that a one-tier structure with continuing involvement generally should be adequate if the transferor's credit rating is sufficiently high that the chance of sudden bankruptcy is remote. The Board did not accept that view because isolation should not depend on the credit standing of the transferor.

156. Some constituents questioned whether the term *affiliates* was used in Statement 125 in the same sense as it was used in FASB Statement No. 57, *Related Party Disclosures*, or more narrowly. Their concerns included, for example, how the meaning of that term might affect whether a transfer from a subsidiary to a sister subsidiary, which would be eliminated in the

consolidated financial statements of their common parent, could ever qualify as a sale in the separate financial statements of the transferring subsidiary. The Board chose to clarify that matter by (a) revising the discussion in paragraph 27 of this Statement to emphasize that whether a transfer has isolated the transferred assets can depend on which financial statements are being presented and (b) introducing the term *consolidated affiliate of the transferor* where the Board intended a narrower sense than *affiliate* as used in Statement 57.

If the FDIC Is Receiver

157. During the deliberations leading up to the issuance of Statement 125, constituents asked the Board to explain how the criterion in paragraph 9(a) applied to transfers by institutions subject to possible receivership by the FDIC, in view of the limited, special powers of the FDIC to repudiate certain contracts. The Board's understanding at the time Statement 125 was issued was that financial assets transferred by a U.S. bank were not subject to an automatic stay under FDIC receivership and that the receiver could only obtain those assets if it makes the investors whole, that is, by paying them compensation equivalent to all the economic benefits embodied in the transferred assets (principal and interest earned to date). Based on that understanding, the Board concluded, as explained in paragraphs 58 and 121 of Statement 125, that those limited powers appeared insufficient to place transferred assets within reach of the receiver and, therefore, assets transferred subject to those powers could be considered isolated from their transferor.

158. In implementing Statement 125, the Board's earlier understanding of the powers of the FDIC, as explained in paragraphs 58 and 121 of Statement 125, was called into question. During 1998, the Board learned the following from attorneys specializing in FDIC matters and from members of the FDIC staff:

- a. The FDIC's practice in repudiating contracts has most often been to pay principal and interest *to date of payment*, unless the assets have been fraudulently conveyed or conveyed to an affiliate under improper circumstances. However, the FDIC has the power to repudiate contracts that it characterizes as secured borrowings and, thereby, reclaim transferred assets by paying principal and interest *to the date of receivership*, which may be as many as 180 days before the date of payment.
- b. Relevant statutes require, in the case of certain repurchase agreements and similar contracts characterized as *qualified financial contracts*, that the FDIC pay all reasonably expected damages to repudiate those contracts. Therefore, the FDIC has to pay at least principal and interest *to date of payment* on those contracts.
- c. Attorneys generally have been unable to provide opinions sufficient to satisfy preparers and auditors that many kinds of transfers of financial assets by financial institutions subject to the powers of the FDIC have isolated those assets. It is unclear in which circumstances attorneys might be able to provide such opinions for certain other transfers of financial assets by those institutions.

159. Based on that new information, the Board decided that this issue required reconsideration.

The Board considered whether the FDIC's powers to reclaim transferred assets by paying principal and interest to date of receivership were still limited enough that transferred assets potentially subject to those powers could be considered isolated. The Board rejected the possibility of modifying the observations in paragraphs 58 and 121 of Statement 125 to indicate that a receiver's right to reclaim transferred assets by paying principal and interest *to date of receivership* does not preclude sale accounting because that would selectively weaken the standard of isolation and impair comparability across industries. Instead, the Board decided that any discussion about the FDIC's powers should simply reiterate, perhaps more clearly, that transferred financial assets subject to the limited power of a receiver to reclaim them could be considered isolated only if the receiver would have to pay at least principal and interest *to date of payment*.

160. After that decision, representatives of the FDIC, the Auditing Standards Board of the AICPA, banks, and the securities bar discussed what actions, if any, the FDIC could take that would alleviate those legal, auditing, and accounting difficulties. In July 2000, the FDIC adopted, after public comment and other due process, a final rule, *Treatment by the Federal Deposit Insurance Corporation as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection with a Securitization or Participation*. That final rule modifies the FDIC's powers so that, subject to certain conditions, it shall not recover, reclaim, or recharacterize as property of the institution or the receivership any financial assets transferred by an insured depository institution in connection with a securitization or participation. The final rule also states that the FDIC may repeal or amend that final rule but that any such repeal or amendment would not apply to any transfers of financial assets made in connection with a securitization or participation that was in effect before such repeal or amendment. In view of that final rule and after consultation with other affected parties, the Board concluded that specific guidance about the effect of the FDIC's powers as receiver on the isolation of transferred assets would no longer be needed. Therefore, this Statement removes that specific guidance.

Transferee's Rights to Pledge or Exchange

161. The second criterion (paragraph 9(b)) for a transfer to be a sale focuses on whether the transferee has the right to pledge or exchange the transferred assets. That criterion is consistent with the idea that the entity that has an asset is the one that can use it in the various ways set forth in Concepts Statement 6, paragraph 184 (quoted in paragraph 143 of this Statement). A transferee may be able to use a transferred asset in some of those ways but not in others. Therefore, establishing criteria for determining whether control has been relinquished to a transferee necessarily depends in part on identifying which ways of using the kind of asset transferred are the decisive ones. In the case of transfers of financial assets, the transferee holds the assets, but that is not necessarily decisive because the economic benefits of financial assets consist primarily of future cash inflows. The Board concluded that the ways of using assets that are important in determining whether a transferee holding a financial asset controls it are the ability to exchange it or pledge it as collateral and thus obtain all or most of the cash inflows that

are the primary economic benefits of financial assets. As discussed in paragraph 173, if the transferee is a qualifying SPE, the ultimate holders of the assets are the beneficial interest holders (BIHs), and the important rights concern their ability to exchange or pledge their interests.

162. The Exposure Draft of Statement 125 proposed that a transferee be required to have the right—free of transferor-imposed conditions—to pledge or exchange the transferred assets for a transfer to qualify as a sale. Respondents to the Exposure Draft observed that some transferor-imposed conditions may not indicate that the transferor retains control over the assets transferred. The respondents suggested that some conditions are imposed for business or competitive purposes, not to keep control over future economic benefits of the transferred assets, and that those conditions should not preclude a transfer from being accounted for as a sale. Other respondents noted that not all conditions that might limit a transferee’s ability to take advantage of a right to pledge or exchange transferred assets were necessarily imposed by the transferor. The Board decided that the criterion should not be restricted to being transferor imposed and that some conditions, described in paragraph 25 of Statement 125, should not disqualify a transaction, so long as those conditions do not constrain the transferee from taking advantage of its right to pledge or exchange the transferred assets.

163. In implementing Statement 125, two issues emerged relating to its second criterion for recognizing a transfer of financial assets as a sale (paragraph 9(b)(1) of Statement 125). The first issue was what types of constraints on the transferee’s right to pledge or exchange transferred assets preclude sale accounting. The second issue was whether a transferee must obtain *either* the right to pledge transferred assets *or* the right to exchange them or whether a transferee must obtain *both* rights for the transfer to qualify for sale accounting.

164. The Board questioned whether sale accounting should be precluded because of a constraint on the transferee’s ability to sell or pledge that does not benefit the transferor. The Board concluded that unless the constraint provides more than a trivial benefit to the transferor, it does not affect whether the transferor has surrendered control and, therefore, there is little reason for the transferor to continue recognizing the transferred asset. Consequently, such constraints should not preclude sale accounting.

165. Whether a constraint is of more than trivial benefit to the transferor may not always be clear. The Board reasoned that transferors incur costs if they impose constraints, since transferees presumably pay less than they would pay to obtain the asset without constraint. Transferors presumably incur those costs for good reasons. The Board therefore concluded that, absent evidence to the contrary, imposition of a constraint by a transferor results in a more than trivial benefit to the transferor.

166. However, it is not so clear whether conditions not imposed by the transferor constrain the transferee *and* benefit the transferor. The Board considered four possibilities. First, Statement 125 could have been left unchanged, and therefore it would have continued to preclude sale

accounting if any condition constrained the transferee, even if the transferor did not somehow benefit. The Board rejected that first possibility because transferred assets from which the transferor can obtain no further benefits are no longer its assets and should be removed from its statement of financial position. Second, the Board could have returned to the provisions proposed in the Exposure Draft of Statement 125, under which conditions not imposed by the transferor that constrain the transferee have no effect on the accounting. The Board rejected that second possibility because it would have excluded from the transferor's statement of financial position some assets from which, through the constraint, it still can obtain future benefits. Third, the Board could have precluded sale accounting for conditions not imposed by the transferor that constrain the transferee, unless the transferor has no continuing involvement with the transferred assets. The Board rejected that third possibility, even though it avoided the problems of the first two possibilities, because it seemed in conflict with the financial-components approach and would have required resolving numerous issues including whether some types of continuing involvement are so minor that they should not preclude sale accounting. The fourth possibility, which the Board adopted because it avoided the problems of the other three possibilities, was to preclude sale accounting for conditions not imposed by the transferor that constrain the transferee only if the constraint is known to the transferor and it is evident that the transferor, directly or indirectly, obtains a more than trivial benefit from those constraints. While some respondents to the Exposure Draft for this Statement raised issues about the difficulty in making judgments about whether a transferor is aware of a constraint and whether a benefit to the transferor is more than trivial, the Board concluded that the fourth possibility is nonetheless the best of the alternatives and reaffirmed that conclusion.

167. As discussed in paragraphs 32 and 33, assessing whether an option to reacquire a transferred asset constrains a transferee's apparent right to pledge or exchange transferred assets requires judgment. Despite the challenges of making such judgments in practice, the Board concluded that some options do constrain a transferee and benefit a transferor so that a transferor remained in control, and others do not. Whether they do or do not can only be assessed after considering all the relevant facts and circumstances. The Board reasoned that if, for example, a call option is sufficiently deep-in-the-money, the transferee would be more likely to have to hold the assets to comply with a potential exercise of the call. Conversely, even though it technically conveys no right to a transferor, a put option written by the transferor to the transferee on assets not readily obtainable elsewhere might constrain a transferee if, for example, it is sufficiently deep-in-the-money that it would be imprudent for the transferee to sell the assets for the market price rather than holding it to get the much higher put price from the transferor. The Board concluded that that assessment of whether an option constrains a transferee need only be made at the date of transfer because it was impractical to require that the transferor reevaluate the written call or put option after the transfer date, and if prices changed sufficiently that a call that did not initially constrain the transferee subsequently went into-the-money, it might not matter because the transferee might already have sold the transferred assets.

168. Paragraph 9(b)(1) of Statement 125 established a criterion that, for sale treatment, the transferee be able to pledge *or* exchange the transferred assets. Some constituents found that

criterion ambiguous for (a) certain transfers after which transferees have the right to pledge the transferred assets but not to exchange them and (b) other transfers after which the transferees are permitted to exchange transferred assets but not to pledge them. Some constituents contended that because the implementation guidance in paragraph 25 of Statement 125 included no mention of pledging in its examples of when a transferee is constrained, the Board must have meant that the test of paragraph 9(b)(1) could be failed exclusively by lack of the unconstrained right to exchange the asset, implying that the transferee must have both the right to pledge and the right to exchange to qualify for sale treatment under that criterion. The Board intended that the *or* in that test should be inclusive, indicating in paragraph 122 of Statement 125 (and carried forward in paragraph 161 of this Statement) that the ability to obtain all or most of the cash inflows that are the primary economic benefits of a financial asset, whether by exchanging it or pledging it as collateral, is what is important in determining whether a transferee controls a financial asset.

169. The Board revisited the “exchange *or* pledge” question and again in developing this Statement concluded that the criterion in paragraph 9(b) is inclusive: it is the ability to obtain all or most of the cash inflows, *either* by exchanging the transferred asset *or* by pledging it as collateral. The Board was concerned that requiring both the ability to pledge and the ability to exchange would, for example, permit some transferors to opt out of sale accounting by simply adding a prohibition—unimportant to that transferee—against pledging the asset.

Settlement Date and Trade Date Accounting

170. Many transfers of financial assets have been recognized at the settlement date. During its redeliberations of Statement 125, the Board discussed the implications of that Statement on trade date accounting for certain securities transactions and concluded that Statement 125 did not set out to address that issue. Therefore, the Board decided that Statement 125 should not modify generally accepted accounting principles, including FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, and AICPA Statements of Position and audit and accounting Guides for certain industries, that require accounting at the trade date for certain contracts to purchase or sell securities. That decision is carried forward without reconsideration in this Statement.

Transfers to Qualifying SPEs, including Securitizations

171. Many transfers of financial assets are to qualifying SPEs of the type described in paragraph 26 of Statement 125 (paragraph 35 of this Statement). After those transfers, the qualifying SPE holds legal title to the transferred assets but does not have the right to pledge or exchange the transferred assets free of constraints. Rather, the activities of the qualifying SPE are limited to carrying out the provisions of the legal documents that established it. One significant purpose of those limitations on activities often is to make remote the possibility that a qualifying SPE could enter bankruptcy or other receivership, even if the transferor were to enter receivership.

172. Some commentators asked whether the qualifying SPE criteria apply to entities formed for

purposes other than transfers of financial assets. The Board decided that the description of a qualifying SPE in paragraph 26 of Statement 125 should be restrictive. Transfers to entities that meet all of the conditions in paragraph 26 of Statement 125 may qualify for sale accounting under paragraph 9 of Statement 125. Other entities with some similar characteristics also might be broadly described as “special-purpose.” For example, an entity might be formed for the purpose of holding specific nonfinancial assets and liabilities or carrying on particular commercial activities. The Board decided that those entities are not qualifying SPEs under Statement 125 nor under this Statement and that the accounting for transfers of financial assets to SPEs should not be extended to transfers to any entity that does not satisfy all of the conditions in paragraph 26 of Statement 125 (paragraph 35 of this Statement).

173. Qualifying SPEs issue beneficial interests of various kinds—variously characterized as debt, participations, residual interests, and otherwise—as required by the provisions of those agreements. Holders of beneficial interests in the qualifying SPE have the right to pledge or exchange those interests but do not control the individual assets held by the qualifying SPE. The effect of establishing the qualifying SPE is to merge the contractual rights in the transferred assets and to allocate undivided interests in them—the beneficial interests. Therefore, the right of holders to pledge or exchange those beneficial interests is the counterpart of the right of a transferee to pledge or exchange the transferred assets themselves.

174. Sometimes financial assets, especially mortgage loans, are securitized and the transferor retains all of the beneficial interests in the qualifying SPE as securities. The objective is to increase financial flexibility because securities are more liquid and can more readily be sold or pledged as collateral to secure borrowings. In some cases, securitization may reduce regulatory capital requirements. The Board concluded that transfers of financial assets to a qualifying SPE, including securitizations, should qualify as sales only to the extent that consideration other than beneficial interests in the transferred assets is received.

The Conditions for a Qualifying SPE

175. One condition for sale accounting in Statement 125 was that the transferee must obtain “the right—free of conditions that constrain it from taking advantage of that right. . .—to pledge or exchange the transferred assets” (Statement 125, paragraph 9(b)(1)). In developing that criterion, the Board reasoned that the transferee’s ability to control the transferred financial assets provides strong evidence that the transferor has surrendered control. However, one principal objective of Statement 125 was to address the accounting for securitization transactions; the Board recognized that often the transferee in a securitization is a trust, corporation, or other legal vehicle (an SPE) that can engage in only limited activities and, therefore, is typically constrained from pledging or exchanging the transferred asset. The Board decided that some transfers to SPEs should qualify for sale accounting and, therefore, developed in Statement 125 the idea of a qualifying SPE.

176. Under Statement 125, a trust, corporation, or other legal vehicle that has a standing at law

distinct from the transferor and whose activities are permanently limited by the legal documents establishing it to those identified in paragraph 26 of Statement 125 (and reconsidered in this Statement in paragraph 35) is a qualifying SPE. The Board observed that “the effect of establishing the qualifying special-purpose entity is to merge the contractual rights in the transferred assets and to allocate undivided interests in them—the beneficial interests” (Statement 125, paragraph 127). The Board reached that conclusion in part because a qualifying SPE “does not have the right to pledge or exchange the transferred assets” (paragraph 125 of Statement 125, reconsidered in this Statement in paragraph 171), a right that would involve its acting as an operating entity. Therefore, the Board observed that if the transferee is a qualifying SPE, the assets are legally owned by the trustee on behalf of those parties having a beneficial interest in the assets, and the right of those BIHs to pledge or exchange their beneficial interests is the counterpart of the right of an ordinary transferee (for example, an entity other than a qualifying SPE) to pledge or exchange the transferred assets themselves.

177. When Statement 125 was issued, the Board’s understanding was that the activities of most SPEs used in securitization transactions were limited to those identified in paragraph 26 of Statement 125. After Statement 125 was issued, commentators expressed concern that many SPEs that are transferees in securitization transactions have more and different powers than those described in that paragraph.

178. In response to that concern, the FASB staff developed an announcement issued as EITF Topic No. D-66, “Effect of a Special-Purpose Entity’s Powers to Sell, Exchange, Repledge, or Distribute Transferred Financial Assets under FASB Statement No. 125,” in January 1998. While the FASB staff was developing that announcement, it became apparent that some SPEs engage in activities such as selling transferred assets and refinancing or reselling the rights to transferred financial assets. While the Board did not object to the issuance of Topic D-66 as an interim step, the Board recognized that it raised significant issues that warranted consideration as part of its project to amend Statement 125.

179. In 1998 and 1999, the Board reconsidered how it could better distinguish between qualifying SPEs, transfers to which fell under paragraph 9(b)(2) of Statement 125, and other entities, transfers to which fell under paragraph 9(b)(1) of Statement 125. The Board reviewed the various powers held and activities engaged in by SPEs whose primary purpose is limited to passively holding financial assets on behalf of BIHs in those assets. The Board concluded that some powers and activities are appropriate or even necessary to support that primary purpose, while other powers and activities are unnecessary or even inappropriate for that purpose. The Board developed a revised notion of *qualifying SPE* based on that conclusion. The Board identified four conditions necessary for an SPE to be a qualifying SPE under this Statement. Those conditions must be present in order for it to be appropriate to look through the qualifying SPE to the BIHs and their ability to pledge or exchange their interests to determine sale accounting.

Need to Be Demonstrably Distinct from the Transferor

180. The first condition is that a qualifying SPE must be demonstrably distinct from the transferor. One of the original conditions for being a qualifying SPE in Statement 125, carried over in the Exposure Draft for this Statement, required a qualifying SPE to have distinct standing at law. Commentators urged the Board to replace that notion with the requirement that the transferor not be able to unilaterally dissolve an SPE as a condition for qualifying status. Those commentators argued that (a) *distinct standing at law* does not seem to have a uniform meaning that could be an acceptable basis upon which to build a standard, (b) distinct standing at law is possible without a third-party investor and could be achieved in some cases by simply pledging collateral, (c) a standard that enables accountants to determine, through analyzing the provisions of a trust agreement, whether or not the termination and dissolution of the trust are within the control of the transferor would be preferable, and (d) attorneys cannot opine on the concept of “distinct standing at law” by using case law or legal references because it is not an established legal concept. In lieu of *distinct standing at law*, some commentators suggested that the Board develop a notion based on the premise that no accounting recognition should be given to a transaction with an SPE unless a third party is involved. A number of constituents went further to suggest that there be some minimum level of outside beneficial interests.

181. The Board considered those suggestions and concluded that requiring that a qualifying SPE have a minimum level of outside beneficial interests is a useful concept. The Board reasoned that a required minimum outside beneficial interest is consistent with the idea that an ownership interest has been transferred and gave substance to the qualifying SPE’s limitations in that another party is relying on those limitations. But to be operational, it was necessary to determine the minimum percentage of outside beneficial interests. After considering the characteristics of common securitization SPEs, the Board chose not to set a high minimum percentage, in part because, while most common securitization SPEs have outside interests in excess of two-thirds much of the time, they do not maintain that level during ramp-up and wind-down phases or, in some cases, during seasonal variations in the levels of assets in the trust. The Board concluded that its objective in requiring a minimum outside beneficial interest is to establish that the qualifying SPE is demonstrably distinct from the transferor. The Board decided that if at least 10 percent of the interests in the transferred assets (or 10 percent of the interests in a series in the master trust) were currently held by third parties and if the transferor could not unilaterally dissolve the SPE, that is sufficient evidence to demonstrate that the SPE is demonstrably distinct from the transferor, its affiliates, or its agents. The Board settled on the 10 percent level, not because it was grounded in any particular literature, but because it appeared sufficient to demonstrate that the transferee is distinct from the transferor.

182. In connection with its discussion of minimum outside beneficial interest, the Board was asked whether a guarantee, if it is the only outside beneficial interest and worth less than 10 percent of the total value of the securitization, was sufficient to demonstrate that an SPE was distinct from the transferor. Some commentators mentioned “swap-and-hold” securitizations, in which the transferor takes back and retains all the mortgage-backed securities. The Board decided to make an exception to the 10 percent minimum for what this Statement refers to as a

guaranteed mortgage securitization, a securitization of mortgage loans that is within the scope of FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, as amended, and includes a substantive guarantee by a third party. While a substantive guarantee by a third party clearly can have significant impact on the value and liquidity of the interests retained in guaranteed mortgage securitizations, which is consistent with the conclusion that the SPE is demonstrably distinct from the transferor, that impact is not the primary reason for this exception. Instead, the Board made that exception primarily in view of the long history of specialized accounting for mortgage banking activities, including its recent reconsideration of the measurement of retained mortgage-backed securities in FASB Statement No. 134, *Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise*.

183. The Board considered extending that exception to other kinds of securitizations, for example, securitizations using nonqualifying SPEs or securitizations of assets that do not arise from mortgage banking activities, but decided that that exception should not be extended, even by analogy in practice. That resolves an issue that was the subject of proposed FASB Technical Bulletin 99-a, *Classification and Measurement of Financial Assets Securitized Using a Special-Purpose Entity*, issued for comment on August 11, 1999, but not issued in final form.

Limits on Permitted Activities

184. The second condition is that the permitted activities of a qualifying SPE are significantly limited, were entirely specified in the legal documents that established the SPE or that created the beneficial interests in the transferred assets that it holds, and may be significantly changed only with the approval of at least a majority of the beneficial interests held by entities other than the transferor, its affiliates, or its agents. In Statement 125, the Board required that a qualifying SPE's powers be permanently limited, in part so that a transferor could not treat as sold assets it had seemingly relinquished if it could still control them by changing the SPE's rules specifying required or permitted activities. However, the Board later learned that limitations on entities in certain forms, including many corporation or partnership forms sometimes used for SPEs, cannot be permanent. Rather than effectively precluding sale treatment for transfers to such SPEs, the Board instead chose to modify this condition to allow for the impermanence of limitations but still limit the ability of the transferor to modify the structure. Consequently, the second condition allows changes to the structure only with the approval of a majority of third-party BIHs that, presumably, would be reluctant to make changes that would adversely affect their interests.

Limits on the Assets It Can Hold

185. The third condition is that a qualifying SPE must be limited as to the assets it can hold. That is in keeping with the Board's view that a qualifying SPE is not an ordinary business but rather a vehicle for indirect ownership by the BIHs of the assets held by the qualifying SPE. The principal type of assets that a qualifying SPE can hold are financial assets transferred to it. The Board concluded that it would be inconsistent with a qualifying SPE's limited purpose for it to

actively purchase its principal assets in the marketplace; instead, the SPE should passively accept those assets transferred to it. The Board also concluded that it would be inconsistent for a qualifying SPE to hold assets that are not passive, because holding nonpassive assets involves making decisions and decision-making is not consistent with the notion of only having passive custody of assets for the benefit of BIHs. Thus, the Board did not allow a qualifying SPE to hold investments large enough either in themselves or in combination with other investments to enable it or any related entity to exercise control or significant influence over an investee. For the same reasons, the Board did not allow a qualifying SPE to hold equity securities that have voting rights attached unless the SPE has no ability to exercise the voting rights or choose how to vote.

186. The Exposure Draft of this Statement proposed that in addition to financial assets transferred to it, a qualifying SPE be permitted to hold five other types of assets: (a) derivative instruments entered into at the same time that financial assets were transferred to the SPE or beneficial interests (other than derivatives) were created, (b) rights to service its financial assets, (c) financial assets that would reimburse it if others were to fail to adequately service its financial assets or to timely pay obligations due on those financial assets, (d) temporarily, nonfinancial assets received in connection with collection of its financial assets, and (e) cash collected from its financial instruments and certain investments purchased with that cash pending distribution. Constituents pointed out that SPEs used in securitizations were commonly permitted to hold those types of assets. The Board decided to permit a qualifying SPE to hold those types of assets because they are inherent in financial assets, are necessary in connection with fiduciary responsibilities to BIHs, or are held only temporarily as a result of collecting or attempting to collect some of the financial assets the qualifying SPE previously held. The Board decided that only those types of assets can be held because holding other types of assets is inconsistent with the qualifying SPE's principal purpose of passively conveying indirect ownership of transferred financial assets to BIHs.

187. The concerns of respondents to the Exposure Draft of this Statement as to the types of assets that a qualifying SPE can hold focused on the proposed limitations on derivative instruments. Specifically, respondents were concerned whether allowing a qualifying SPE to enter into a derivative instrument avoids accounting requirements under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and whether a large derivative instrument could be put into or entered into by a qualifying SPE that held only a small amount of other financial assets. They also were concerned that some derivative instruments require too many decision-making abilities to be held by a qualifying SPE. The Board decided to limit the notional amount of derivative instruments that a qualifying SPE could enter into. The Board decided that the limit should comprehend only derivative instruments that pertain to outside beneficial interests—those 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. The Board noted that if the transferor wanted to enter into derivative instruments pertaining to the beneficial interests it holds, it could accomplish that by entering into such derivative instruments on its own behalf, which would be

accounted for under Statement 133.

188. Several other issues arose concerning derivative instruments in qualifying SPEs. The Board considered requiring that the derivative instruments qualify as a fair value or cash flow hedge of the qualifying SPE's assets or beneficial interests under Statement 133. The Board rejected that approach after considering the various purposes for which securitizations and other qualifying SPE activities are formed. The Board, however, still wanted to ensure that the derivative instrument *pertains* to outside beneficial interests. Therefore, the Board decided that for a qualifying SPE, a derivative instrument should have a notional amount not exceeding the amount of those beneficial interests. Because leverage can make a derivative instrument more powerful than its notional amount indicates, the Board decided that a derivative instrument should have characteristics that relate to and partly or fully (but not excessively) counteract some risk associated with those beneficial interests or the related transferred assets. The Board also decided, consistent with its decisions on equity instruments, that qualifying SPEs should hold only derivative instruments that do not require active decisions. The Board further decided, in keeping with limiting qualifying SPEs to holding financial assets, that the only derivative instruments they can hold are those that are financial instruments—*derivative financial instruments*.

Limits on Sales or Other Dispositions of Assets

189. The fourth condition is that if a qualifying SPE has powers to sell or otherwise dispose of **25** its assets those powers must be limited in specified ways. After considering what the FASB staff had learned in developing its announcement on Topic D-66, the Board concluded, in contrast to its conclusion in Statement 125, that a qualifying SPE should not be entirely prohibited from disposing of assets. The Board considered that, in many securitizations, the trustee or management of the SPE (under fiduciary duties to protect the interests of *all* parties to the structure) is required to dispose of assets in response to adverse events specified in the legal documents that established the SPE or created its beneficial interests in the transferred assets, that are outside the control of the transferor, its affiliates, or its agents. Also, in some securitizations, the SPE is required to dispose of assets, if necessary, to repurchase or redeem beneficial interests at the option of BIHs other than the transferor and its affiliates. In other securitizations, the transferor has the right to remove assets from the SPE under ROAPs or call provisions (discussed further in paragraphs 231–236). And in some securitizations, the SPE is required to liquidate itself or otherwise dispose of its assets on a date set at inception. The Board reasoned that in all four of those situations, the disposal is forced on the SPE. That is, in none of those situations does the SPE or its agents have the power to choose whether the SPE disposes of specific assets or when that disposal occurs. The Board therefore concluded that a qualifying SPE's powers to dispose of assets should be limited to those four narrowly defined circumstances. Constituents generally supported allowing disposal of assets in those circumstances, although some suggested that disposal of transferred assets also be allowed in response to a specified adverse event, without having to wait for it to cause a specified decline in fair value, if it is the type of event that would reasonably be expected at the outset to cause such

a decline and that event is identified in the documents establishing the SPE. The Board adopted that suggestion.

190. The Board reasoned that an SPE that has the power to choose whether to dispose of its assets, even in limited circumstances, has much of the same ability to manage its assets as an ordinary entity. In those situations, the Board concluded that the SPE is not simply acting like a custodian, passively holding assets on behalf of the BIHs, and consequently it should not be a qualifying SPE. Some constituents argued that a qualifying SPE or its servicer should be allowed to exercise at least what constituents termed a *commercially reasonable and customary amount of discretion* in deciding whether to dispose of assets in the specified circumstances. Some constituents argued that allowing a qualifying SPE only to have provisions that require disposal without choice raises the risks of forcing a disposal at a bad time or that allowing no discretion conflicts with the fiduciary duties of the SPE's trustee or servicer. The Board acknowledged the concerns that underlie those views but did not change that provision, reasoning that a qualifying SPE with that flexibility should not be considered to be a passive conduit through which its BIHs own portions of its assets, as opposed to owning shares or obligations in an ordinary business enterprise.

191. The Board considered but rejected a general condition that would permit a qualifying SPE to sell assets as long as the sales were made "to avoid losses." Such a condition would have allowed an SPE to have powers to sell as long as the primary objective was not to realize gains or maximize return, a concept introduced in Topic D-66. The Board rejected it because it would have given the trustee, servicer, or transferor considerable discretion in choosing whether or not the SPE should sell if a loss was threatened. Such discretion is more in keeping with being an ordinary business that manages its own assets than with being a passive repository of assets on behalf of others. The Board did, however, choose to retain some notion of selling to avoid losses in paragraph 42 of this Statement. That paragraph describes circumstances specified at the inception of the qualifying SPE in which the qualifying SPE is required to sell transferred assets that have declined (or are expected to decline) below their fair value at the date of transfer into the qualifying SPE. The Board also considered but rejected requiring that a qualifying SPE derive no more than an insignificant value from collecting or otherwise preserving the assets it holds. The Board reasoned that while some financial assets need more servicing efforts than do others, the amount of effort expended in servicing an asset does not justify different accounting.

Securitizations with Revolving-Period Features

192. As noted in paragraph 74, in some securitizations, short-term receivables are transferred to an SPE, and the SPE then issues long-term beneficial interests. Collections from transferred receivables are used to purchase additional receivables during a defined period called the revolving period. Thereafter, the collections are used to redeem beneficial interests in due course. Some have questioned the propriety of sales treatment in those securitizations because much of the cash collected during the revolving period is returned to the transferor. The Board decided that sales treatment is appropriate for transfers with revolving-period features because

the transferor surrenders control of the assets transferred. While the revolving-period agreement requires that the transferor sell receivables to the trust in exchange for cash on prearranged terms, sales of additional receivables during the revolving period are separate transactions from the original sale.

193. The transferor in a transfer with a revolving-period agreement, such as a credit card securitization, must sell receivables to the securitization trust on prearranged terms. The transferor can perhaps predict the timing of transfers, but the actual timing depends primarily on borrower behavior. If not bound by that contract, the transferor could sell its new receivables elsewhere, possibly on better terms. The transferor obtains the cash as proceeds in exchange for new receivables transferred under the revolving-period agreement, not as benefits from its previous ownership of the receivables or its residual interest in the securitization trust.

194. The revolving-period agreement is an implicit forward contract, with rights and obligations on both sides. The transferor has little or no discretion to avoid its obligations under the revolving-period agreement and would suffer adverse consequences for failure to deliver receivables to the trust during the revolving period. For example, if the transferor were to take deliberate actions to avoid its obligations to sell receivables by triggering the agreement's "early amortization" provisions, the transferor would be exposed to litigation for not honoring its commitment. The transferor also could suffer if it later tried to sell its receivables in the securitization market: the transferor would probably have to offer wary investors a higher return. Deliberate early termination by the transferor is rare in practice because of those adverse consequences. Similarly, the securitization trust and investors cannot avoid the obligation to purchase additional receivables. For those reasons, the revolving-period agreement does not provide control over receivables previously sold but rather is an implicit forward contract for future sales of receivables.

195. Some respondents to the Exposure Draft of Statement 125 proposed that existing revolving-period securitizations should continue to apply previous accounting standards for all transfers into an existing trust after the effective date of Statement 125. Several respondents asked about the effect of the provisions of Statement 125 on transfers into a master trust that is used for a series of securitizations. They pointed out that it would be difficult to change the present structure of those trusts in response to new accounting standards. Others observed that because master trusts have very long or indefinite lives, "grandfathering" transfers to existing trusts would result in noncomparable financial statements for a long time to come. After considering those arguments, the Board decided to retain the proposed requirement that Statement 125 apply to all transfers of assets after its effective date, in order to minimize the noncomparability caused by the transition. For similar reasons, the Board adopted the same requirement in this Statement. (Paragraph 341 discusses transition provisions relating to qualifying SPEs that would no longer qualify under current guidance in this Statement.) Separately, in response to constituents' questions, the Board also clarified in paragraph 79 that a transfer into a master trust in exchange for beneficial interests is neither a sale nor a secured borrowing under the provisions of paragraph 9.

Qualifying SPEs and Consolidated Financial Statements

196. Statement 125 did not address whether a transferor should consolidate a qualifying SPE. In that Statement, the Board acknowledged that consolidation of SPEs was an issue that merited further consideration and that it would deliberate that issue in its current project on consolidated financial statements. Because the Board had not yet issued a new Statement on consolidation policy, ²⁶ constituents were concerned about whether assets sold to a qualifying SPE might still be shown in the consolidated financial statements of the transferor and requested additional guidance on that issue. In September 1996, the EITF discussed Issue No. 96-20, “Impact of FASB Statement No. 125 on Consolidation of Special-Purpose Entities.” The EITF reached a consensus that the Statement 125 definition of control should be applied in assessing whether an SPE should be consolidated, but only if all assets in the qualifying SPE are financial assets and are not the result of a structured transaction that has the effect of converting nonfinancial assets into financial assets or recognizing previously unrecognized financial assets. In all other circumstances, the EITF stated that the transferor should continue to apply the criteria of EITF Topic No. D-14, “Transactions involving Special-Purpose Entities,” and EITF Issue No. 90-15, “Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions,” as appropriate. The Board indicated at that time that it planned to include further guidance on consolidating qualifying SPEs either in the Statement on consolidation policy or in this Statement.

197. The Board considered resolving the qualifying SPE consolidation issue by making an exception to present and perhaps future consolidation standards to exempt from ordinary consolidation policies entities whose assets are all or almost all financial assets. That exception arguably could be justified because financial assets are different from other assets and entities that hold little else should be treated differently. While that alternative would have resolved the immediate issue, the Board rejected it because it would have prejudged a significant issue in the separate project on consolidation policy, without having sufficiently examined the ramifications of an exception to consolidation.

198. Instead, the Board reasoned that the event that warrants derecognition of assets transferred to a qualifying SPE is the issuance of beneficial interests in the transferred assets to third-party BIHs in exchange for cash or other assets. That reasoning is consistent with paragraphs 9 and 79 of this Statement (paragraphs 9 and 53 of Statement 125). Paragraph 9 states that “a transfer of financial assets . . . 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*” (emphasis added). Paragraph 79 states that “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*” (emphasis added). Once beneficial interests are issued to BIHs other than the transferor or its affiliates in exchange for consideration, the

economic benefits of all the assets held in a qualifying SPE are divided among and controlled by the BIHs, not by the transferor whose assets they once were and not by the qualifying SPE or the trustee that may be the legal owner. Once the assets are legally isolated and beneficial interests in those assets are issued, the qualifying SPE is in the position of a custodian holding the underlying assets for the BIHs. Assets held in a qualifying SPE are therefore effectively the assets of its BIHs. Accordingly, the Board proposed in the Exposure Draft of this Statement that assets sold to a qualifying SPE should not be recognized as assets and that related beneficial interests should not be recognized as liabilities in consolidated or other financial statements of a transferor, servicer, or sponsor of the SPE.

199. Constituents urged the Board to retain that provision. They argued that it would be unreasonable to grant sale treatment to a transferor for a transfer of assets to a qualifying SPE and issuance of beneficial interests to third-party BIHs, which acknowledges that such assets have been effectively sold to third parties, and then to require that a qualifying SPE be consolidated in the financial statements of the transferor with the sale effectively eliminated in consolidation. The Board accepted that reasoning, in view of the criteria for sale treatment in paragraph 9 and the characteristics of entities that meet the conditions established by this Statement to be qualifying SPEs. However, the Board concluded that this Statement's special guidance for consolidation of qualifying SPEs should focus only on the consolidated financial statements of the transferor and its affiliates because, unless it is an affiliate of the transferor, a servicer, sponsor, agent, or other BIH of a qualifying SPE did not transfer the assets and record a sale. This Statement therefore provides that a qualifying SPE should not be consolidated in the financial statements of a transferor and its affiliates. The Board has tentatively decided that the scope of the planned Statement on consolidation policy will exclude that issue; however, any entity that is not a transferor of assets to a qualifying SPE, or an affiliate of the transferor, needs to consider other existing or future generally accepted accounting principles on consolidation policy to determine whether it is required to consolidate a qualifying SPE in the financial statements being presented.

Arrangements That Arguably Maintain a Transferor's Effective Control over Transferred Assets

Repurchase Agreements and Securities Lending Transactions

200. The Exposure Draft of Statement 125 proposed that transfers of financial assets with repurchase commitments, such as repurchase agreements and securities lending transactions, should qualify as secured borrowings only if the transfer was *assuredly temporary*—the period until repurchase is less than three months or the period is indefinite but the contracts are repriced daily at overnight market rates and can be terminated by either party on short notice. It also proposed that the assets to be repurchased had to be the same (for example, U.S. securities having the same CUSIP number) as those transferred. Respondents generally disagreed with those provisions of the Exposure Draft of Statement 125 about those transactions, and the Board

changed the provisions in its redeliberations.

Legal and Economic Ambiguity of These Transactions

201. Repurchase agreements and securities lending transactions are difficult to characterize because those transactions are ambiguous: they have attributes of both sales and secured borrowings. Repurchase agreements typically are documented as sales with forward purchase contracts and generally are treated as sales in bankruptcy law and receivers' procedures, but as borrowings in tax law, under court decisions that cite numerous economic and other factors. Repurchase agreements are commonly characterized by market participants as secured borrowings, even though one reason that repurchase agreements arose is that selling and then buying back securities, rather than borrowing with those securities as collateral, allow many government agencies, banks, and other active participants in the repurchase agreement market to stay "within investment and borrowing parameters that delineate what they may or may not do."

²⁷ Securities loans are commonly documented as loans of securities collateralized by cash or by other securities or by letters of credit, but the "borrowed" securities are invariably sold, free of any conditions, by the "borrowers," to fulfill obligations under short sales or customers' failure to deliver securities they have sold; securities loans are generally treated as sales under U.S. bankruptcy and tax laws (but only as they relate to income distributions).

202. Previous accounting practice generally has treated repurchase agreements as secured borrowings, although "repos-to-maturity" and certain other longer term repurchase agreements have been treated as sales. Previous accounting practice has not recognized some securities lending transactions, because the transactions were executed by an entity's custodian or other agent, and has treated others as secured borrowings. Supporting arguments exist for accounting for both kinds of transactions as borrowings, both kinds as sales, or some as borrowings and others as sales.

203. The American Law Institute ²⁸ describes the legal status of a securities lending transaction as follows:

The securities lender does not retain any property interest in the securities that are delivered to the borrower. The transaction is an outright transfer in which the borrower obtains full title . . . the borrower needs the securities to transfer them to someone else . . . if the securities borrower defaults on its redelivery obligation, the securities lender has no property interest in the original securities that could be asserted against any person to whom the securities borrower may have transferred them. . . . The securities lender's protection is its right to foreclose on the collateral given to secure the borrower's redelivery obligation. Perhaps the best way to understand securities lending is to note that the word "loan" in securities lending transactions is used in the sense it carries in loans of money, as distinguished from loans of specific identifiable chattels. Someone who lends money does not retain any property interest in the money that is handed over to the borrower.

204. While that description focuses on securities lending, much of it appears applicable to repurchase agreements as well. If judged by the criteria in paragraphs 9(a) and 9(b) and the legal reasoning in paragraph 203, financial assets transferred under typical repurchase or securities lending agreements would qualify for derecognition as having been sold for proceeds consisting of cash and a forward purchase contract. During the term of the agreement, the transferred assets are isolated from the transferor, are placed in the hands of a transferee that can—and typically does—obtain their benefits by selling or pledging them, and are readily obtainable in the market.

205. The Board considered requiring sales treatment for all of those transactions. The Board also considered an approach that would have recognized the effects of the transaction in the statement of financial position (recognizing the proceeds received as cash or securities and a forward purchase contract) without characterizing the transaction as a sale. The Board ultimately decided, for both conceptual and practical reasons, that secured borrowing treatment should be retained for most of those transactions.

206. In concept, having a forward purchase contract—a right and obligation to buy an asset—is not the same as owning that asset. Dividends or interest on securities are paid by the issuer to the current security holder, that is, to whoever may now hold the securities transferred in the repurchase agreement or loan, while the transferor has at most only the contractual right to receive—from the transferee—payments in lieu of dividends or interest. In addition, the voting rights reside not with the transferor but with the current security holder, because those rights generally cannot be contractually released.

207. However, the commitments entered into in a repurchase or securities lending agreement are more extensive than a common forward purchase contract. The transferor has agreed to repurchase the security, often in as little as a day, at a fixed price that differs from the sale price by an amount that is essentially interest on the cash transferred. The transferor also commonly receives payments in lieu of interest or dividends and has protection of collateral that is valued daily and adjusted frequently for changes in the market value of the transferred asset—collateral that the transferor is entitled to use to purchase replacement securities should the transferee default, even in the event of bankruptcy or other receivership. Those arrangements are not typical of forward purchase contracts and suggest that having a repurchase agreement or securities lending contract to repurchase a transferred asset before its maturity is much like still owning that asset.

208. Practically, participants in the very large markets for repurchase agreements and securities lending transactions are, for the most part, unaccustomed to treating those transactions as sales, and a change to sale treatment would have a substantial impact on their reported financial position. Given the difficulty in characterizing those ambiguous transactions, the decision to treat all of those transactions as sales would be a close call, and the Board was not convinced that the benefits of a change based on that close call would justify the costs.

209. The Exposure Draft of Statement 125 proposed that transfers of financial assets with repurchase commitments, such as repurchase agreements and securities lending transactions, should be accounted for as secured borrowings if the transfers were assuredly temporary, and as sales if the transfers were not assuredly temporary. As proposed, to be assuredly temporary, the period until repurchase would have had to be short enough not to diminish assurance that the contract and arrangements backing it up would prove effective, that is, with maturities either under three months or indefinite and terminable by either party on short notice. Also, to be assuredly temporary, the entity would have had to be entitled and obligated to repurchase the same assets. After considering comment letters and testimony at the public hearing, the Board decided to change both of those proposed requirements.

The Period until Repurchase

210. The Exposure Draft of Statement 125 proposed that transfers of financial assets should qualify as borrowings if the period until repurchase is less than three months or the period is indefinite but the contracts are repriced daily at overnight market rates and can be terminated by either party on short notice. A three-month limit was arbitrary, but based on its initial inquiries, the Board tentatively concluded that three months would be a clear and workable time limit that should not present difficulty, because it understood that most repurchase agreements and securities loans are for periods much shorter than three months or are indefinite, and almost all of the others are for periods much longer than three months.

211. Respondents generally disagreed with that provision of the Exposure Draft of Statement 125. They argued that the arbitrary three-month limit would not be effective and that entities could alter the accounting for a transfer by adding or subtracting one or two days to or from the term of the agreement. While some offered other arbitrary time limits, many respondents argued that all transfers accompanied by a forward contract to repurchase the transferred assets before maturity should be accounted for as secured borrowings. In their view, most repurchase agreements represent a temporary transfer of only some elements of control over the transferred assets.

212. After considering those comments, the Board decided to remove the proposed requirement that the period until repurchase be less than three months. Board members concluded that any distinction based on the specified time until repurchase would not be workable. As outlined in paragraph 207, the elements of control by the transferee over assets obtained in a typical securities lending or repurchase agreement are both temporary and limited. The Board concluded that the contractual obligation and right to repurchase an asset before its maturity effectively bind the asset transferred back to the transferor.

213. Some respondents suggested a distinction based on a different time period, or on the proportion of the life of the asset transferred, but the Board rejected those possibilities. Any other time period would have the same faults as the three-month limit proposed in that Exposure Draft: it would be arbitrary, with no meaningful distinction between transactions just on one side

of the limit and those just on the other side. Similarly, the Board concluded that the only meaningful distinction based on required repurchase at some proportion of the life of the assets transferred is between a "repo-to-maturity," in which the typical settlement is a net cash payment, and a repurchase before maturity, in which the portion of the asset that remains outstanding is indeed reacquired in an exchange.

Substantially the Same Assets

214. The Exposure Draft of Statement 125 proposed that a repurchase agreement would have to require return of the same asset (for example, U.S. securities having the same CUSIP number) for the transfer to be treated as a borrowing. In that Exposure Draft, the Board reasoned that agreements to acquire securities that—while perhaps similar—are not the same as those transferred do not maintain any kind of control over the transferred securities. Most repurchase agreements require return of the same asset. Some are less rigid. For example, some mortgage-backed instruments are transferred in a class of repurchase agreements known as *dollar rolls*. There are several procedural differences between dollar-roll transactions and ordinary repurchase agreements. However, the most significant difference is the agreement that assets returned need not be the same as those transferred. Instead, the transferor agrees to accept back assets with characteristics that are substantially the same within limits established by the market.

215. While a few respondents supported the reasoning in the Exposure Draft of Statement 125, most did not. Respondents argued that the economic differences between the assets initially transferred and assets to be reacquired under a dollar-roll transaction that meets the existing accounting criteria for being substantially the same are, as the term implies, not substantial and should not result in an accounting difference. They argued that existing accounting guidance found in 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*, has proven adequate to constrain the characteristics of assets that are to be reacquired. After redeliberation, the Board accepted those arguments and decided that if the assets to be repurchased are the same or substantially the same as those concurrently transferred, the transaction should be accounted for as a secured borrowing. The Board also decided to incorporate the definition in SOP 90-3 in this Statement (carried forward without reconsideration). The Board noted that not all contracts in the dollar-roll market require that the securities involved have all of the characteristics of "substantially the same." If the contract does not require that, the transferor does not maintain effective control.

The Importance of the Right and Obligation to Repurchase, Collateral, and Symmetry

216. The Board based its decisions about agreements that maintain effective control over transferred assets in part on observation of contracts and practices that prevail in the repurchase agreement and securities lending markets. Concerns of market participants about risk of default by the parties to the contract, rights at law in the event of default, and credit risk of transferred assets, among other factors, have led to several contractual features intended to assure that the

transferors indeed maintain effective control.

217. The Board decided that to maintain effective control, the transferor must have *both* the contractual right *and* the contractual obligation to reacquire securities that are identical to or substantially the same as those concurrently transferred. Transfers that include only the right to reacquire, at the option of the transferor or upon certain conditions, or only the obligation to reacquire, at the option of the transferee or upon certain conditions, generally do not maintain the transferor's control, because the option might not be exercised or the conditions might not occur. Similarly, expectations of reacquiring the same securities without any contractual commitments, as in "wash sales," provide no control over the transferred securities.

218. The Board also decided that the transferor's right to repurchase is not assured unless it is protected by obtaining collateral sufficient to fund substantially all of the cost of purchasing identical replacement securities during the term of the contract so that it has received the means to replace the assets even if the transferee defaults. Judgment is needed to interpret the term *substantially all* and other aspects of the criterion that the terms of a repurchase agreement do not maintain effective control over the transferred asset. However, arrangements to repurchase or lend readily obtainable securities, typically with as much as 98 percent collateralization (for entities agreeing to repurchase) or as little as 102 percent overcollateralization (for securities lenders), valued daily and adjusted up or down frequently for changes in the market price of the security transferred and with clear powers to use that collateral quickly in the event of default, typically fall clearly within that guideline. The Board believes that other collateral arrangements typically fall well outside that guideline.

219. Some commentators argued for a continuation of previous asymmetrical practices in accounting for dollar rolls. In previous practice, transferors have accounted for dollar-roll agreements as borrowing transactions, while dealers who receive the transferred assets have accounted for them as purchases. The Board observed that the same transaction cannot in concept or simple logic be a borrowing-lending arrangement to the transferor and a purchase-sale transaction to the transferee. The Exposure Draft of Statement 125 would have resolved that asymmetry by requiring that transferors account for the transactions as sales. In response to commentators' concerns about transferors' accounting, Statement 125 and this Statement instead call for transferors to account for qualifying dollar-roll transactions as secured borrowings and requires that dealers account for the same transactions as secured loans.

Other Arrangements to Reclaim Transferred Assets

220. The Board considered whether to allow sale treatment if a transferor of financial assets concurrently acquires from the transferee a call option on the assets sold. Some questioned under what conditions the transferor that holds a call option has surrendered control of the assets to the transferee. Some believe that an entity that holds an option to acquire a financial asset controls that asset. However, the holder of a call option does not receive interest or dividends generated by the asset, cannot exercise any voting rights inherent in the asset, may not be aware

of the location or present custody of the asset, and is not able to sell the asset and deliver it without first exercising the call. And it may never exercise the call. If an entity that holds a call option on an asset controls that asset, then it follows that the entity should recognize the asset under the call option at the time the call option is acquired. However, two parties would then recognize the same asset—the entity that holds the call option and either the writer of the call option or the party from whom the writer plans to acquire the asset if the call is exercised. Therefore, others believe that a call option never conveys effective control over a transferred asset. The Board concluded that whether a transferor maintains effective control over a transferred asset through an option to reacquire it depends on the nature of the asset and the terms of that option.

221. The Board concluded in Statement 125 that sale treatment should not be precluded in instances in which the transferor simultaneously obtains a call option on the asset sold, provided that the asset is readily obtainable. The writer of a call option on a financial asset may choose not to own the asset under the call option if it is readily obtainable; it may instead plan to acquire that asset if the call is exercised and delivery is demanded. In those circumstances, it is realistic to assume that the transferee can sell or repledge the asset to a third party and, at the same time, in good faith write a call option on that asset.

222. The Board concluded in Statement 125 that a sale should not be recognized in instances in which the transferor simultaneously obtains a call on a transferred asset that is not readily obtainable. The resulting accounting treatment of an option on a not-readily-obtainable asset that is obtained as part of a transfer of financial assets is different from the accounting treatment generally accorded to the same option that is purchased for cash. From the transferor's viewpoint, that difference in accounting treatment between an option purchased and an option obtained as part of a transfer of assets conflicts with the principle that the recognition of financial assets and liabilities should not be affected by the sequence of transactions that led to their existence. However, as noted in paragraph 25 of Statement 125, if the option is a component of a transfer of financial assets, and it does not constrain the transferee from selling or pledging the asset, that should not preclude the transfer from being accounted for as a sale. If the existence of an option constrains the transferee from selling or pledging the transferred asset (because the asset is not readily obtainable to satisfy the option if exercised), then the transferor has not relinquished effective control over the asset and thus should not derecognize it.

223. The Board reached a somewhat different conclusion in this Statement. The Board began its work on this Statement by considering the impact of Statement 125 on Issue 90-18. In particular, the concern was whether certain ROAPs maintain the transferor's effective control over the transferred assets through an agreement to repurchase or redeem transferred financial assets that are not readily obtainable and thus preclude sale treatment under paragraph 9(c)(2) of Statement 125. Initial Board discussions focused on the various circumstances under which transferors can remove transferred assets from securitization trusts and on the nature of the assets in question.

224. In those discussions, the Board noted that assets substantially the same as the credit card receivables in a particular securitization trust are readily obtainable only from within the trust itself or from the transferor, arguably indicating that such transfers fail to satisfy the criterion for sale treatment in paragraph 9(c)(2) of Statement 125 and therefore should be accounted for as secured borrowings. In developing this Statement, the Board concluded that after a securitization that isolates assets transferred into a qualifying SPE, the assets being accounted for in a securitization are not the underlying transferred assets but rather the beneficial interests in those assets that were sold to third-party investors or retained by the transferor. Therefore, for qualifying SPEs, the pertinent criterion is whether the transferor has a right to redeem the beneficial interests that constrain the BIHs from exchanging or pledging those interests, a matter already dealt with in a separate criterion (paragraph 9(b) of this Statement).

225. The Board concluded in this Statement that whether the transferor maintains control over assets transferred to a qualifying SPE does not depend entirely on whether those assets were readily obtainable. Rather, whether the transferor maintains control depends on whether it can unilaterally cause the return of specific transferred assets (for example, an asset with a certain certificate number) held in the qualifying SPE. That led to the criterion in paragraph 9(c) of this Statement, as discussed in paragraphs 231–236.

Rights to Repurchase or Redeem Assets from Transferees That Are Not Qualifying SPEs

226. The Board also discussed in developing this Statement whether it should continue to include an explicit criterion, like that in paragraph 9(c)(2) of Statement 125, that would preclude sale treatment for transfers of not-readily-obtainable assets to transferees that are *not* qualifying SPEs if the transferor has the right to repurchase or redeem those assets. Some constituents suggested that transfers in which the transferor has a call provision entitling it to repurchase the transferred assets should not be accounted for as sales, particularly if the assets are not readily obtainable, because the transferor is able to use the call to get back the same assets it transferred or similar assets. Those constituents argue that the transferee's ability or inability to exchange or pledge the assets should not determine whether the transfer is a sale.

227. The Board reviewed its reasoning in Statement 125, paragraph 156, and again concluded that a call provision or other right to repurchase or redeem should preclude sale accounting if (a) the existence of that right constrains the transferee from exchanging or pledging the assets or (b) the rights to reacquire transferred assets result in the transferor's maintaining effective control over the transferred assets. The Board continues to support the fundamental principle of symmetry in Statement 125: for a transfer to be a sale, the transferor must relinquish control and the transferee must be in control, so that the criteria need to look to the position of both parties.

228. The Board reasoned that if the transferee is able, notwithstanding the transferor's right to repurchase or redeem, to pledge or exchange the transferred assets and thereby obtain substantially all of the cash flows embodied in them, then the transferor's right to repurchase or redeem does not give it effective control over the assets and should not preclude sale accounting,

except in the circumstances described in paragraph 9(c) of Statement 125 and this Statement. The Board agreed that a transferee is not constrained if it can subsequently pledge or exchange transferred assets subject to an attached or embedded call, even if the assets are not readily obtainable. The Board also agreed that the transferee is not constrained by a freestanding call if it can redeem or repurchase the assets it has sold or repledged from the subsequent transferee or obtain them elsewhere when the call is exercised. In light of that set of decisions, the Exposure Draft to this Statement concluded that the condition in paragraph 9(c)(2) of Statement 125 should no longer be required because (a) it is redundant for transfers to entities other than qualifying SPEs and (b) it is unnecessary for transfers to qualifying SPEs as discussed in paragraphs 224 and 225.

229. Some respondents to the Exposure Draft of this Statement suggested that the Board reconsider whether a call on not-readily-obtainable assets should preclude sale accounting, expressing particular concern about the accounting for attached calls. They argued that the transferor is in the same economic position and therefore indifferent to whether the call is freestanding or attached, because it can reassume control over the assets in either case. In redeliberations, the Board concluded that a freestanding call leaves both the transferor and the transferee in a different economic position than does an attached call. A freestanding call may constrain the transferee from disposing of a transferred asset, out of concern that it could not be replaced should the transferor exercise its call. If the transferee is constrained, the transferor's control over the asset is maintained because the transferee is not only obligated to deliver the asset but has on hand the very asset that was transferred. However, if the transferee is not constrained by a freestanding call (for example, because the asset is readily obtainable), the call gives the transferor no remaining connection with the transferred asset. The transferor's only asset under a nonconstraining freestanding call is the transferee's promise to find an asset sufficiently like the transferred asset to satisfy the transferor should it exercise its call. In contrast, a call attached to the asset does not constrain the transferee from disposing of the asset, subject to that call, even if the asset is not readily obtainable. However, an attached call maintains the transferor's connection with the transferred asset, because exercise of the call brings back that very asset from whoever now holds it. The Board concluded that those different economic positions call for different accounting.

230. The Board considered two approaches for resolving this difficulty. The first would have reinstated the wording in paragraph 9(c)(2) of Statement 125. The Board rejected that approach because some calls on not-readily-obtainable assets (for example, certain conditional calls or out-of-the-money calls) do not necessarily constrain transferees or benefit transferors, making it difficult to conclude that they give a transferor effective control over the assets, and because that approach would be difficult to reconcile with the accounting for ROAPs (paragraphs 231–236). The other approach, which the Board adopted because it avoided those difficulties, was to revise paragraph 9(c)(2) to preclude sale accounting if the transferor maintains effective control through a call option or other right that gives it the ability to unilaterally cause the transferee to return specific transferred assets, and to clarify in paragraphs 50–54 the kinds of rights that do and do not maintain effective control. The Board continues to believe that an option to acquire

assets, even assets previously owned, is not the same as owning those assets, unless that option conveys effective control over the assets.

Rights to Unilaterally Reclaim Specific Assets Transferred to Qualifying SPEs

231. The Board concluded in Statement 125 that sale treatment is inappropriate for transfers to a qualifying SPE of assets that the transferor is in a position to reclaim. The Board did not change its view in developing this Statement. However, the Board decided to change the way that view is carried out in the standards. Statement 125 excluded the ability to return assets to the transferor from the list of activities that a qualifying SPE was permitted to engage in. Therefore, an SPE that was permitted to return assets to the transferor could not be a qualifying SPE under Statement 125 as originally interpreted. (The staff announcement in Topic D-66 later did permit qualifying SPEs to have certain powers to return assets to the transferor, its affiliates, or its agents.) Rather than disqualify SPEs because the transferor has the unilateral ability to cause the SPE to return specified assets, this Statement instead provides that transfers of assets to qualifying SPEs are not sales if the transferor through that ability retains effective control over specific transferred assets.

232. The Board chose to preclude sale accounting if the transferor has any ability to unilaterally reclaim specific transferred assets from a qualifying SPE on terms that are potentially advantageous to the transferor—whether through a ROAP, the ability to cause the liquidation of the entity, a call option, forward purchase contract, or other means—because, in those circumstances, the transferor would effectively control the transferred assets. The transferor maintains effective control by being able to initiate action to reclaim specific assets with the knowledge that the qualifying SPE cannot sell or distribute the assets because of restrictions placed on it.

233. The Board's decision precludes sale accounting for transfers of financial assets subject to an unconditional ROAP or repurchase agreement that allows the transferor to specify the assets removed. It also precludes sale accounting for transfers of financial assets subject to a ROAP in response to a transferor's decision to exit some portion of its business. The Board reached that conclusion because such provisions allow the transferor to unilaterally remove specified assets from the qualifying SPE, which demonstrates that the transferor retains effective control over the assets.

234. The Board did decide to allow sale accounting for transfers subject to certain other types of ROAPs that are commonly found in securitization structures. For example, it permitted sale treatment for transfers subject to a ROAP that allows the transferor to remove specific financial assets after a third-party cancellation, or expiration without renewal, of an affinity or private-label arrangement on the grounds that the removal would be allowed only after a third party's action (cancellation) or decision not to act (expiration) and could not be initiated *unilaterally* by the transferor. In reaching that conclusion, the Board acknowledged that the transferor may, through its action or inaction, sometimes instigate the third-party cancellation or

expiration of an affinity or private-label arrangement but noted that it would be unworkable to base the accounting on identifying which entity was the main instigator and unreasonable to deny sale treatment just because removal of accounts could be required by a cancellation or nonrenewal that the transferor was powerless to avoid. The Board's decision also does not preclude sale accounting because of a ROAP that allows the transferor to randomly remove transferred assets at its discretion, but only if the ROAP is sufficiently limited so that it does not allow the transferor to remove *specific* transferred assets.

235. This Statement also precludes sale accounting if the transferor of financial assets to a qualifying SPE has the ability to unilaterally take back specific transferred assets through the liquidation of the entity, a call option, forward purchase contract, or other means. The Board's reasoning behind this more general principle is the same as for ROAPs. For example, the Board concluded that a transferor has maintained effective control over specific transferred assets if (a) the transferor or its affiliates may reclaim the transferred assets, for example, at termination of the qualifying SPE or at maturity or redemption of the beneficial interests *and* (b) either the price the transferor is to pay is fixed or determinable or the transferor holds the residual interest in the transferred assets, because those abilities provide the transferor with effective control over the assets. In the latter circumstance, the transferor that holds the residual interest could pay any price it wished to buy back the assets in a public auction, for example, because it would get back any excess paid over fair value via its residual interest.

236. For the same practical reasons as those in Statement 125, the Board chose to continue to allow a cleanup call and, in response to constituents' requests, changed the definition of *cleanup call* to allow the servicer, which may be the transferor, to hold a cleanup call as Statement 77 had done. In reaching this decision, the Board considered but rejected the notion that parties other than the servicer could hold the option, because only the servicer is burdened when the amount of outstanding assets falls to a level at which the cost of servicing the assets becomes burdensome—the defining condition of a cleanup call—and any other party would be motivated by some other incentive in exercising a call. The Board permitted a cleanup call on beneficial interests in the transferred assets because the same sort of burdensome costs in relation to benefits may arise when the remaining assets or beneficial interests fall to a small portion of their original level.

Collateral

Accounting for Collateral under Statement 125

237. The Exposure Draft of Statement 125 proposed that for transactions involving collateral, including securities lending transactions and repurchase agreements, secured parties should recognize all cash collateral received as well as all other financial instruments received as collateral that they have the ability by contract or custom to sell or repledge prior to the debtor's default, because they have important rights over that collateral. Secured parties in those

positions are entitled and able to use the cash received as collateral, or the cash they can obtain by selling or repledging other collateral, for their own purposes. Therefore, in the Exposure Draft of Statement 125, the Board concluded that that collateral is the secured party's asset, along with an obligation to return the collateral that is the secured party's liability, and reasoned that if that collateral was permitted to be excluded from the statement of financial position, assets that secured parties can use to generate income would not be recognized. Reporting income but not the assets that generate it could understate a secured party's assets (and liabilities) as well as overstate its return on assets. In contrast, noncash collateral that secured parties are not able to sell or repledge cannot be used to generate cash or otherwise benefit the secured party (other than by reducing the credit risk on the financial asset it secures, an effect already recognized in measuring that financial asset) and is not the secured party's asset.

238. The Board noted that the accounting proposed was consistent with Governmental Accounting Standards Board (GASB) Statement No. 28, *Accounting and Financial Reporting for Securities Lending Transactions*, which was issued in May 1995. GASB Statement 28 also requires, for reasons similar to those noted in Statement 125, that securities lenders record noncash collateral if the contract specifically allows the governmental entity to pledge or sell the collateral before a debtor defaults.

239. Many respondents to the Exposure Draft of Statement 125 objected to recognition of collateral because they contended that the proposed accounting would result in the same asset being recognized by two entities. As discussed in paragraph 259 of this Statement (carried forward from paragraph 172 of Statement 125), while the secured party reports the security as its asset, the transferor reports a different asset, a receivable for the return of the collateral from the secured party. Respondents also argued that recognizing the collateral implies that the secured party expects all the benefits of that asset, whereas it typically is not entitled to retain dividends, interest, or benefits from appreciation. Respondents who objected to recognizing collateral generally preferred that secured parties disclose collateral received. Other respondents suggested that it was not clear that the proposed collateral provisions applied not only to a secured borrowing but also to collateral pledged in all other kinds of transactions.

240. The Board reconsidered the provisions of the Exposure Draft of Statement 125 in light of those comments. To improve clarity and refine its conclusions, the Board focused on four types of collateral that a secured party arguably should recognize as its assets: (a) cash collateral, (b) collateral securing obligations in default, (c) other collateral that the secured party has sold or repledged, and (d) other collateral that the secured party can sell or repledge.

Cash Collateral

241. Some respondents objected to recording any asset received as collateral, even cash, on the grounds that it remains the asset of the party posting it as collateral and is therefore not the secured party's asset. Other respondents agreed that cash collateral should be recognized because transfers of financial assets in exchange for cash collateral cannot be distinguished from

borrowing cash and because cash is fungible. It is therefore impossible to determine whether it has been used by the secured party. The Board concluded for the latter reason that all cash collateral should be recorded as an asset by the party receiving it, together with a liability for the obligation to return it to the payer, whose asset is a receivable.

Collateral Securing Obligations in Default

242. Many respondents pointed out that collateral securing an obligation becomes the property of the secured party upon default on the secured obligation. A respondent argued differently, maintaining that a defaulting debtor does not relinquish control over the collateral until it no longer has an opportunity to redeem the collateral by curing the default. The Board agreed in Statement 125 that the secured party should recognize collateral, to the extent it has not already recognized the collateral, if the debtor defaults and is no longer entitled to redeem it.

Other Collateral That the Secured Party Has Sold or Repledged

243. Some respondents to the Exposure Draft of Statement 125 who agreed that cash collateral should be recognized argued that the secured party should not recognize other collateral unless the debtor had defaulted, no matter what powers it has over that collateral, again because in their view the transferred assets remain the assets of the transferor. Others argued that while it may make sense for the secured party to recognize an obligation if collateral is sold, as is common practice in some industries, it is not common practice for broker-dealers and others to recognize an asset and a liability when they repledge collateral. Respondents from the broker-dealer community noted that they regularly repledge substantial amounts of collateral in conjunction with loans secured by customer margin balances and "borrow versus pledge" matched securities transactions and that that collateral activity has not been recognized under previous practice, although it has been disclosed. After considering those arguments, the Board concluded that collateral should be considered for recognition when it is sold or repledged, because the ability to pledge or exchange an asset is the benefit that the Board determined constitutes control over a financial asset, as set forth in paragraph 9(b) and discussed in paragraphs 161 and 162 of this Statement.

244. One respondent observed that the documentation supporting some transactions preserves the transferor's legal right to redeem its collateral, even though the transferee has repledged the assets to a third entity. In those instances, should the transferee default, the transferor has rights to redeem its collateral directly from the third entity to which the initial transferee repledged it. The respondent argued that a transferee with that right has not surrendered control over the assets. The Board agreed with that reasoning and adopted it. Because the status of the right to redeem may not always be clear, the Board chose to implement it by requiring recognition of collateral by the secured party if it sells or repledges collateral on terms that do not enable it to repurchase or redeem the collateral from the transferor on short notice. One result is that broker-dealers and others who obtain financial assets in reverse repurchase agreements, securities loans, or as collateral for loans and then sell or repledge those assets will in some cases recognize under Statement 125 assets and liabilities that previously went unrecognized. The

Board noted that obligations to return to the transferor assets borrowed and then sold have sometimes been effectively recognized as part of a liability for securities sold but not yet purchased, and it did not require any change in that practice.

Other Collateral That the Secured Party Can Sell or Repledge

245. The Exposure Draft of Statement 125 called for recognition of collateral that the secured party can repledge or exchange but has not yet used. Some argued that secured parties should not be required to recognize any unused collateral, reasoning that the collateral and related obligation do not meet the definition of an asset or a liability of the secured party. They contended that to be considered an asset of the secured party the collateral must embody a probable future economic benefit that contributes directly or indirectly to future net cash inflows and that in the case of many kinds of collateral, there is only a possible benefit that has not been realized until that collateral is sold or repledged. The Board disagreed, noting that collateral that can be sold or repledged has a capacity to contribute directly to future cash inflows—from a sale or secured borrowing—and that the obligation to return the collateral when reclaimed will require a future economic sacrifice—the relinquishing of control. The Board also observed that broker-dealers and others are able to benefit from collateral in various ways and that the right to benefit from the use of a financial asset is, in itself, an asset.

246. A respondent to the Exposure Draft of Statement 125 pointed out that the right to repledge or exchange is significantly constrained if the transferor has the right and ability to redeem the collateral on short notice, for example, by substituting other collateral or terminating the contract on short notice, and thereby demand the return of the particular security pledged as collateral. The Board agreed, reasoning that a transferor that can redeem its pledged collateral on short notice has not surrendered control of the transferred assets. The transferee would be able to use the transferred assets in certain ways to earn a return during the period of the agreement, but the value of its asset may be very limited because of the transferor's rights to substitute or cancel.

247. In developing the Exposure Draft of Statement 125, the Board considered an approach that would have recorded only the net value of the specific rights that the secured party has over the collateral. That approach might have been consistent with the financial-components approach, and several respondents asked the Board to consider it. However, no one, including the Board, was able to identify a method that the Board judged to be sound for separating the collateral into components.

248. Another possibility considered would have been to recognize the transfer of control over the collateral and for the two parties each to report their mutual rights and obligations under the contract net, that is, for the debtor to net its receivable for the transferred security against its obligation under the secured borrowing and for the secured creditor to net its obligation to return the security against its secured loan receivable. The only change to the statement of financial position would have been the difference in carrying amounts, if any, with a note disclosing the details. That approach is different from present practice in its details but would have produced

similar total assets and liabilities. It arguably would have been more consistent with the financial-components approach that focuses on control and would have simplified the accounting. While this approach appealed to some Board members, the Board ultimately rejected it. The approach would have been inconsistent with other pronouncements that govern offsetting, because in this case there is no intent to settle net.

249. After considering comments and testimony on those matters, the Board decided in Statement 125 that financial assets transferred as collateral in a secured borrowing should be recognized by the secured party as an asset with a corresponding liability for the obligation to return the collateral if the secured party was permitted by contract or custom to sell or repledge the collateral and the transferor did not have the right and ability to redeem the collateral on short notice, for example, by substituting other collateral or terminating the contract.

Accounting for Collateral under This Statement

250. After the issuance of Statement 125, implementation issues emerged in applying the requirements for accounting for collateral in paragraph 15 of that Statement. Those issues focused on whether the secured party is constrained from taking advantage of the right to sell or repledge collateral. The notion of constraint was expressed in paragraph 15(a)(2) of Statement 125, which required determining whether the debtor has the right and ability to redeem the collateral on short notice, for example, by substituting other collateral or terminating the contract. In developing Statement 125, the Board assumed that the debtor's right to redeem the collateral on short notice would significantly constrain the secured party from realizing a substantial portion of the value from the collateral and that that constraint would benefit the debtor. While a secured party subject to that constraint might use the collateral in certain ways to earn a return during the period of the agreement, the value of its asset seemed to be very limited because of the debtor's right to demand the return of the particular security pledged as collateral on short notice.

251. However, the Board learned that paragraph 15 had been interpreted by constituents to indicate that collateral is not required to be recorded as an asset by a secured party if the debtor has the right to substitute other collateral or terminate the agreement on short notice, even if that right to substitute or terminate does not constrain the secured party from selling or repledging the collateral and therefore realizing all or most of its value. Because paragraph 15 did not explicitly require the secured party to consider factors beyond the existence of the debtor's right to substitute the collateral or terminate the contract on short notice in determining whether the ability of a secured party to obtain a benefit from the collateral is significantly constrained, some secured parties may not have recognized as assets collateral pledged under contracts even if the debtor's right may not have imposed a significant constraint. The result of those differing interpretations was lack of comparability between entities.

252. The Board decided to address this issue by reconsidering the accounting model for transfers of collateral. The Board proposed in the Exposure Draft of this Statement to require

that the secured party record the fair value of the right to sell or repledge collateral in all transactions in which the secured party receives that right. The fair value of that right would have been symmetrically derecognized by the debtor.

253. Under that approach, the nature of the right to sell or repledge would have been viewed as the secured party's opportunity to use that asset to generate income during the period that it is available to the secured party. That right represents only a portion of the rights associated with the collateral. Not recording the full value of the collateral is consistent with the Board's conclusion that the secured party does not obtain enough control to cause the transferor to derecognize the assets but that the secured party does obtain some rights to the collateral.

254. The Board also decided at that time that if a secured party has exercised its right to sell or repledge the collateral, it has and should recognize a liability to the transferor. The Board concluded that if the secured party has sold another entity's asset, the best measure of that liability is what it would have to sacrifice now to settle the liability—by obtaining a similar asset in the market to deliver to the debtor—which is the fair value of the pledged asset. Extending that reasoning, the Board concluded in the Exposure Draft of this Statement that the best measure of the secured party's liability if it has repledged the collateral is what it would have to sacrifice now to settle its obligation—either by redeeming the repledged asset early or by borrowing in the market a similar asset to deliver to the debtor—which is the fair value of the right to sell or repledge.

255. Constituents expressed concern about whether the approach proposed in the Exposure Draft of this Statement was operational. Some members of the Bond Market Association also questioned the operability of the approach and conducted a limited field test. At a Board meeting to discuss the results of the field test, representatives of that association voiced three concerns about the "value-of-the-rights" approach. First, the value of the right was not priced in the marketplace, so it was necessary to estimate the fair value of the right indirectly by measuring the difference between the unsecured rate and the secured rate for each transaction category multiplied by the duration and the notional amount. Second, there were a number of ways to calculate that estimate. Third, it was necessary to assume durations for open transactions, because there is no termination date on open transactions, and there was little evidence to support the assumptions as to how long the transaction would be open. Participants in the field test argued that subsequent accounting at fair value would be difficult but that disclosure of the gross amount of the collateral instead would convey useful information that would be less difficult to obtain.

256. After considering the results of that field test and other comments, the Board decided that while the value-of-the-rights approach was conceptually the best of the alternatives it had discussed, the cost of measuring the value of the right to use collateral outweighed the benefit of the generally immaterial result of the measurement. In addition, some Board members expressed concern that the right under consideration (the financial component of the asset no longer held by the debtor) in that approach was not the same as the debtor's right to reclaim the pledged

asset.

257. The Board adopted an alternative approach that requires the debtor to reclassify, in its statement of financial position, financial assets pledged that the secured party has the right to sell or repledge. That alternative carries over, and extends, a requirement in Statement 125 that applied only to collateral that the debtor did not have the right to redeem on short notice. The Board considers separate classification of pledged receivables in the statement of financial position to be necessary once those assets are pledged to a party who has the right to, and commonly does, sell or repledge them, because those financial assets pledged are effectively only receivables from the secured party and should not be reported in a way that suggests that the debtor still holds them. The Board considered requiring that the secured party recognize all such collateral as its assets but concluded that was inappropriate for the reasons cited in developing the value-of-the-rights approach. The Board carried over the requirement in Statement 125 that the secured party recognize its obligation to return collateral that it has sold to other parties, which had not been questioned by commentators. The Board also carried over, in paragraphs 92–94 of this Statement, the requirement to recognize cash “collateral” or securities received as “collateral” that a securities lender is permitted to sell or repledge, because the Board considers them to be, not collateral, but the proceeds of either a sale of the “loaned” securities or a borrowing secured by them.

Security Interests, Custodial Arrangements, Contributions, and Other Transfers That Do Not Qualify as Sales

258. The Board concluded that a borrower that grants a security interest in financial assets should not derecognize the financial assets during the term of the secured obligation. Although the borrower’s rights to those assets are restricted because it cannot sell them until the borrowing is repaid, it has not surrendered control if the lender cannot sell or repledge the assets unless the borrower defaults. That assets subject to a security interest have been pledged, and are therefore collateral in the possession of the lender or the lender’s agent, does not affect recognition by the debtor because effective control over those assets remains with the debtor in the absence of default under the terms of the borrowing.

259. To maintain symmetry in the accounting of secured parties and debtors (paragraphs 237–257), the Board decided that debtors should reclassify in their statements of financial position collateral that has been put into the hands of a secured party that is permitted by contract or custom to sell or repledge it. That reclassification avoids a situation in which two or more entities report the same assets as if both held them (as could occur under previous accounting practices).

260. Under previous practice, financial assets transferred to another party for safekeeping or custody continue to be carried as assets by the transferor. The only consideration exchanged in those transfers is, perhaps, payment of a fee by the transferor to the custodian for the custodial services. The custodian does not control the assets but must follow the transferor’s instructions.

The Board concluded that existing practice should continue and that this Statement need not deal with transfers of custody for safekeeping.

261. Some transfers of financial assets are unconditional nonreciprocal transfers that are contributions. The Board did not address them in Statement 125 and this Statement because accounting for contributions is addressed in FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*.

262. Some transfers of financial assets will fail to meet the criteria specified in paragraph 9 to be accounted for as sales even though they might be structured as and purport to be sales. The Board concluded that those transfers should be accounted for as secured borrowings.

Scope and Definition

263. In developing this Statement, the Board chose to exclude from its scope transfers of investments in financial assets that are in substance the sale of real estate and exchanges of equity method investments for similar productive assets. Those transactions were excluded because, as the EITF noted in its Issues No. 98-7, “Accounting for Exchanges of Similar Equity Method Investments,” and No. 98-8, “Accounting for Transfers of Investments That Are in Substance Real Estate,” there were inadvertent overlaps in scope between Statement 125 and other accounting standards issued previously. Under APB Opinion No. 29, *Accounting for Nonmonetary Transactions*, exchanges of similar productive assets, including equity investments accounted for under the equity method, are accounted for based on the recorded amount of the asset relinquished. Under FASB Statement No. 66, *Accounting for Sales of Real Estate*, the sale of stock in enterprises with substantial real estate or of interests in certain partnerships are examples of transactions that are in substance the sale of real estate, and sales of real estate are accounted for differently from the accounting for transfers of financial assets under Statement 125. The Board’s decision affirms the consensus in Issues 98-7 and 98-8. The Board also considered removing from the scope of this Statement all other transfers of equity interests accounted for under the equity method but decided against that because no other pronouncements of the FASB or its predecessors provide accounting standards for such transactions.

264. Statement 125 amended earlier leasing pronouncements to require the residual value of an asset leased in a sales-type or direct financing lease to be classified as a financial asset, and the increase in its estimated value to be recognized over the remaining lease term, *to the extent that the residual value is guaranteed* by any party. In response to a constituent’s comment that practice in interpreting that guidance was diverse, the Board decided to amend that guidance, in paragraphs 89 and 352 of this Statement, to clarify that a residual value of a leased asset is a financial asset only to the extent of a guarantee obtained (whether from a third party or the lessee) *at inception of the lease*. The Board considered several alternatives. It rejected financial instrument classification for all guaranteed residual values (whether guaranteed at inception or later) because the Board views a guarantee obtained after lease inception as a contract separate

from the lease. The Board rejected restricting that classification only to residual values guaranteed by the lessee because it was convinced by constituents that it did not matter who guaranteed the residual value and that securitizations of leases commonly involve a third-party guarantee. The Board also accepted that it was important for securitization purposes to allow a guarantee at inception to change the nature of a residual value to a financial asset so that it could be held by a qualifying SPE. Constituents noted that unless the qualifying SPE holds the residual interests as well as the guarantee and the lease receivables, concern may arise that the party holding the residual interests could nullify the lease contract in receivership.

Measurement under the Financial-Components Approach

265. Following a transfer of financial assets that qualifies as a sale, assets retained or obtained and liabilities incurred by the transferor could at first be measured at either (a) fair value at the date of the transfer or (b) an allocated portion of the transferor's carrying amount for the assets transferred.

266. The usual initial measure of assets and liabilities is the price in an exchange transaction or the equivalent fair value. Paragraph 88 of FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, states:

Initial recognition of assets acquired and liabilities incurred generally involves measurement based on current exchange prices at the date of recognition. Once an asset or a liability is recognized, it continues to be measured at the amount initially recognized until an event that changes the asset or liability or its amount occurs and meets the recognition criteria.

267. In Opinion 29, the Accounting Principles Board, in prescribing the basis for measurement of assets received in nonmonetary exchanges, states:

. . . in general accounting for nonmonetary transactions should be based on the fair values of the assets (or services) involved which is the same basis as that used in monetary transactions. [Paragraph 18, footnote reference omitted.]

268. The Board believes that those concepts should be applied to new interests obtained or incurred in transfers of financial assets. At issue is whether the financial assets controlled and liabilities incurred in a transfer of financial assets that qualifies as a sale are new to the transferor and thus are part of the proceeds from the transfer, subject to initial measurement using the concepts summarized in paragraphs 266 and 267, or instead are retained beneficial interests over which the transferor has not surrendered control that need not be subject to new measurement under those concepts. The Board concluded that the answer depends on the type of financial instrument or other interest held or incurred.

269. The Board decided that a distinction can and should be made between new assets and liabilities that are part of the proceeds from the transfer and continuing interests in retained

assets held in a new form. Cash received as proceeds for assets sold has no continuing connection with those assets and is clearly a new asset. Unrelated assets obtained also are clearly new assets, for example, a government bond received in exchange for transferred accounts receivable. Any asset received that is not an interest in the transferred asset is new to the transferor and thus is part of the proceeds from the sale. Any liability incurred, even if it is related to the transferred assets, is an obligation that is new to the transferor and thus a reduction of proceeds. Therefore, all of those new assets and liabilities should be initially measured at fair value. The issue becomes more challenging for assets controlled after a sale that are related to the assets sold.

Measuring Liabilities and Derivative Financial Instruments Related to Assets Sold at Fair Value

270. An entity that sells a financial asset may incur liabilities that are related to the assets sold. A common example of a liability incurred by the transferor is a recourse or guarantee obligation. Certain risks, such as recourse or guarantees, are inherent in the original financial asset before it is transferred, which might seem to support carrying over the prior carrying amount. However, before the transfer, the transferor has no obligation to another party; after the transfer, it does. The Board concluded that liabilities incurred in a transfer of financial assets are therefore new and should be initially measured at fair value.

271. An entity that sells a financial asset may enter into derivative financial instrument contracts that are related to the assets sold, for example, options, forwards, or swaps. One example is an option that allows purchasers of receivables to put them back to the transferor, which is similar to a recourse obligation. Another example is a repurchase commitment held by the seller in a repurchase agreement that is accounted for as a sale,²⁹ which is a kind of forward contract. A third example is an agreement similar to an interest rate swap in which the transferor receives from a securitization trust the fixed interest amounts due on securitized receivables and pays the trust variable amounts based on a floating interest rate index. A party to an option or a forward purchase or sale commitment generally does not recognize the acquisition or disposition of the underlying assets referenced in the contract until and unless delivery occurs. A party to a swap recognizes the net present value of amounts receivable or payable under the swap rather than the full notional amount of the contract. Options, forward commitments, swaps, and other derivative contracts are financial assets or liabilities separate and distinct from the underlying asset. For that reason and because of the practical need to make a workable distinction, the Board concluded that derivative financial instruments entered into by a seller in an exchange for a financial asset are newly created in the transaction and should be considered part of the proceeds and initially measured at fair value at the date of exchange.

272. Respondents to the Exposure Draft of Statement 125 asked the Board to provide more detailed guidance on how they should differentiate between an asset or liability that is part of the proceeds of a transfer and a retained interest in transferred assets. The Board acknowledges that, at the margin, it may be difficult to distinguish between a retained interest in the asset transferred and a newly created asset. The Board believes that it is impractical to provide detailed guidance

that would cover all possibilities. A careful examination of cash flows, risks, and other provisions should provide a basis for resolving most questions. However, the Board agreed that it would be helpful to provide guidance if an entity cannot determine how to classify an instrument and decided that in that case the instrument should be considered to be a new asset and thus part of the proceeds of the sale initially measured at fair value.

Measuring Retained Interests in Assets Sold at Allocated Previous Carrying Amount

273. The Board decided that all other interests in the transferred financial assets held after a securitization or other transfer of financial assets should be measured at their previous carrying amount, allocated between the assets sold, if any, and the retained interests, if any, based on their relative fair values at the date of the transfer. Retained interests in the transferred assets continue to be assets of the transferor, albeit assets of a different kind, because they never left the possession of the transferor and, thus, a surrender of control cannot have occurred. Therefore, the retained interests should continue to be carried at their allocated previous carrying amount, with no gain or loss recognized. Defining this category as the residual set of interests in transferred instruments held after the transfer (those interests that are neither derivatives nor liabilities of the transferor) establishes a clearer distinction between assets and liabilities that are part of the proceeds of the transfer and retained interests.

Other Alternatives Considered

274. In developing the Exposure Draft of Statement 125, the Board considered several alternative measurement approaches including (a) measuring all assets held after a securitization or sale of a partial undivided interest (either a pro rata interest or a nonproportional interest) initially at fair value, (b) measuring interests held after a securitization at fair value and measuring retained undivided interests at allocated previous carrying amounts, and (c) measuring all interests in transferred financial assets held after a transfer at their allocated previous carrying amounts. Some respondents to that Exposure Draft supported each of those approaches. However, most respondents agreed with the Board's reasoning that a retained interest in a transferred asset represents continuing control over a previous asset, albeit in different form, and thus should not be remeasured at fair value. Most respondents also accepted the approach proposed in the Exposure Draft of Statement 125 as workable.

275. Another possibility that was rejected by the Board was to allocate the carrying amount between the portion of an asset sold and the portion of an asset retained based on relative fair values at the date the receivable was originated or acquired by the transferor, adjusted for payments and other activity from the date of acquisition to the date of transfer. The consensus reached in EITF Issue No. 88-11, "Allocation of Recorded Investment When a Loan or Part of a Loan Is Sold," required use of that acquisition date method unless it is not practical, in which case the allocation should be based on relative fair values at the date of sale. In its deliberations of Statement 125 and this Statement, the Board decided to require allocation based on fair values at the date of sale or securitization because it is more representative of the asset's value, and the cost of re-creating the information from the date of acquisition would exceed the perceived

benefits. The Board decided that the acquisition date method was not clearly superior in concept to an allocation based on fair values at the date of sale or securitization and, based in part on practices under that consensus, that that method was so often impractical because of recordkeeping difficulties that it was not useful as a general principle. No other possible methods of allocation appeared likely to produce results that were significantly more relevant.

Servicing Assets and Servicing Liabilities

276. Previously, net "mortgage servicing rights" were recognized as assets, and those rights were accounted for in accordance with FASB Statements No. 65, *Accounting for Certain Mortgage Banking Activities*, No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, and No. 122, *Accounting for Mortgage Servicing Rights*. The amount recognized as net mortgage servicing rights was based on the fair value of certain expected cash inflows net of expected cash outflows. The expected cash inflows—future servicing revenues—included a normal servicing fee, ³⁰ expected late charges, and other ancillary revenues. The expected cash outflows—future servicing costs—included various costs of performing the servicing. A separate "excess servicing fee receivable" was recognized if the servicer expected to receive cash flows in excess of a normal servicing fee, and a liability was recognized if the servicer expected to receive less than a normal servicing fee or if the entity's servicing costs were expected to exceed normal costs. The servicing rights asset was subsequently measured by amortization and assessment for impairment based on its fair value. That set of procedures has been called the mortgage servicing method.

277. Servicing assets and obligations for other assets sold or securitized were either accounted for like mortgage servicing or, more commonly, remained unrecognized until amounts were received and services were provided. Attempts have been made in practice to extend the mortgage servicing method to the servicing of other financial assets. However, identifying a normal servicing fee and other aspects of the mortgage servicing method have been difficult and disparate practices have resulted. The Board concluded it was necessary to address in this project accounting for servicing of all kinds of financial assets.

278. In October 1993, the Board decided to reconsider the accounting for mortgage servicing activities established in Statement 65. The primary thrust of that project was to resolve differences in the accounting for purchased versus originated mortgage servicing. Statement 122 was the result of that effort. In February 1995, the Board decided that accounting for excess mortgage servicing receivables and other servicing issues should be dealt with, to the extent necessary, not in that project but rather in this one, because those issues largely arise in transfers of financial assets and possible answers are necessarily interrelated. The Board considered alternative methods of accounting for servicing (the mortgage servicing method required by Statement 65, as amended by Statement 122, as well as a gross method and a right or obligation method) and chose a method that combines the best features of the mortgage servicing method and other possible methods.

Alternatives to the Mortgage Servicing Method

279. The mortgage servicing method described in paragraph 276 was required by Statement 65, as amended by Statement 122, for mortgage servicing rights. While that method was familiar to mortgage servicers and had certain advantages over other methods, the distinction between normal and excess servicing and other complexities of the method made it difficult to apply for some other kinds of servicing.

280. The Board considered a gross method that would have required that a servicer recognize both a servicing receivable asset consisting of expected future servicing revenues and a servicing obligation liability for the servicing work to be performed. The Board decided that it was questionable whether a receivable for servicing not yet rendered met the definition of an asset and that, given the conceptual questions, that method did not merit the large change in practice that it would have required.

281. The Board also considered a right or obligation method that would have recognized a single item, commonly an asset but occasionally a liability, for each servicing contract. That asset or liability would have been the net of the gross asset and liability that would have been reported separately under the gross approach. The resulting asset would have been subsequently measured like an interest-only strip, that is, at fair value with unrealized gains and losses recognized in equity if available-for-sale. Some respondents suggested that servicing rights should be subsequently measured in that way, because reporting servicing rights at fair value would be more useful to investors and other financial statement users than the historical cost amortization and impairment methods of the mortgage servicing approach. Furthermore, under an approach like that in Statement 115, unrealized gains and losses would not have been recognized in earnings, but rather in a separate component of shareholders' equity.

282. The Board considered the right or obligation method well suited in several respects to the range of mortgage and other servicing contracts that now exist or might arise. However, the Board did not choose that method in part for the practical reason of avoiding an early change from the recently adopted provisions of Statement 122. Instead, the Board chose to combine the best features of that method—the simplicity of reporting only a single asset or liability for each servicing contract and not having to distinguish between normal and excess servicing—with the best features of the mortgage servicing method.

Recognition and Measurement of Servicing Assets and Servicing Liabilities

283. The method adopted in Statement 125 carries forward the amortization and impairment provisions that were required under the mortgage servicing method in Statements 65 and 122 and that method was not reconsidered in this Statement. The Board considers those subsequent measurement provisions workable. However, changes to the mortgage servicing method are necessary to adapt the accounting for mortgage servicing to all servicing assets and servicing liabilities, to reduce complexities for financial statement preparers and users, and to be

compatible with the other recognition and initial measurement principles in Statement 125 and this Statement.

284. One change is the elimination of the distinction between normal and excess servicing. The Board decided that that distinction has been too difficult to make except in markets as liquid as the market for residential mortgage servicing. The Board considered two ways in which normal and excess servicing might be retained in accounting for those liquid markets.

285. One way would have been to leave in place the accounting for servicing of mortgages as required in Statement 65, as amended by Statement 122, while using a different method that was not dependent on determining a normal servicing fee for all other servicing. However, the Board concluded that comparability of financial statements would have suffered if the accounting for essentially similar servicing activities differed depending on the type of asset serviced. Another way would have been to revise the definition of normal servicing fee rates so that servicers could determine a normal servicing fee rate in the absence of a developed secondary market for servicing. That change would have provided servicers of other types of loans or receivables (such as auto loans and credit card balances) with an opportunity to establish normal servicing rates and apply the mortgage servicing method to other servicing rights, rather than be subject to recognizing less gain or more loss on the sale of receivables because normal servicing was unknown. The Board considered that method but concluded that that alternative might result in continuing questions about what are normal servicing fees for different types of servicing.

286. The Board also noted that the distinction between normal and excess servicing, even in liquid markets, is no longer relevant for financial reporting because under current market practices, excess and normal servicing assets, which arise from a single contract, generally cannot be sold separately after the sale or securitization of the underlying financial assets. The excess servicing receivable, like normal servicing, will be collected only if the servicing work is performed satisfactorily. In addition, accounting based on that distinction is unduly complex and often results in several assets and liabilities being recognized for one servicing contract. While excess servicing continues to resemble an interest-only strip in some respects, the Board concluded in light of the lessened distinction between normal and excess servicing that it is more useful to account for all servicing assets and servicing liabilities in a similar manner.

287. The Board chose instead to distinguish only between the benefits of servicing—amounts that will be received only if the servicing work is performed to the satisfaction of the assets' owner or trustee—and other amounts retained after a securitization or other transfer of financial assets. A consequence of that method is that interest-only strips retained in securitizations, which do not depend on the servicing work being performed satisfactorily, are subsequently measured differently from servicing assets that arise from the same securitizations. That difference in accounting could lead transferors that retain an interest in transferred assets to select a stated servicing fee that results in larger servicing assets and lower retained interests (or vice versa) with an eye to subsequent accounting. The Board believes, however, that the potential accounting incentives for selecting a higher or lower stated servicing fee largely will

counterbalance each other.

288. Most respondents agreed with the Board's decision to eliminate the distinction between excess and normal servicing. Some respondents to the Exposure Draft of Statement 125 asked for further explanation of the new terms it used for accounting for servicing and about how they differed from the terminology of the mortgage servicing approach used in prior pronouncements. In response, Statement 125 defines the terms *adequate compensation* for servicing, *benefits of servicing*, and *contractually specified servicing fees*. Those definitions and the discussion of them are carried forward without reconsideration in the glossary and in paragraphs 61–64 of this Statement.

289. The Exposure Draft of Statement 125 proposed that an entity account for all servicing assets in the same manner because rights to service financial assets, while they may differ in the particulars of the servicing, in the extent of compensation, and in liquidity, are in essence the same. As with other retained interests in transferred assets, valid arguments can be made for measuring servicing assets either at allocated previous carrying amount or at fair value. However, the Board saw no reason to treat retained servicing assets differently than other retained interests and therefore decided that they should be initially measured at allocated previous carrying amount.

290. For similar reasons, the Board viewed servicing liabilities as new obligations arising from a transfer and decided to account for them like other liabilities incurred upon sale or securitization, at fair value.

291. Some respondents questioned how to apply the transition provisions to servicing rights and excess servicing receivables in existence as of the effective date of Statement 125. The Board retained paragraph 20 of Statement 125 without reconsideration in this Statement. Paragraph 25 does not permit retroactive application of Statement 125 to (a) ensure comparability between entities and (b) clarify how Statement 125 should be applied to previous balances.

Financial Assets Subject to Prepayment

292. Paragraph 362 of this Statement carries forward without reconsideration from Statement 125 the amendment to Statement 115 to eliminate the use of the *held-to-maturity* category for securities subject to substantial prepayment risk, thereby requiring that they be classified as either available-for-sale or trading and subsequently measured at fair value. Paragraph 14 extends that measurement principle to interest-only strips, loans, other receivables, and retained interests in securitizations subject to substantial prepayment risk.

293. The justification for using historical-cost-based measurement for debt securities classified as held-to-maturity is that no matter how market interest rates fluctuate, the holder will recover its recorded investment and thus realize no gains or losses when the issuer pays the amount promised at maturity. The same argument is used to justify historical-cost-based measurement

for other receivables not held for sale. That justification does not extend to receivables purchased at a substantial premium over the amount at which they can be prepaid, and it does not apply to instruments whose payments derive from prepayable receivables but have no principal balance, as demonstrated by large losses realized in recent years by many holders of interest-only strips and other mortgage derivatives. As a result, the Board concluded that those receivables must be subsequently measured at fair value with gains or losses being recognized either in earnings (if classified as trading) or in a separate component of shareholders' equity (if classified as available-for-sale). The Board, by deciding that a receivable may not be classified as held-to-maturity if it can be prepaid or otherwise settled in such a way that the holder of the asset would not recover *substantially all* of its recorded investment, left room for judgment, so that investments in mortgage-backed securities or callable securities purchased at an insubstantial premium, for example, are not necessarily disallowed from being classified as held-to-maturity.

294. Some respondents to the Exposure Draft of Statement 125 agreed with the Board's conclusions about financial assets subject to prepayment when applied to interest-only strips but questioned the application of those conclusions to loans, other receivables, and retained interests in securitizations. They maintained that the nature of the instrument and management's intent should govern classification rather than actions that a borrower might take under the contract.

295. The Board did not agree with those arguments. A lender that holds a portfolio of prepayable loans or bonds at par will realize the carrying amount of its investment if the borrowers prepay. However, if the lender originated or acquired those loans or bonds at a substantial premium to par, it may lose some or all of that premium and thus not recover a substantial portion of its recorded investment if borrowers prepay. The potential loss is less drastic for premium loans or bonds than for interest-only strips, but it can still be substantial. The Board concluded that the rationale outlined in paragraph 293 extends to any situation in which a lender would not recover substantially all of its recorded investment if borrowers were to exercise prepayment or other rights granted to them under the contracts. The Board also concluded that the provisions of paragraph 14 do not apply to situations in which events that are not the result of contractual provisions, for example, borrower default or changes in the value of an instrument's denominated currency relative to the entity's functional currency, cause the holder not to recover substantially all of its recorded investment.

296. Other respondents asked that the Board clarify the term *substantially all*. Some suggested that the Board use the 90 percent test found in APB Opinion No. 16, *Business Combinations*. Although applying the term *substantially all* requires judgment about how close to 100 percent is close enough, the Board decided to leave the language of paragraphs 14 and 362 unchanged rather than to require a specific percentage test that would be inherently arbitrary.

Fair Value

297. The Board decided to include an approach for measuring fair value that would be broadly

applicable. The definition of fair value in paragraphs 68–70 is consistent with that included in other recent Statements.³¹ The Board found no compelling reason to redefine *fair value* under the financial-components approach.

298. Many of the assets and liabilities held after a sale by a transferor with continuing involvement are not traded regularly. Because quoted market values would not be available for those assets and liabilities, fair values would need to be determined by other means in applying the financial-components approach. There was concern that, in some cases, the best estimate of fair value would not be sufficiently reliable to justify recognition in earnings of a gain following a sale of financial assets with continuing involvement, because errors in the estimate of asset value or liability value might result in recording a nonexistent gain. The Board considered requiring that fair value be verifiable to achieve a higher degree of reliability to justify recognition in earnings of a gain following a sale of financial assets with continuing involvement. However, to promote consistency between its Statements, the Board decided not to introduce a new notion of fair value based on reliability.

299. The Exposure Draft of Statement 125 proposed that gain recognition following a sale with continuing involvement should be allowed only to the extent that it is practicable to estimate fair values for assets obtained and liabilities incurred in sales with continuing involvement. To accomplish that, the Board concluded that if it is not practicable to estimate their fair values, assets should be measured at zero and liabilities at the greater of the amount called for under FASB Statement No. 5, *Accounting for Contingencies*, as interpreted by FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, or the excess, if any, of the fair value of the assets obtained less the fair value of the other liabilities incurred over the sum of the carrying values of the assets transferred. That requirement was intended to prevent recognition of nonexistent gains through underestimating liabilities. The Board considered whether the practicability exception should be extended to the transferee's accounting and decided not to allow such an exception. The Board concluded that because the transferee is the purchaser of the assets, it should be able to value all assets and any liabilities it purchased or incurred, presumptively based on the purchase price paid. In addition, because the transferee recognizes no gain or loss on the transfer, there is no possibility of recognizing a nonexistent gain.

300. Respondents to the Exposure Draft of Statement 125 asked the Board to clarify the meaning of the term *practicable*, especially in relation to the use of the same term in Statement 107. The comment letters also revealed a considerable range of interpretation of that provision among respondents. Some suggested that the provision would apply to all but the most common transactions. Others suggested that the provision would seldom apply and alluded to the relatively few entities that have used the practicability exception in Statement 107.

301. Because no practicability exception is used, for example, in Statement 133, the Board considered whether to expand the discussion of practicability, or to remove it from Statement 125 and this Statement. The Board ultimately concluded that the practicability provisions should remain unchanged in this Statement for the reasons noted in paragraphs 298 and 299.

302. Other respondents to the Exposure Draft of Statement 125 suggested that there should be a limit on the amount of gain that can be recognized in a transfer of financial assets. Several suggested the limitation found in Issue 88-11. In that Issue, the task force reached a consensus that “the amount of any gain recognized when a portion of a loan is sold should not exceed the gain that would be recognized if the entire loan was sold.” Respondents maintained that a limitation would meet the Board’s objective of preventing recognition of nonexistent gains through underestimating liabilities.

303. The Board rejected the suggested limitation for several reasons. First, it was not clear that the limitation in Issue 88-11 could have been applied across a wide range of transactions. The limitation presumes that a market price exists for transfers of whole assets, but one reason that securitization transactions take place is because sometimes no market exists for the whole assets being securitized. Second, the limitation would have required that accountants ignore the added value that many maintain is created when assets are divided into their several parts. Third, the use of relative fair values at the date of transfer, rather than relative fair values on initial acquisition as in Issue 88-11, would have mitigated many of the concerns that appear to have prompted the task force to adopt a limitation. Finally, the Board was concerned that a gain limitation might have obscured the need to consider whether the transaction gives rise to a loss.

304. In its deliberations of this Statement, the Board considered constituents’ concerns that retained interests were not being appropriately valued in certain securitizations. One constituent suggested that, under the relative-fair-value allocation method required by paragraph 10 of Statement 125, transferors were allocating too much to the relatively low-risk senior interests that have been sold, whereas the bulk of the profit from lending and selling loans ought to be attributed to realizing the value of the high-risk subordinated interests, which typically have not yet been sold. The Board again considered limiting the amount of the gain, as discussed prior to Statement 125, but rejected that limitation for the same reasons cited in paragraph 303.

305. The Board recognizes that risk assumed in connection with subordinated retained interests will affect the expected cash flows or discount rate used to value the retained interests and agreed with constituents’ concern that risk has not always been adequately taken into account. To the extent that risk is not adequately taken into account, subordinated retained interests are overvalued and consequently the gain calculated is higher (or loss is lower) than it should be. However, the Board does not believe that concerns about failure to reasonably estimate the fair value of the various items created in a securitization can be eliminated by an arbitrary ceiling. Instead, the Board believes those responsible for financial statements need to exercise care in applying this Statement, and, as discussed in paragraph 59, should be able to identify the reasons for gains on securitization. For the same reasons, as discussed in paragraphs 323–332, the Board also decided in this Statement to require disclosure about the key assumptions made in valuing retained interests.

Subsequent Measurement

306. The provisions of Statement 125 that were carried forward without reconsideration in this Statement focus principally on the initial recognition and measurement of assets and liabilities that result from transfers of financial assets. This Statement does not address subsequent measurement except for servicing assets and servicing liabilities and financial assets subject to prepayment that were also addressed in Statement 125.

307. Several respondents to the Exposure Draft of Statement 125 also asked the Board to include guidance about subsequent measurement. They observed that the financial-components approach leads to recognition of assets and liabilities that were not recognized under previous standards. They also observed that accountants who draw analogies to existing accounting practices may find a variety of equally plausible approaches to subsequent measurement.

308. The Board is sensitive to concerns about subsequent measurement, especially to the possibility of emerging diversity in practice. However, attempting to address subsequent measurement would have expanded significantly the scope of this project. In addition, any guidance on subsequent measurement in this project would have applied only to assets and liabilities that emerge from a transfer of financial assets. Accounting for similar assets and liabilities not connected with a transfer of financial assets would have continued to follow existing practice; if so, diversity would have continued to exist. On balance, the Board concluded that it was better to complete this project without providing guidance on subsequent measurement and leave reconsideration of existing standards and practices for subsequent measurement for future segments of the Board's financial instruments project or other projects.

Extinguishments of Liabilities

309. Statement 76 required that a debtor treat a liability as if extinguished if it completed an in-substance defeasance. Under that Statement, a debtor derecognized a liability if it transferred essentially risk-free assets to an irrevocable defeasance trust and the cash flows from those assets approximated the scheduled interest and principal payments of the debt that was being extinguished. Under that Statement, the debtor also derecognized the assets that were set aside in the trust.

310. Derecognition of liabilities after an in-substance defeasance has been controversial. A number of respondents to the Exposure Drafts that led to Statement 76 and subsequent Board requests for comment have criticized the transactions as having insufficient economic substance to justify derecognition or gain recognition. Researchers and analysts have demonstrated that in-substance defeasance transactions conducted after interest rates have risen, which resulted in an accounting gain under Statement 76, have economic impact; those transactions constitute an economic loss to shareholders.³² That research and analysis suggest that derecognition of liabilities and recognition of a gain in those circumstances may not be representationally faithful.

311. Under the financial-components approach, an in-substance defeasance transaction does not

meet the derecognition criteria for either the liability or the asset. The transaction lacks the following critical characteristics:

- a. The debtor is not released from the debt by putting assets in the trust; if the assets in the trust prove insufficient, for example, because a default by the debtor accelerates its debt, the debtor must make up the difference.
- b. The lender is not limited to the cash flows from the assets in trust.
- c. The lender does not have the ability to dispose of the assets at will or to terminate the trust.
- d. If the assets in the trust exceed what is necessary to meet scheduled principal and interest payments, the transferor can remove the assets.
- e. Neither the lender nor any of its representatives is a contractual party to establishing the defeasance trust, as holders of interests in a qualifying SPE or their representatives would be.
- f. The debtor does not surrender control of the benefits of the assets because those assets are still being used for the debtor's benefit, to extinguish its debt, and because no asset can be an asset of more than one entity, those benefits must still be the debtor's assets.

312. The Board concluded that the previous treatment of in-substance defeasance was inconsistent with the derecognition criteria of the financial-components approach and that the provisions on in-substance defeasance in Statement 76 should be superseded by Statement 125. Respondents to the Exposure Draft of Statement 125 generally accepted that change, although some disagreed, citing arguments similar to those made in Statement 76 and refuted, in the Board's view, by the critical characteristics cited in paragraph 311.

313. Paragraph 3(a) of Statement 76 required derecognition of the transferred assets and the liability by the debtor if a debtor transfers assets to its creditor in exchange for a release from all further obligation under the liability. That provision has not been controversial and is consistent with the financial-components approach. Accordingly, paragraph 3(a) of Statement 76 was incorporated substantially unchanged as paragraph 16(a) of this Statement.

314. Paragraph 3(b) of Statement 76 stated, “The debtor is legally released from being the primary obligor under the debt either judicially or by the creditor *and it is probable that the debtor will not be required to make future payments with respect to that debt under any guarantees*” (emphasis added; footnote references omitted). Except for the italicized portion, paragraph 3(b) was carried forward without reconsideration as paragraph 16(b) of this Statement. Some respondents to the Exposure Draft of Statement 125 disagreed with that change, arguing that the revised provision was too lenient in that it might allow, for example, derecognition of liabilities and inappropriate gain recognition when entities are replaced as primary obligor by entities with little economic substance. However, the italicized phrase is omitted from Statement 125 and this Statement because it is contrary to the financial-components approach. If an entity is released from being a primary obligor and becomes a secondary obligor and thus effectively a guarantor of that liability, it should recognize that guarantee in the same manner as a third-party guarantor that was never the primary obligor. The Board noted, however, that concerns about

inappropriate gains are unwarranted: if an entity with little substance were to become a primary obligor, a guarantor of that obligation would have to recognize a liability almost as great as if it were the primary obligor. To emphasize those matters, the Board included a discussion of the secondary obligor's liability in Appendix A.

315. The Board concluded that the basic principle that liabilities should be derecognized only if the debtor pays the creditor or is legally released from its obligation applies not just to debt securities but to all liabilities. Accordingly, Statement 125 and this Statement broaden the scope of paragraphs 3(a) and 3(b) of Statement 76 to include all liabilities not excluded from Statement 125 and this Statement's scope by paragraph 4 and to delete the reference to sales in the public market.

Disclosures

316. The Board decided that Statement 125 should continue to require disclosure of debt defeased in accordance with Statement 76 before the effective date of Statement 125 because Statement 125 does not change the accounting for those defeasance transactions. The Board also decided to require that an entity disclose assets restricted to the repayment of particular debt obligations, for example, in in-substance defeasance transactions after Statement 125 becomes effective, because while that restriction is insufficient cause to derecognize the assets, that information is useful in determining what resources are unavailable to general creditors and for general operations. The Board decided that an entity should disclose its policies for requiring collateral or other securities in repurchase agreements and securities lending transactions accounted for as borrowings. The Board believes that that information is useful for assessing the amount of risk that an entity assumes in repurchase agreements and securities lending transactions, which appears to vary considerably in practice.

317. The Board also decided to carry forward the disclosures required by Statement 122 and extend them to all servicing rights, because those disclosures provide information financial statement users need to make independent judgments about the value of servicing rights and obligations and the related risks.

318. In addition, the Board decided to require that an entity describe items for which it is impracticable to measure their fair value and disclose why the fair value of an asset obtained or liability incurred could not be estimated, despite the concerns of some Board members that this requirement was unnecessary and might lead to uninformative disclosures.

Disclosures about Collateral

319. In connection with the issuance of Statement 125, the Board decided to require entities to disclose their policies for requiring collateral or other security for securities lending transactions and repurchase agreements to inform users about the credit risk that entities assume in those transactions, because there appeared to be significant variation in practice. Commentators did

not object to that disclosure, which is carried forward without substantial change in this Statement.

320. After it decided to remove certain of Statement 125's recognition requirements for collateral, the Board decided that further disclosures about the value of collateral are appropriate. It chose to require disclosure of (a) the fair value of collateral accepted that could be sold or repledged and (b) the portion of that collateral that had been sold or repledged. The Board considers that information relevant for investors and creditors who wish to understand the scale of collateralized transactions, the extent to which that collateral is used, or the relationship between income from use of collateral and the amount of collateral used and available for use. In considering the costs of preparing that information, the Board determined that similar information is already maintained for other purposes by entities that accept large amounts of collateral. The Board believes that that information could be developed by other entities at a moderate cost well justified by the value of the information. Commentators generally favored that disclosure instead of the proposal to account for the value of rights to use collateral. After the Board decided in its redeliberations that collateral should not be accounted for under the value-of-the-rights approach or recognized as an asset by secured parties, it concluded that those disclosures are necessary to indicate the extent of collateral available to the secured party and the usage of that resource, and required them in this Statement.

321. In the Exposure Draft of Statement 125, the Board did not propose additional disclosures by entities that pledge their assets, largely because disclosure of assets pledged as security is already required under paragraphs 18 and 19 of Statement 5. After the Board decided in its redeliberations that collateral should not be accounted for under the value-of-the-rights approach, as discussed in paragraphs 255 and 256, it chose to refine the general requirement from Statement 5, to avoid redundant information. Specifically, this Statement requires an entity that pledges any assets as collateral that the secured party *cannot* sell or repledge to disclose the carrying amount and classification of those assets. Collateral that a secured party can sell or repledge is already reclassified and separately reported in the statement of financial position pursuant to paragraph 15(a).

322. In the redeliberations of this Statement, the Board considered two other alternatives for disclosing collateral. The first alternative was to require disclosure of the value of the right to use collateral, in place of recognition of that value in the financial statements. The Board concluded, based in part on the results of the informal field test, that the cost of computing and disclosing the value of the right to use the collateral would exceed its benefits. The second alternative would have required the disclosure of earnings generated by secured parties from the use of pledged collateral. Additional research on the feasibility of that alternative uncovered a potential for inconsistency in disclosures across firms that could result in lack of comparability. In addition, the Board accepted arguments that information about earnings generated from the use of collateral is not currently isolated for management or reporting purposes and therefore new systems would have been needed to be developed by the larger firms to generate that information for disclosure. Because it appeared doubtful that the value of this information would

justify the cost of extensive systems changes, the Board rejected that alternative.

Disclosures about Securitizations

323. During the deliberations leading to Statement 125, the Board considered whether additional disclosures were necessary in the context of that Statement or whether current standards provide adequate disclosure of interests retained in a transfer of financial assets. The Board concluded then that sufficient requirements were in place (for example, in FASB Statement No. 95, *Statement of Cash Flows*, and other pronouncements) for transfers and servicing of financial assets, extinguishments of liabilities, and the resulting components of those transfers and extinguishments and that the potential benefits of requiring additional disclosures did not appear to justify the costs involved.

324. Since Statement 125 became effective, however, a number of entities that securitize financial assets have materially restated gains recognized in earlier financial statements or have materially changed estimates of the fair value of their retained interests. Those restatements led some to contend that gain or loss recognition should not be permitted for securitizations in which significant interests are retained by the transferor and others to demand additional disclosures. The Board rejected suggestions that gain or loss recognition is inappropriate for transfers of financial assets that qualify as sales, though it observed that Statement 125 and this Statement do have procedures to be followed if it is impracticable to measure the fair value of retained interests. However, the Board did agree to consider whether, in light of those developments, the benefits of further disclosure might indeed justify the costs involved.

325. Members of the Board and staff met with analysts, investors, and preparers during 1998 to learn more about the type of information that financial statement users need to adequately assess the amounts of risks involved in securitization transactions and the availability of that information. Some analysts and investors called for increased disclosure about key assumptions because they believe that the current disclosures are inadequate and sometimes misleading. They contend that assumptions about interest rates, prepayments, and losses are especially important in assessing whether the projected future earnings of an entity are attainable and whether write-downs of retained interests or other unfavorable events will occur.

326. Based on those discussions and the concerns voiced, the Board concluded that disclosures about securitization transactions needed to be enhanced. Preparers of financial statements from the financial services industry told Board members and staff that they already prepare and disclose much of the information that financial statement users want, in documents required to be filed with the SEC, in electronic information media in connection with publicly offered securitizations, or in data voluntarily provided on an entity-wide basis. They suggested that summary disclosures (disaggregated on a product-by-product basis) provided in financial statements or in the management discussion and analysis (MD&A) could offer investors and analysts the information that they need to assess both the level of risk and the impact that securitizations have on an entity's overall earnings.

327. The Board decided that enhanced disclosures should focus on two aspects of securitizations: the results of securitization transactions entered into during the period and the valuation of retained interests in past securitizations that are still outstanding at the end of the period.

328. The Board concluded that, at a minimum, financial statements should provide, for all securitizations entered into during the period, a description of (a) the transferor's accounting policies for initially measuring interests retained in a securitization; (b) the characteristics of securitizations entered into, and gain or loss from securitizations of financial assets during the year by major type of asset; (c) quantitative information about key assumptions used to value interests retained at the time of securitization that affect the amount of income recognized during the period; and (d) cash flows between the securitization SPE and the transferor. The Board concluded that under those requirements, financial statement users would receive information that would assist them in assessing the effect of securitization transactions on the results of operations and cash flows and be useful in assessing the valuation of interest-only strips, subordinated tranches, servicing, cash reserve accounts, and other interests retained in the securitization. The Board chose to require disclosures by major class of asset securitized because prepayment, credit loss, and interest rates vary so widely between major classes that aggregating data across those classes would obscure useful information. The Board decided to require information about weighted-average life so that disclosures of prepayment assumptions would be more comparable if different companies use different calculation methods. While other disclosures were suggested, the Board concluded that the problems associated with restatements and inappropriate assumptions could be best highlighted by the disclosures it selected and that the cost of further disclosures might outweigh the benefits of requiring those disclosures.

329. Some commentators suggested that certain of the proposed required disclosures about cash flows between the securitization SPE and the transferor might be redundant with information already disclosed elsewhere; for example, the proceeds from securitization might already be reported in cash flow statements. Other constituents pointed out that that information is not always apparent in cash flow statements, perhaps because it is aggregated with other information. The Board agreed with both groups. To avoid requiring any redundancy, the Board revised its proposed requirement to require disclosure of cash flows between the securitization SPE and the transferor, unless that information is reported separately elsewhere in the financial statements or notes.

330. For retained interests outstanding at the end of the period, the Board concluded that three types of disclosures would be useful in assessing their valuation. Those disclosures include (a) the accounting policies for measuring retained interests at the end of the period being reported on, including the methodology used in determining or estimating their fair value; (b) quantitative information about key assumptions used in valuing those retained interests; and (c) a sensitivity analysis or stress test that would quantify the effect that unfavorable variations from the expected levels of interest rates, prepayment patterns, credit losses, or other key assumptions would have

on the estimates of fair value of the retained interests. The Board decided to require static pool information so that disclosures of credit loss assumptions would be more comparable if different entities use different calculation methods. The Board concluded that sensitivity information would provide users of financial statements with a means of comparing their estimates of the market's performance with the entity's estimates, seeing the pro forma effects of changes in assumptions on the financial statements, and assessing the potential effect of a future change in market conditions on the value of the entity's retained interests. The Board chose to require disclosure of the impact of two or more pessimistic variations for each key assumption so that the results would indicate whether the valuation had a linear relationship to the assumption. The Board chose not to specify any particular changes in assumptions so that companies could select the changes that best portray the sensitivity of estimates of fair value.

331. Some commentators supported the proposed disclosures and asked for additional information. One request that the Board adopted was to require disclosure of the total financial assets managed by securitizers from loans sold as well as those that remain on the statement of financial position, with the goal of highlighting a source of risks (and benefits) to securitizers through their retained interests. The Board chose to specifically exclude from this disclosure securitized assets that an entity continues to service but with which it has no other continuing involvement. The Board reasoned that a disclosure of the total financial assets managed by securitizers, including loans sold as well as those that remain on the statement of financial position, would not only be useful but would also be economical for many securitizers to produce because many already report that in the MD&A or in voluntary disclosures. The Board discussed, but decided against, requiring disclosure of average balances of managed assets outstanding for the year, partly because current GAAP does not require disclosures of other average balances; it decided to encourage that disclosure, however, in part, because it provides a useful base for comparison of credit losses for the year.

332. Some commentators suggested that this Statement include a specific materiality threshold below which certain disclosures for securitization transactions would not be required. The Board chose not to do that. Materiality and relevance are both defined in terms of what influences or makes a difference to a decision maker. The Board's position is that ". . . no general standards of materiality could be formulated to take into account all the considerations that enter into an experienced human judgment," but that quantitative materiality criteria may be given by the Board in specific standards, as appropriate (FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, paragraph 131). The Board has only rarely given quantitative materiality criteria in specific standards. The one recent example is the 10 percent threshold for reported segments in FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information*, which the Board retained from an earlier Statement "because it can be objectively applied and because preparers and users of financial statements already understand it" (paragraph 76). The latter reason does not apply in this Statement, and the Board identified no persuasive reason to take its place. Therefore, this Statement does not include a materiality threshold. However, that conclusion does not imply that the provisions of this Statement must be applied to immaterial items. Some entities may determine that some or

all disclosures about securitization transactions are not material after an evaluation of all the relevant facts and circumstances.

Effective Date and Transition for Statement 125

333. The Board proposed that Statement 125 should be effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after December 31, 1996, and the Board did not change that effective date in the final Statement. While many respondents accepted and some even urged adoption on that date, some respondents expressed concern about the ability to carry out certain of Statement 125's provisions by that date, including systems changes needed to keep track of supporting data efficiently. The Board concluded that some of those concerns should be ameliorated by the effects of changes from the Exposure Draft on the accounting for repurchase agreements, securities lending, loan participations, and collateral, and that in other cases data adequate for external financial reporting could be obtained in other ways while systems changes were being completed. After Statement 125 was issued, representatives from various enterprises, particularly those representing brokers and dealers in securities, continued to express to the Board concerns about the effective date of Statement 125 for those types of transactions (repurchase agreements, securities lending, loan participations, and collateral). Those representatives convinced the Board that for those types of transactions, substantial changes to information systems and accounting processes were essential for brokers and dealers in securities and other enterprises to comply with Statement 125 and that those changes would make it extremely difficult, if not impossible, for affected enterprises to account for those transfers of financial assets and apply the secured borrowing and collateral provisions of Statement 125 as soon as January 1, 1997. The Board appreciated the concerns expressed by those enterprises that attempting to account for those types of transactions manually until appropriate modifications could be made to information systems and accounting processes might lead to a significant temporary deterioration in the financial controls and quality of financial information of the affected enterprises. In November 1996, the Board decided to defer for one year the effective date (a) of paragraph 15 and (b) for repurchase agreement, dollar-roll, securities lending, and similar transactions, of paragraphs 9–12 and 237(b) of Statement 125. For those types of transfers, Statement 125 became effective for transfers occurring after December 31, 1997.

334. The Exposure Draft of Statement 125 proposed that the Statement should be applied prospectively to achieve consistency in accounting for transfers of financial assets. That requirement was also meant to ensure that all entities entering into a given transaction report that transaction under the same guidance. If entities were permitted to implement early or implement at the beginning of fiscal years that did not coincide, opportunities might arise to structure transactions in ways that result in the same assets and liabilities being reported in the financial statements of both parties or in the financial statements of neither party. The Board found that possibility undesirable. Most respondents to the Exposure Draft of Statement 125 generally accepted that conclusion.

335. The Board also decided that retroactive implementation for all entities was not feasible and that allowing voluntary retroactive implementation was unwise because it would impair comparability of financial statements by permitting disparate accounting treatment for similar transactions reported in previous periods. The Board concluded that those considerations outweighed the lack of consistency within an entity's financial statements for transactions occurring before and after the effective date of Statement 125. In addition, the Board concluded that the benefits of retroactive application of the provisions of Statement 125 would not justify the considerable cost of doing that. Respondents generally accepted that conclusion.

Effective Date and Transition for This Statement

336. The Board decided that the accounting provisions of this Statement that are changed from or in addition to those in Statement 125 should be applied prospectively to transfers of financial assets occurring after March 31, 2001, except for the provisions relating to collateral. That transaction-based prospective approach is the same as that used in Statement 125 and was adopted in this Statement for the same reason: to achieve consistency in accounting for transfers of financial assets and to ensure that all entities entering into a given transaction report that transaction under the same guidance. Retroactive implementation for all entities was not feasible, and allowing voluntary retroactive implementation was unwise because it would impair comparability of financial statements by permitting disparate accounting treatment for similar transactions reported in previous periods.

337. The Board initially considered making this Statement effective for transfers occurring after December 31, 2000. Adopting the accounting provisions of this Statement at the beginning of a calendar year would simplify the transition for preparers and users of the financial statements of a majority of larger U.S. enterprises, which use the calendar year as their fiscal year. However, after considering constituents' comments, the Board concluded that an effective date that soon would be inappropriate. The Board also concluded that a one-year postponement in effective date would unduly delay necessary improvements in financial reporting. Instead, the Board decided that entities would be in a better position to implement this Statement if it were effective for transfers occurring after March 31, 2001, six months after issuance. The Board concluded that that interval should allow constituents the time needed to assess the standards, consider the effect of EITF issues and other implementation guidance, negotiate new contractual arrangements, and revise their accounting systems to conform to the amendment.

338. The Board believes that the disclosure requirements of this Statement for securitization transactions should be implemented as early as possible, in view of concerns that markets for securitized assets and other securities of the issuers of securitized assets have been adversely affected by the lack of sufficient and comparable information. In addition, constituents informed the Board that many entities that securitize assets use the kind of information required to be disclosed under this Statement to manage internally. Therefore, for many entities, the cost and time to aggregate the data for disclosure in financial statements should be minimal. For those reasons, the Board concluded that securitization disclosures mandated by this Statement could be

required for financial statements for fiscal years ending after December 15, 2000. The Board also decided that disclosures required for securitization transactions that have occurred during the period that are accounted for as sales should be made for each year for which an income statement is presented for comparative purposes, so that investors and creditors can better understand the effects of the key assumptions on those income statements. However, in response to comments from constituents, the Board chose not to require that those disclosures be reported for periods ending on or before December 15, 2000, for which an income statement is presented for comparative purposes. The Board reasoned that those disclosures should be required only prospectively because they might be difficult to develop for prior years, especially if securitizations are not the company's core business.

339. For the reasons cited above, the Board decided that disclosures about the assumptions used in valuing the retained interests remaining at the end of the period and the sensitivity of those assumptions need not be required for earlier periods in comparative financial statements, as that information is relevant primarily as of the latest statement of financial position.

340. In light of the Board's decision not to require that collateral be accounted for under the value-of-the-rights approach, the Board decided that collateral that was previously recognized by secured parties in accordance with paragraphs 15(a)(ii) and 15(b) of Statement 125 should not continue to be recognized in financial statements for fiscal years ending after December 15, 2000, and that financial statements for earlier periods presented for comparative purposes should be restated accordingly. The Board concluded that (a) to do so would improve comparability between entities and consistency between periods in recognized amounts and (b) the amount of collateral that would be reported on future statements of financial position would soon become minimal given the short average time that much pledged collateral is held. The Board had originally proposed in the Exposure Draft of this Statement that disclosure requirements for collateral should first be required in financial statements prepared for fiscal years ending after December 15, 2001, because of the relationship between the disclosures about collateral and the proposed accounting provisions that would not have been effective until January 1, 2001. However, in keeping with its decision to require that the asset and liability accounts currently being reported for collateral be removed from the statement of financial position for fiscal years ending after December 15, 2000, the Board decided to require the same effective date for disclosures about collateral. The Board reasoned that those disclosures should be required only prospectively because they might be difficult to develop for prior years.

341. The Board also considered the effect of applying this Statement on previously transferred assets and previously qualifying SPEs in light of constituents' arguments that changing the requirements for a qualifying SPE without some transition relief would result in (a) assets that were previously recorded as having been sold to previously qualifying SPEs suddenly reappearing in the financial statements of the transferor solely because the SPEs could not meet the revised standards for qualifying SPEs and (b) future transfers that were required under previous commitments to unrelated transferees or BIHs having to be accounted for as secured borrowings. The Board discussed the validity of constituents' concerns that changes in the

requirements would (1) cause an unexpected build-up of assets on the transferor's balance sheet, (2) conflict with transition guidance in paragraph 55 of this Statement, (3) result in significant costs to restructure existing qualifying SPEs if that could be done at all, (4) result in partial consolidation of transferred assets, and (5) cause certain transfers subject to the new conditions for ROAPs to no longer be accounted for as sales. The Board decided to ameliorate what it judged to be the more onerous of those concerns by permitting formerly qualifying SPEs to continue to apply the requirements of Statement 125 but limiting that "grandfathering" to entities just carrying out previous commitments made to unrelated BIHs, and at the same time complying with previous standards. The Board did not extend that transition relief to SPEs that engage in new transactions, such as taking in new assets not already committed to or issuing new beneficial interests, because the Board wanted to minimize the length of the period of noncomparability that that transition provision will cause.

Appendix C: ILLUSTRATIVE GUIDANCE

342. This appendix provides specific examples that illustrate the disclosures that are required by this Statement. The formats in the illustrations are not required by the Statement. The Board encourages entities to use a format that displays the information in the most understandable manner in the specific circumstances. References to paragraphs of this Statement in which the relevant requirements appear are given in parentheses.

343. The first example illustrates the disclosure of accounting policies for retained interests. In particular, it describes the accounting policies for (a) initial measurement (paragraph 17(f)(1)) and (b) subsequent measurement(paragraph 17(g)(1)), including determination of fair value.

NOTE X—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Receivable Sales

When the Company sells receivables in securitizations of automobile loans, credit card loans, and residential mortgage loans, it retains interest-only strips, one or more subordinated tranches, servicing rights, and in some cases a cash reserve account, all of which are retained interests in the securitized receivables. Gain or loss on sale of the receivables depends in part on the previous carrying amount of the financial assets involved in the transfer, allocated between the assets sold and the retained interests based on their relative fair value at the date of transfer. To obtain fair values, quoted market prices are used if available. However, quotes are generally not available for retained interests, so the Company generally estimates fair value based on the present value of future expected cash flows estimated using management's best estimates of the key assumptions—credit losses, prepayment speeds, forward yield curves, and discount rates commensurate with the risks involved.

344. In addition to the disclosure of assumptions used in determining the values of retained interests at the time of securitization that are presented in paragraph 343, this Statement also requires similar disclosures at the end of the latest period being presented. The following example illustrates disclosures about the characteristics of securitizations and gain or loss from securitizations and other sales by major type of asset (paragraph 17(f)(2)).

NOTE Y—SALES OF RECEIVABLES

During 20X2 and 20X1, the Company sold automobile loans, residential mortgage loans, and credit card loans in securitization transactions. In all those securitizations, the Company retained servicing responsibilities and subordinated interests. The Company receives annual servicing fees approximating 0.5 percent (for mortgage loans), 2 percent (for credit card loans), and 1.5 percent (for automobile loans) of the outstanding balance and rights to future cash flows arising after the investors in the securitization trust have received the return for which they contracted. The investors and the securitization trusts have no recourse to the Company's other assets for failure of debtors to pay when due. The Company's retained interests are subordinate to investor's interests. Their value is subject to credit, prepayment, and interest rate risks on the transferred financial assets.

In 20X2, the Company recognized pretax gains of \$22.3 million on the securitization of the automobile loans, \$30.2 million on the securitization of credit card loans, and \$25.6 million on the securitization of residential mortgage loans.

In 20X1, the Company recognized pretax gains of \$16.9, \$21.4, and \$15.0 million on the securitization of the automobile loans, credit card loans, and residential mortgage loans, respectively.

345. The following is an illustration of the quantitative information about key assumptions used in measuring retained interests at the date of sale or securitization for each financial period presented (paragraph 17(f)(3)).

Key economic assumptions used in measuring the retained interests at the date of securitization resulting from securitizations completed during the year were as follows (rate* per annum):

	20X2				20X1			
	Automobile Loans	Credit Card Loans	Residential Mortgage Loans		Automobile Loans	Credit Card Loans	Residential Mortgage Loans	
Fixed- Rate			Adjustable†	Fixed- Rate			Adjustable†	
Prepayment speed	1.00%	15.0%	10.00%	8.0%	1.00%	12.85%	8.00%	6.00%
Weighted-average life (in years) 33	1.8	0.4	7.2	6.5	1.8	0.4	8.5	7.2
Expected credit losses	3.10–3.40%	6.10%	1.25%	1.30%	3.50–3.80%	5.30%	1.25%	2.10%
Residual cash flows discounted at	12.0–13.0%	12.00%	10.00%	8.50%	13.00–13.50%	13.00%	11.75%	11.00%
Variable returns to transferees	Forward Eurodollar yield curve plus contractual spread over LIBOR ranging from 30 to 80 basis points			Not applicable	Forward Eurodollar yield curve plus contractual spread over LIBOR ranging from 28 to 70 basis points			Not applicable

346. The following is an illustration that combines disclosure of the key assumptions used in valuing retained interests at the end of the latest period (paragraph 17(g)(2)) and the hypothetical effect on current fair value of two or more pessimistic variations from the expected levels for each of the key assumptions (paragraph 17(g)(3)).

At December 31, 20X2, key economic assumptions and the sensitivity of the current fair value of residual cash flows to immediate 10 percent and 20 percent adverse changes in those assumptions are as follows (\$ in millions):

	<u>Automobile Loans</u>	<u>Credit Card Loans</u>	<u>Residential Mortgage Loans</u>	
			<u>Fixed-Rate</u>	<u>Adjustable</u>
Carrying amount/fair value of retained interests	\$15.6	\$21.25	\$12.0	\$13.3
Weighted-average life (in years) ³⁴	1.7	0.4	6.5	6.1
Prepayment speed assumption (annual rate)	1.3%	15.0%	11.5%	9.3%
<i>Impact on fair value of 10% adverse change</i>	<i>\$0.3</i>	<i>\$1.6</i>	<i>\$3.3</i>	<i>\$2.6</i>
<i>Impact on fair value of 20% adverse change</i>	<i>\$0.7</i>	<i>\$3.0</i>	<i>\$7.8</i>	<i>\$6.0</i>
Expected credit losses (annual rate)	3.0%	6.1%	0.9%	1.8%
<i>Impact on fair value of 10% adverse change</i>	<i>\$4.2</i>	<i>\$3.2</i>	<i>\$1.1</i>	<i>\$1.2</i>
<i>Impact on fair value of 20% adverse change</i>	<i>\$8.4</i>	<i>\$6.5</i>	<i>\$2.2</i>	<i>\$3.0</i>
Residual cash flows discount rate (annual)	14.0%	14.0%	12.0%	9.0%
<i>Impact on fair value of 10% adverse change</i>	<i>\$1.0</i>	<i>\$0.1</i>	<i>\$0.6</i>	<i>\$0.5</i>

<i>Impact on fair value of 20% adverse change</i>	\$1.8	\$0.1	\$0.9	\$0.9
Interest rates on variable and adjustable contracts		Forward Eurodollar yield curve plus contracted spread		
<i>Impact on fair value of 10% adverse change</i>	\$1.5	\$4.0	\$0.4	\$1.5
<i>Impact on fair value of 20% adverse change</i>	\$2.5	\$8.1	\$0.7	\$3.8

These sensitivities are hypothetical and should be used with caution. As the figures indicate, changes in fair value based on a 10 percent variation in assumptions generally cannot be extrapolated because the relationship of the change in assumption to the change in fair value may not be linear. Also, in this table, the effect of a variation in a particular assumption on the fair value of the retained interest is calculated without changing any other assumption; in reality, changes in one factor may result in changes in another (for example, increases in market interest rates may result in lower prepayments and increased credit losses), which might magnify or counteract the sensitivities.

347. The following is an illustration of disclosure of expected static pool credit losses (paragraph 17(g)(2)).

<u>Actual and Projected Credit Losses (%) as of:</u>	<u>Automobile Loans Securitized in</u>		
	<u>20X0</u>	<u>20X1</u>	<u>20X2</u>
December 31, 20X2	5.0	5.9	5.1
December 31, 20X1	5.1	5.0	
December 31, 20X0	4.5		

Note: Static pool losses are calculated by summing the actual and projected future credit losses and dividing them by the original balance of each pool of assets. The amount shown here for each year is a weighted average for all securitizations during the period.

348. The following is an illustration of the disclosure of cash flows between the securitization SPE and the transferor (paragraph 17(f)(4)).

The table below summarizes certain cash flows received from and paid to securitization trusts (\$ in millions):

	<u>Year Ended December 31</u>	
	<u>20X2</u>	<u>20X1</u>
Proceeds from new securitizations	\$1,413	\$ 971
Proceeds from collections reinvested in previous credit card securitizations	3,150	2,565
Servicing fees received	23	19
Other cash flows received on retained interests*	81	52
Purchases of delinquent or foreclosed assets	(45)	(25)
Servicing advances	(102)	(73)
Repayments of servicing advances	90	63

349. The following illustration presents quantitative information about delinquencies, net credit losses, and components of securitized financial assets and other assets managed together with them (\$ in millions):

Type of Loan	Total Principal Amount of Loans		Principal Amount of Loans 60 Days or More Past Due*		Average Balances ³⁵		Net Credit Losses [†]	
	At December 31				During the Year			
	20X2	20X1	20X2	20X1	20X2	20X1	20X2	20X1
Automobile loans	\$ 830	\$488	\$42.3	\$26.8	\$720	\$370	\$21.6	\$12.6
Residential mortgage loans (fixed-rate)	482	302	5.8	3.6	470	270	5.6	3.2
Residential mortgage loans (adjustable)	544	341	7.1	6.8	520	300	6.2	6.0
Credit card loans	<u>300</u>	<u>250</u>	<u>15</u>	<u>12.5</u>	<u>350</u>	<u>300</u>	<u>16</u>	<u>15</u>
Total loans managed or securitized[‡]	2,156	1,381	<u>\$70.2</u>	<u>\$49.7</u>	2,060	1,240	<u>\$49.4</u>	<u>\$36.8</u>
Less:								
Loans securitized [§]	1,485	905			1,368	752		
Loans held for sale or securitization	<u>19</u>	<u>11</u>			<u>17</u>	<u>9</u>		
Loans held in portfolio³⁶	<u>\$652</u>	<u>\$465</u>			<u>\$675</u>	<u>\$479</u>		

Appendix D: AMENDMENTS TO EXISTING PRONOUNCEMENTS

350. This Statement replaces FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, and rescinds FASB Statement No. 127, *Deferral of the Effective Date of Certain Provisions of FASB Statement No. 125*.

351. This Statement also carries forward the following supersessions that were made by Statement 125:

- a. FASB Statement No. 76, *Extinguishment of Debt*
- b. FASB Statement No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse*
- c. FASB Statement No. 122, *Accounting for Mortgage Servicing Rights*
- d. FASB Technical Bulletin No. 84-4, *In-Substance Defeasance of Debt*
- e. FASB Technical Bulletin No. 85-2, *Accounting for Collateralized Mortgage Obligations (CMOs)*.

352. Paragraph 20 of FASB Statement No. 13, *Accounting for Leases*, as amended by Statements 77 and 125, and FASB Statement No. 135, *Rescission of FASB Statement No. 75 and Technical Corrections*, is replaced by the following:

The sale or assignment of a lease or of property subject to a lease that was accounted for as a sales-type lease or direct financing lease shall not negate the original accounting treatment accorded the lease. Any transfer of minimum lease payments under, or residual values that are guaranteed at the inception of, a sales-type lease or direct financing lease shall be accounted for in accordance with FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. However, transfers of unguaranteed residual values and residual values that are guaranteed after the inception of the lease are not subject to the provisions of Statement 140.

353. FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, is amended as follows:

- a. In the last sentence of paragraph 10(f), *FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* is replaced by *FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.
- b. In both sentences of footnote 9 to paragraph 21, *paragraph 37(g) of Statement 125* is replaced by *paragraph 63(g) of Statement 140*.
- c. In the first and second sentences of paragraph 56, *paragraph 37(g) of Statement 125* is replaced by *paragraph 63(g) of Statement 140*.

d. In the first sentence of paragraph 59(e), *paragraphs 68 and 69 of Statement 125* is replaced by *paragraphs 98 and 99 of Statement 140*.

354. In footnote 5 to paragraph 8 of FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*, the reference to *FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* is replaced by *FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* and (*paragraph 243*) is replaced by (*paragraph 364*).

355. In footnote 2 to paragraph 3 of FASB Interpretation No. 43, *Real Estate Sales*, the reference to *FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* is replaced by *FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

356. Paragraph 12 of FASB Technical Bulletin No. 86-2, *Accounting for an Interest in the Residual Value of a Leased Asset: Acquired by a Third Party or Retained by a Lessor That Sells the Related Minimum Rental Payments*, as amended by Statement 125, is replaced by the following:

Yes. A residual value of a leased asset is a financial asset to the extent guaranteed at the inception of the lease. Accordingly, increases to its estimated value over the remaining lease term should be recognized.

Amendments and Deletions Made by Statement 125 Carried Forward in This Statement with Minor Changes

357. Paragraph 3(a) of APB Opinion No. 26, *Early Extinguishment of Debt*, as amended by Statement 76, is replaced by the following:

Extinguishment of liabilities. FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, defines transactions that the debtor shall recognize as an extinguishment of a liability.

358. The last sentence of footnote 1 to paragraph 1 of FASB Statement No. 22, *Changes in the Provisions of Lease Agreements Resulting from Refundings of Tax-Exempt Debt*, as amended by Statement 76 is deleted.

359. FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, is amended as follows:

- a. Paragraph 8, as amended by FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, is deleted.
- b. The last sentence of paragraph 9(a) prior to the amendment by Statement 115 is deleted.

- c. In paragraph 10, (*paragraphs 16 through 19*) is deleted and replaced by (*paragraph 13 of FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*).
- d. Paragraph 11 and footnote 4 are deleted.
- e. In paragraph 15, the reference to paragraph 18 (as amended by FASB Statement No. 122, *Accounting for Mortgage Servicing Rights*) is deleted, and the following is added to the end of paragraph 15 replacing the sentence added by Statement 122:

The rate used to determine the present value shall be an appropriate long-term interest rate. For this purpose, estimates of future servicing revenue shall include expected late charges and other ancillary revenue. Estimates of expected future servicing costs shall include direct costs associated with performing the servicing function and appropriate allocations of other costs. Estimated future servicing costs may be determined on an incremental cost basis. The amount capitalized shall be amortized in proportion to, and over the period of, estimated net servicing income—the excess of servicing revenues over servicing costs.

- f. Paragraphs 16–19 and 30 and footnote 6, as amended by Statement 122, are deleted.
- g. The three paragraphs added by Statement 122 after paragraph 30 are deleted.
- h. In paragraph 34, the terms *current (normal) servicing fee rate* and *servicing* and their definitions are deleted.

360. This Statement carries forward the following amendments that Statement 122 made to Statement 65:

- a. In the first sentence of paragraph 1, *origination or acquisition* is replaced by *purchase or acquisition*.
- b. In the first sentence of paragraph 10, *of existing* is replaced by *or origination of*.

361. FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, is amended as follows:

- a. Paragraph 8(b) is replaced by the following:

Substantively extinguished debt subject to the disclosure requirements of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*

- b. In the last sentence of paragraph 28, *,or the rate that an entity would have to pay to acquire essentially risk-free assets to extinguish the obligation in accordance with the requirements of Statement 76* is deleted.

362. The following sentence is added after the first sentence of paragraph 7 of Statement 115 as amended by FASB Statement No. 135, *Rescission of FASB Statement No. 75 and Technical Corrections*:

A security may not be classified as held-to-maturity if that security can contractually be prepaid or otherwise settled in such a way that the holder of the security would not recover substantially all of its recorded investment.

363. FASB Technical Bulletin No. 87-3, *Accounting for Mortgage Servicing Fees and Rights*, is amended as follows:

- a. Paragraphs 1–7 are deleted.
- b. Paragraph 9, as amended by Statement 122, is replaced by the following:

An enterprise may acquire servicing assets or liabilities by purchasing or originating financial assets with servicing rights retained or by purchasing the servicing rights separately. Servicing assets and liabilities are amortized in proportion to, and over the period of, estimated net servicing income—the excess of servicing revenues over servicing costs.

Appendix E: GLOSSARY

364. This appendix defines terms used in this Statement.

Adequate compensation

The amount of benefits of servicing that would fairly compensate a substitute servicer should one be required, which includes the profit that would be demanded in the marketplace.

Agent

A party that acts for and on behalf of another party. For example, a third-party intermediary is an agent of the transferor if it acts on behalf of the transferor.

Attached call

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

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.

Benefits of servicing

Revenues from contractually specified servicing fees, late charges, and other ancillary sources, including "float."

Cleanup call

An option held by the servicer or its affiliate, which may be the transferor, to purchase

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

Collateral

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

Consolidated affiliate of the transferor

An entity whose assets and liabilities are included with those of the transferor in the consolidated, combined, or other financial statements being presented.

Contractually specified servicing fees

All amounts that, per contract, are due to the servicer in exchange for servicing the financial asset and would no longer be received by a servicer if the beneficial owners of the serviced assets (or their trustees or agents) were to exercise their actual or potential authority under the contract to shift the servicing to another servicer. Depending on the servicing contract, those fees may include some or all of the difference between the interest rate collectible on the asset being serviced and the rate to be paid to the beneficial owners of those assets.

Derecognize

Remove previously recognized assets or liabilities from the statement of financial position.

Derivative financial instrument

A derivative instrument (as defined in Statement 133) that is a financial instrument (refer to Statement 107, paragraph 3).

Embedded call

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.

Fair value

Refer to paragraphs 68–70.

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 (Statement 107, paragraph 3(b)).

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 (Statement 107,

paragraph 3(a)).

Freestanding call

A call that is neither embedded in nor attached to an asset subject to that call.

Guaranteed mortgage securitization

A securitization of mortgage loans that is within the scope of FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, as amended, and includes a substantive guarantee by a third party.

Interest-only strip

A contractual right to receive some or all of the interest due on a bond, mortgage loan, collateralized mortgage obligation, or other interest-bearing financial asset.

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.

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 contractually specified 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.

Unilateral ability

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

Footnotes

FAS140 Footnote 1—Terms defined in Appendix E, the glossary, are set in **boldface type** the first time they appear.

FAS 140 Footnote 2—Contributions—unconditional nonreciprocal transfers of assets—are addressed in FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*.

FAS140 Footnote 3—Although a transfer of securities may not be considered to have reached completion until the settlement date, this Statement does not modify other generally accepted accounting principles, including FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, and AICPA Statements of Position and audit and accounting Guides for certain industries, that require accounting at the trade date for certain contracts to purchase or sell securities.

FAS140 Footnote 4—Cash “collateral,” sometimes used, for example, in securities lending transactions (paragraphs 91–95), shall be derecognized by the payer and recognized by the recipient, not as collateral but rather as proceeds of either a sale or a borrowing.

FAS140 Footnote 5—If nonrecourse debt (such as certain mortgage loans) is assumed by a third party in conjunction with the sale of an asset that serves as sole collateral for that debt, the sale and related assumption effectively accomplish a legal release of the seller-debtor for purposes of applying this Statement.

FAS140 Footnote 6—Refer to footnote 11 to paragraph 19.

FAS140 Footnote 7—If an entity has made multiple securitizations of the same major asset type during a period, it may disclose the range of assumptions.

FAS140 Footnote 8—The weighted-average life of prepayable assets in periods (for example, months or years) can be calculated by multiplying the principal collections expected in each future period by the number of periods until that future period, summing those products, and dividing the sum by the initial principal balance.

FAS140 Footnote 9—Expected static pool losses can be calculated by summing the actual and projected future credit losses and dividing the sum by the original balance of the pool of assets.

FAS140 Footnote 10—Excluding securitized assets that an entity continues to service but with which it has no other continuing involvement.

FAS140 Footnote 11—Statement 125 applies to transfers and servicing of financial assets and

extinguishments of liabilities occurring after December 31, 1996 (after December 31, 1997, for transfers affected by FASB Statement No. 127, *Deferral of the Effective Date of Certain Provisions of FASB Statement No. 125*) and on or before March 31, 2001. Statement 127 deferred until December 31, 1997, the effective date (a) of paragraph 15 of Statement 125 and (b) for repurchase agreement, dollar-roll, securities lending, and similar transactions, of paragraphs 9–12 and 237(b) of Statement 125.

FAS140 Footnote 12—In this Statement, the term *affiliate* is used in the same sense as it is used in FASB Statement No. 57, *Related Party Disclosures*.

FAS140 Footnote 13—The Board crafted an exception to this principle so that repurchase agreements, securities lending transactions, and similarly structured transactions would not be accounted for as sales.

FAS140 Footnote 14—In the case of a partial sale of a financial asset, the transferor generally has reduced the marketability of the asset because it can no longer sell the entire asset—it can only sell part of that asset. Consequently, the partial interest in the original asset has different rights and privileges than those embodied in the original asset and, therefore, is a new asset—different from the original asset.

FAS140 Footnote 15—And it is necessary to consider the overall effect of related rights and obligations in assessing such matters as whether a transferee is constrained or a transferor has maintained effective control. For example, if the transferor or its affiliate or agent is the servicer for the transferred asset and is empowered to decide to put the asset up for sale, and has the right of first refusal, that combination would place the transferor in position to unilaterally cause the return of a specific transferred asset and thus maintain the transferor's effective control of the transferred asset as discussed in paragraphs 9(c)(2) and 50.

FAS140 Footnote 16—The description of a qualifying SPE is restrictive. The accounting for qualifying SPEs and transfers of financial assets to them should not be extended to any entity that does not currently satisfy all of the conditions articulated in this paragraph.

FAS140 Footnote 17—An effect of that provision, in conjunction with paragraph 46, is that mortgage-backed securities retained in a guaranteed mortgage securitization in which the SPE meets all conditions for being a qualifying SPE are classified in the financial statements of the transferor as securities that are subsequently measured under Statement 115.

FAS140 Footnote 18—In this Statement, the term *substantially the same* is used consistently with the usage of that term in the 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*.

FAS140 Footnote 19—For example, for mortgage loans, financial asset type refers to the various conventional or government guaranteed or insured mortgage loans and adjustable-rate or fixed-rate mortgage loans.

FAS140 Footnote 20—FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, discusses the use of present value techniques in measuring the fair value of an asset (or liability) in paragraphs 42–54 and 75–88. The Board believes that an expected present value technique is superior to traditional “best estimate” techniques, especially in situations in which the timing or amount of estimated cash flows is uncertain, as is often the case for retained interests in transferred financial assets. Concepts Statement 7 also discusses in paragraph 44 the steps needed to complete a proper search for the “rate commensurate with the risk” in applying the traditional technique.

FAS140 Footnote 21—The timing and amount of future cash flows for retained interests in securitizations are commonly uncertain, especially if those interests are subordinate to more senior beneficial interests. Applying the present value approach depends heavily on assumptions about default and prepayment of all the assets securitized, because of the implicit credit or prepayment risk enhancement arising from the subordination.

FAS140, Par. 72 Footnote *—Assets shall be recorded at zero if an estimate of the fair value of the assets is not practicable.

FAS140, Par. 72 Footnote †—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.

FAS140 Footnote 22—If the “collateral” in a transaction that meets the criteria in paragraph 9 is a financial asset that the holder is permitted by contract or custom to sell or repledge, 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 by contract or custom to sell or repledge, 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.

FAS140 Footnote 23—Instead of cash, other securities or letters of credit sometimes are exchanged. Those transactions are accounted for in the same manner as securities lending transactions (paragraphs 92–94).

FAS140 Footnote 24—FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, par. 119.

FAS140 Footnote 25—The term *dispose of* is used to collectively refer to the SPE's ability to

sell, exchange, put, or distribute its assets.

FAS140 Footnote 26—An Exposure Draft, *Consolidated Financial Statements: Purpose and Policy*, was issued in February 1999, with a comment period that ended May 24, 1999. That Exposure Draft has not yet resulted in a final Statement.

FAS140 Footnote 27—Marcia Stigum, *The Repo and Reverse Markets* (Homewood, Ill.: Dow Jones-Irwin, 1989), 313.

FAS140 Footnote 28—*Uniform Commercial Code, Revised Article 8, Investment Securities*, Proposed Final Draft (Philadelphia: American Law Institute, 1994), 18 and 19.

FAS140 Footnote 29—Accounting for repurchase agreements is discussed in paragraphs 96–101.

FAS140 Footnote 30—Statement 65 defined a current (normal) servicing fee rate as "a servicing fee rate that is representative of servicing fee rates most commonly used in comparable servicing agreements covering similar types of mortgage loans." FASB Technical Bulletin No. 87-3, *Accounting for Mortgage Servicing Fees and Rights*, clarified what rate a seller-servicer should use as a servicing fee rate as described in Statement 65.

FAS140 Footnote 31—FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, par. 7, Statement 122, par. 3(f), and Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, par. 540.

FAS140 Footnote 32—The research referred to includes John R. M. Hand, Patricia J. Hughes, and Stephan E. Sefcik, "In-Substance Defeasances: Security Price Reactions and Motivations," *Journal of Accounting and Economics* (May 1990): 47–89; Judy Beckman, J. Ralph Byington, and Paul Munter, "Extinguishment of Debt by In-Substance Defeasance: Managerial Perspectives," *Journal of Corporate Accounting and Finance* (Winter 1989/90): 167–174; Bruce R. Gaumnitz and Joel E. Thompson, "In-Substance Defeasance: Costs, Yes; Benefits, No," *Journal of Accountancy* (March 1987): 102–105; and Abraham M. Stanger, "Accounting Developments: In-Substance Defeasance—Reality or Illusion?" *The Corporation Law Review* (Summer 1984): 274–277.

FAS140, Par. 345 Footnote *—Weighted-average rates for securitizations entered into during the period for securitizations of loans with similar characteristics.

FAS140, Par. 345 Footnote †—Rates for these loans are adjusted based on an index (for most loans, the 1-year Treasury note rate plus 2.75 percent). Contract terms vary, but for most loans, the rate is adjusted every 12 months by no more than 2 percent.

FAS140 Footnote 33—The weighted-average life in periods (for example, months or years) of

prepayable assets is calculated by summing the product of (a) the sum of the principal collections expected in each future period times (b) the number of periods until collection, and then dividing that total by (c) the initial principal balance.

FAS140 Footnote 34—Footnote 8, paragraph 17(f)(3), describes how weighted-average life can be calculated.

FAS140, Par. 348 Footnote *—This amount represents total cash flows received from retained interests by the transferor other than servicing fees. Other cash flows include, for example, all cash flows from interest-only strips and cash above the minimum required level in cash collateral accounts.

FAS140, Par. 349 Footnote *—Loans 60 days or more past due are based on end of period total loans.

FAS140 Footnote 35—This disclosure is optional.

FAS140, Par. 349 Footnote †—Net credit losses are charge-offs and are based on total loans outstanding.

FAS140, Par. 349 Footnote ‡—Owned and securitized loans are customer loans, credit card loans, mortgage loans, auto loans, and other loans, as applicable, in which the transferor retains a subordinate interest or retains any risk of loss (for example, 10 percent recourse).

FAS140, Par. 349 Footnote §—Represents the principal amount of the loan. Interest-only strips and servicing rights (or other retained interests) held for securitized assets are excluded from this table because they are recognized separately.

FAS140 Footnote 36—Loans held in portfolio are reported separately from loans held for securitization because they are measured differently.