

Technical Line

Technical guidance on standards
and practice issues

FASB Statement No. 166, *Accounting for Transfers of Financial Assets, an amendment of FASB Statement No. 140*

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Overview

On 12 June 2009, the Financial Accounting Standards Board (FASB) issued Statement 166¹ to address practices that have developed since the issuance of Statement 140,² and concerns of financial statement users that many of the financial assets that have been derecognized should continue to be reported in the financial statements of transferors. Additionally, because of significant events in the credit markets, financial statement users have expressed concerns about the transparency of disclosures regarding the nature and extent of a transferor's continuing involvement with transferred financial assets. The objective of Statement 166 is to improve the comparability, relevance and transparency of the information that a reporting entity provides in its financial reports about a transfer of financial assets; the effects of a transfer on its financial position, financial performance and cash flows; and a transferor's continuing involvement in transferred financial assets. To meet those objectives, Statement 166 modifies and clarifies several key principles of the derecognition requirements.

Notice to readers

On 1 July 2009, the FASB instituted a major change in the way accounting standards are organized. On that date, the FASB *Accounting Standards Codification* (ASC) became the single source of authoritative nongovernmental US GAAP, with the exception of guidance issued by the SEC. However, the recent guidance issued by the FASB in the form of Statement 166 and Statement 167³ (which amended FIN 46(R)⁴) has not yet been codified as of the date of this publication. As a result, the use of the new codification references is limited to guidance issued prior to Statement 166.

¹ FASB Statement No. 166, *Accounting for Transfers of Financial Assets, an amendment of FASB Statement No. 140*

² FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FASB ASC Topic 860, *Transfers and Servicing*)

³ FASB Statement No. 167, *Amendments to FASB Interpretation No. 46(R)*

⁴ FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities* (FASB ASC Topic 810, *Consolidations*)

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Some fundamental amendments to the previous derecognition framework will change the accounting outcome for many transfers of financial assets. Among the changes introduced by Statement 166, none will have a more profound effect than the changes related to qualifying special-purpose entities (qualifying SPEs). In summary, Statement 166 amends Statement 140 as follows:

- ▶ It simplifies the accounting for transfers of financial assets by removing the concept of a qualifying SPE and improves comparability in financial reporting by eliminating the exception for qualifying SPEs from the consolidation guidance of FIN 46(R). As a result, all transferees, including variable interest entities, must be evaluated for consolidation under the applicable accounting guidance unless another scope exception is available. Consequently, many current qualifying SPEs likely will be consolidated by the transferor, servicer or guarantor of the transferred financial assets
- ▶ It improves consistency in reported financial information by removing the special provisions for guaranteed mortgage securitizations in Statement 140 and Statement 65,⁵ and by requiring those securitizations to be treated the same as any other transfer of financial assets within the scope of Statement 140. If such securitizations do not meet the requirements for sale accounting, the securitized mortgage loans should continue to be classified as loans in the transferor's statement of financial position. Additionally, in those instances the transferor would not separately recognize a servicing asset or servicing liability
- ▶ It modifies the financial-components approach used in Statement 140 and limits the circumstances in which a transferor derecognizes a portion or component of a financial asset when the transferor has not transferred the original financial asset or when the transferor has continuing involvement with the financial asset. Specifically, it limits the unit of account eligible for sale accounting to either; a) an entire financial asset, b) a group of entire financial assets, or c) a participating interest in an entire financial asset. A participating interest is defined as a portion of a financial asset that;
 - ▶ conveys proportionate ownership rights with equal priority to each participating interest holder
 - ▶ involves no recourse (other than standard representations and warranties) to, or subordination by, any participating interest holder and
 - ▶ does not entitle any participating interest holder to receive cash before any other participating interest holder

Based on the new conditions for reporting a transfer of a portion of a financial asset, many transfers that occur today in which the transferor transfers a senior interest and retains a subordinated interest in the contractual cash flows of a specified asset will not qualify for sale accounting in the future

- ▶ It clarifies the legal isolation analysis to ensure that the financial asset has been put beyond the reach of the transferor and its consolidated affiliates (affiliates that are not entities designed to make remote the possibility that they would enter bankruptcy or other receivership) included in the financial statements being presented, and its creditors
- ▶ In assessing whether the transferor has constrained the ability of the transferee to pledge or exchange the transferred financial assets, it requires the transferor to "look-through" the transferee to consider the abilities of the transferee's beneficial interest holders to pledge or exchange their beneficial interests when the sole purpose of the transferee entity is to engage in securitization or asset-backed financing activities. Previously, the look-through provisions were applicable only to transactions involving qualifying SPEs
- ▶ It clarifies the principle in the effective control criteria of Statement 140 that the transferor must evaluate whether it, its consolidated affiliates included in the financial statements being presented, or its agents effectively control the transferred financial asset(s) directly or indirectly

⁵ FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities* (FASB ASC Topic 948, *Financial Services - Mortgage Banking*)

- ▶ When evaluating transfers of financial assets for derecognition, it clarifies that an entity must consider all arrangements or agreements made contemporaneously with, or in contemplation of, a transfer, even if not entered into at the time of the transfer
- ▶ It provides what the FASB believes is more relevant financial information that better captures the economic substance of many transfers and simplifies the accounting for securitizations of financial assets. For example, it requires that a transferor recognize and initially measure at fair value all assets obtained (including beneficial interests) and liabilities incurred as a result of a transfer of an entire asset or group of financial assets accounted for as a sale. Previously, if a transferor transferred financial assets that met the requirements for sale accounting and retained a beneficial interest in the transferred financial assets, the transferor was required to initially record its retained interest based on an allocation of the previous carrying amount of the transferred financial assets
- ▶ It removes the practicability exception from measuring the proceeds received by a transferor in a transfer that meets the conditions for sale accounting at fair value
- ▶ It supersedes FSP FAS 140-4 and FIN 46(R)-8,⁶ but similar to the disclosure requirements of FSP FAS 140-4 and FIN 46(R)-8, it requires a transferor to provide additional disclosures to help users of financial statements better understand a transferor's continuing involvement with transferred financial assets, the risks inherent in the transferred financial assets that have been transferred or retained, and the nature and financial effect of restrictions on the transferor's assets that continue to be reported in the statement of financial position

Although the nature and extent of changes to Statement 140 are significant, there are several provisions of that Statement that are carried-forward without significant reconsideration by the FASB. These provisions include:

- ▶ The scope of the standard (i.e., affected transactions and reporting entities),
- ▶ The requirements that must be met to derecognize (extinguish) liabilities, and
- ▶ The accounting for secured borrowings and collateral, including securities lending and repurchase agreements

The provisions of Statement 166 apply to all entities and are effective for transfers occurring on or after the beginning of a reporting entity's first fiscal year that begins after 15 November 2009, with earlier application prohibited. Additionally, on the effective date, all existing qualifying SPEs must be evaluated for consolidation by all reporting entities in accordance with all applicable consolidation guidance, including the amendments to FIN 46(R). If such an evaluation results in consolidation, the reporting entity will need to apply the transition guidance provided in the pronouncement that requires consolidation.

The amendments summarized above are discussed further later in this publication.

Background

Transfers of financial assets take many forms (e.g., sale agreements, securitizations, securities lending transactions, factoring arrangements, etc.) and often involve the transferor having some continuing involvement either with the assets transferred or with the transferee. Examples of continuing involvement include, but are not limited to, recourse or guarantees, servicing arrangements, agreements to repurchase, options written or held, derivative financial instruments that are entered into contemporaneously with, or in contemplation of, the transfer and pledges of collateral. Accounting for transfers in which the transferor has no continuing involvement with the transferred financial assets or with the transferee has not been controversial. However, transfers of financial assets with continuing involvement raise questions about the circumstances under which the transfers should be accounted for as sales or as secured borrowings and about how transferors and transferees should account for sales and secured borrowings.

⁶ FASB Staff Position No. 140-4 and FIN 46(R)-8, *Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities* (FASB ASC Topic 860, *Transfers and Servicing*)

Statement 140 and its related guidance establish the accounting framework for determining whether a transfer of financial assets constitutes a sale or a secured borrowing, and, if the transfer constitutes a sale, the determination of any resulting gain or loss. When a transfer of financial assets does not qualify for sale accounting, Statement 140 requires the transfer to be accounted for as a secured borrowing with a pledge of collateral. Statement 140 also establishes rules for determining when a liability should be considered extinguished.

Under the financial components approach of Statement 140, a transferor derecognizes a transferred financial asset when control has been surrendered to the transferee. In general, control is surrendered when:

- ▶ The transferred financial asset is legally isolated from the transferor and its creditors – even in bankruptcy
- ▶ The transferee (or, in certain circumstances, the transferee's beneficial interest holders) has the right to pledge or exchange the transferred financial asset, and
- ▶ The transferor has no rights or obligations to reclaim the transferred financial asset

Statement 140, which replaced FASB Statement No. 125 of the same title, was intended to increase transparency and improve the requirements for financial asset transfers to be recognized as sales and, therefore, be removed from the balance sheet. However, Statement 140 and its related guidance have proven difficult to apply in practice. Since its issuance in September 2000, constituents have been asking for reconsideration and clarification of certain of its provisions. Matters that the FASB was asked to reconsider or clarify include:

- ▶ the permitted activities of qualifying SPEs
- ▶ the legal isolation analysis
- ▶ the initial measurement of the transferor's interests in transferred financial assets that qualify for sale accounting
- ▶ how to apply the derecognition guidance to a transfer of a portion of a financial asset and
- ▶ disclosures

The FASB decided to undertake a project to amend Statement 140 to address those concerns. The FASB concluded that a number of changes to the derecognition model were necessary to identify situations in which a transferor continues to maintain control of the transferred financial assets to such an extent that derecognition of the financial assets is not appropriate. After three exposure drafts, significant constituent feedback and years of deliberations, in June 2009, the FASB issued Statement 166.

Concurrent with the issuance of Statement 166, the FASB issued Statement 167. This project was undertaken by the FASB to address the effect of eliminating the qualifying SPE concept from Statement 140 and to respond to concerns about the application of certain key provisions of FIN 46(R), including concerns over the transparency of an enterprise's involvement in a variable interest entity (VIE).

Statement 167's amendments to FIN 46(R) change how an enterprise determines if it must consolidate a VIE. The new standard requires an enterprise to perform a qualitative analysis when determining whether it must consolidate a VIE. Under Statement 167, if an enterprise has an interest in a VIE that provides it with power to direct the activities of the VIE that most significantly impact the entity's economic performance (and the obligation to absorb losses or the right to receive benefits that could potentially be significant), an enterprise must consolidate the VIE. In addition, Statement 167 requires an enterprise to update its primary beneficiary analysis on an ongoing basis and to provide additional disclosures about its involvement with a VIE and any significant changes in risk exposure due to that involvement. Refer to our separate Technical Line on Statement 167,⁷ which further discusses these amendments to FIN 46(R).

⁷ EY Technical Line No. 2009-15, *FASB Statement No. 167, Amendments to FASB Interpretation No. 46(R)*

Statement 166 does not resolve all of the practice issues associated with the accounting for transfers of financial assets. Preparer's of financial statements will still be required to use significant judgment, and often the assistance of legal counsel, to evaluate the legal isolation requirements for derecognition. A transferor's continuing involvement with transferred financial assets will still raise issues that must be considered when evaluating whether control has been surrendered or if the transferee is effectively constrained from pledging or exchanging the transferred financial assets. However, Statement 166 does simplify the derecognition guidance of Statement 140 while the FASB continues to work jointly with the IASB to ultimately issue a converged derecognition standard.

Removal of qualifying SPE concept

The FASB developed the conditions for qualifying SPEs⁸ primarily to permit derecognition of assets in certain transactions in which the transferee is a passive entity that cannot pledge or exchange the transferred financial assets. Prior to Statement 166, the FASB concluded that financial assets transferred to a passive pass-through entity that cannot pledge or exchange the transferred financial assets should be derecognized by the transferor if the holders of interests in the pass-through entity could pledge or exchange their interests and the transfer meets the other conditions for sale accounting. Additionally, Statement 140 and FIN 46(R) exempted a qualifying SPE from consolidation because its primary purpose is limited to passively holding financial assets on behalf of its beneficial interest holders and it was believed that no individual party would have the ability to control such an entity.

The FASB has been advised by certain constituents that, in practice, the conditions specified in Statement 140 that require a qualifying SPE's activities to be "significantly limited" and "entirely specified" were being applied more broadly than originally intended in many securitizations that were being reported as sales. For example, many securitization entities hold financial assets that may require a servicer to exercise a level of decision-making that does not appear to have been entirely pre-specified or significantly limited, as required by Statement 140. Some practitioners believe that the long-term nature of many securitization transactions makes it impractical to predict all the possible events that may require a response from a servicer to protect the interests of the beneficial interest holders and, therefore, such assets are incompatible with the requirements of a qualifying SPE. For instance, because the qualifying SPE guidance requires that its discretion be significantly limited, some have questioned whether a servicer's ability to modify a loan for a borrower that is not in default, but for which an event of default is considered imminent or reasonably foreseeable, is consistent with that requirement.

Another issue that raised questions about the permissible activities of a qualifying SPE relates to rollovers of beneficial interests. Securitization entities often finance long-term financial assets by issuing short-term beneficial interests in the form of commercial paper or other debt instruments. When those initial beneficial interests mature, they are settled with the proceeds from issuing new beneficial interests, rather than from the cash inflows from the pool of financial assets. Practitioners have questioned whether the ability of a securitization entity (its designee or agent) to determine the terms of beneficial interests issued after its inception satisfies the passivity requirements of a qualifying SPE.

After considering all of the practice issues raised by its constituents, the current FASB concluded that the conditions for a qualifying SPE are being applied more broadly than its predecessors intended. The FASB believes that the range of financial assets being securitized and the complexity of securitization structures and arrangements have resulted in the qualifying SPE criteria being stretched in some cases beyond what it believes is the spirit of Statement 140. As a result, and after much consideration, the FASB decided to remove the concept of a qualifying SPE from Statement 140 and the scope exception for qualifying SPEs from the consolidation guidance of FIN 46(R). Consequently, many current qualifying SPEs likely will be consolidated by the transferor, servicer, or guarantor of the transferred financial assets.

⁸ Paragraph 35 of Statement 140 defined a qualifying SPE generally as a trust, special-purpose entity or other legal vehicle that is engaged in activities that are both significantly limited and entirely specified in the legal documents that established the entity (often referred to as being on auto-pilot), and limited to only holding and servicing certain passive financial assets and derivative financial instruments.

Although the concept of the qualifying SPE was eliminated from Statement Statement 140, special rules regarding constraints on transferred financial assets that previously were applicable only to qualifying SPE's have been extended to certain other entities. This change is discussed under the heading "Constraints on transferability."

While the elimination of the qualifying SPE concept will significantly simplify the application of Statement 140, it will require the transferor to consider the requirements of FIN 46(R) and determine whether it must consolidate the transferee. In some cases, that determination will require significant judgment.

Removal of exception for guaranteed mortgage securitizations

Statement 65, as amended by Statement 115,⁹ requires that, after the securitization of a mortgage loan held for sale, any retained mortgage-backed securities will be classified in accordance with the provisions of Statement 115, even if the transfer does not meet the requirements for sale accounting. Statement 140, as amended by Statement 156,¹⁰ requires that a transferor recognize a servicing asset or a servicing liability at fair value if the transferor transfers mortgage loans to a qualifying SPE in a guaranteed mortgage securitization (GMS), regardless of whether the transfer meets the requirements for sale accounting, and retains all the resulting securities and classifies those securities as either available for sale or trading securities.

In practice, some entities were applying the GMS exception to similar types of securitizations that involved other types of assets by analogizing to the guidance for guaranteed mortgage securitizations. The current FASB questioned whether it was appropriate to reclassify a financial asset as a security and change the measurement attribute of the asset, which could result in recognition of a gain or loss, even though the transferor has not met the requirements for sale accounting. As a result, the FASB decided to eliminate the exception for guaranteed mortgage securitizations. The FASB also cited the fair value option provided in Statement 159,¹¹ which permits an originator to initially and subsequently measure mortgage loans and other financial assets at fair value, as another reason for eliminating the exception for GMS transactions under Statement 140.

Unit of account subject to derecognition

Statement 166 amends the unit of account to which the derecognition accounting conditions must be applied. Statement 166 requires the derecognition criteria of paragraph 9 to be applied to:

- ▶ transfers of an entire financial asset
- ▶ transfers of groups of entire financial assets and
- ▶ transfers of a participating interest in an entire financial asset

Inherent in this requirement is that an entire financial asset cannot be divided into components prior to a transfer, with those components being eligible for derecognition upon transfer, unless all of the components meet the definition of a participating interest.

The determination of what constitutes an entire financial asset must consider both (a) the legal form of the asset and (b) what the asset conveys to a second entity. If the asset conveys an ownership interest in a portion of an entire financial asset, further consideration is required to determine whether such a conveyance represents an ownership interest in an asset or an ownership interest in an entity. If the asset being evaluated represents an ownership interest in a portion of an entire financial asset, such ownership interest will need to meet the definition of a participating interest to be eligible for sale accounting. Alternatively, if the asset represents an ownership interest in a portion of an entity (e.g., common stock, limited partnership interests, etc.), such interest would be considered an entire financial asset and would be the unit of account to which the derecognition accounting conditions must be applied.

⁹ FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (FASB ASC Topic 320, *Investments - Debt and Equity Securities*)

¹⁰ FASB Statement No. 156, *Accounting for Servicing of Financial Assets* (FASB ASC Topic 860, *Transfers and Servicing*)

¹¹ FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (FASB ASC Topic 825, *Financial Instruments*)

The following examples from paragraph 26C of Statement 166 illustrate the application of what constitutes an entire financial asset and the unit of account to which the derecognition conditions of paragraph 9 are applied:

Excerpt from Statement 140, as amended by Statement 166 – Paragraph 26C

- a. A loan to one borrower in accordance with a single contract that is transferred to a securitization entity before securitization shall be considered an entire financial asset. Similarly, a beneficial interest in securitized financial assets after the securitization process has been completed shall be considered an entire financial asset. In contrast, a transferred interest in an individual loan shall not be considered an entire financial asset; however, if the transferred interest meets the definition of a participating interest, the participating interest would be eligible for sale accounting.
- b. In a transaction in which the transferor creates an interest-only strip from a loan and transfers the interest-only strip, the interest-only strip does not meet the definition of an entire financial asset (and an interest-only strip does not meet the definition of a participating interest; therefore, sale accounting would be precluded). In contrast, if an entire financial asset is transferred to a securitization entity that it does not consolidate and the transfer meets the conditions for sale accounting, the transferor may obtain an interest-only strip as proceeds from the sale. An interest-only strip received as proceeds of a sale is an entire financial asset for purposes of evaluating any future transfers that could then be eligible for sale accounting.
- c. If multiple advances are made to one borrower in accordance with a single contract (such as a line of credit, credit card loan, or a construction loan), an advance on that contract would be a separate unit of account if the advance retains its identity, does not become part of a larger loan balance, and is transferred in its entirety. However, if the transferor transfers an advance in its entirety and the advance loses its identity and becomes part of a larger loan balance, the transfer would be eligible for sale accounting only if the transfer of the advance does not result in the transferor retaining any interest in the larger balance or if the transfer results in the transferor's interest in the larger balance meeting the definition of a participating interest. Similarly, if the transferor transfers an interest in an advance that has lost its identity, the interest must be a participating interest in the larger balance to be eligible for sale accounting.

Paragraph 8B of Statement 166 defines a participating interest as a financial asset that possesses each of the following characteristics:

Excerpt from Statement 140, as amended by Statement 166 – Paragraph 8B

- a. From the date of the transfer, it represents a proportionate (pro rata) ownership interest in an entire financial asset. The percentage of ownership interests held by the transferor in the entire financial asset may vary over time, while the entire financial asset remains outstanding as long as the resulting portions held by the transferor (including any participating interest retained by the transferor, its consolidated affiliates included in the financial statements being presented, or its agents) and the transferee(s) meet the other characteristics of a participating interest. For example, if the transferor's interest in an entire financial asset changes because it subsequently sells another interest in the entire financial asset, the interest held initially and subsequently by the transferor must meet the definition of a participating interest.
- b. From the date of the transfer, all cash flows received from the entire financial asset are divided proportionately among the participating interest holders in an amount equal to their share of ownership. Cash flows allocated as compensation for services performed, if any, shall not be included in that determination provided those cash flows are not subordinate to the proportionate cash flows of the participating interest and are not significantly above an amount that would fairly compensate a substitute service provider, should one be required, which includes the profit that would be demanded in the marketplace. In addition, any cash flows received by the transferor as

proceeds of the transfer of the participating interest shall be excluded from the determination of proportionate cash flows provided that the transfer does not result in the transferor receiving an ownership interest in the financial asset that permits it to receive disproportionate cash flows.

- c. The rights of each participating interest holder (including the transferor in its role as a participating interest holder) have the same priority, and no participating interest holder's interest is subordinated to the interest of another participating interest holder. That priority does not change in the event of bankruptcy or other receivership of the transferor, the original debtor, or any other participating interest holder. Participating interest holders have no recourse to the transferor (or its consolidated affiliates included in the financial statements being presented or its agents) or to each other, other than standard representations and warranties, ongoing contractual obligations to service the entire financial asset and administer the transfer contract, and contractual obligations to share in any set-off benefits received by any participating interest holder. That is, no participating interest holder is entitled to receive cash before any other participating interest holder under its contractual rights as a participating interest holder. For example, if a participating interest holder also is the servicer of the entire financial asset and receives cash in its role as servicer, that arrangement would not violate this requirement.
- d. No party has the right to pledge or exchange the entire financial asset unless all participating interest holders agree to pledge or exchange the entire financial asset.

The requirements in Statement 166 for a participating interest do not allow for the allocation of specified cash flows unless each cash flow is proportionately allocated to the participating interest holders. For example, in the case of an individual loan when the borrower is required to make a contractual payment that consists of a principal amount and interest amount on the loan, the transferor and transferee must share in the principal and interest payments based on their proportionate ownership interest in the loan. In contrast, if the transferor is entitled to receive an amount that represents a principal payment and another participating interest holder is entitled to receive an amount that represents the interest payments on the loan, such an arrangement would not be consistent with the participating interest definition because the transferor and transferee do not share proportionately in the cash flows received from the entire financial asset. In other cases, a transferor may transfer a portion of an individual receivable that represents a senior interest in an individual receivable. In that case, the transferor would account for the transfer as a secured borrowing because the senior interest in the receivable does not meet the requirements that rights to cash flows be pro rata and unsubordinated.

Compensation for services performed to process the collection and remittance of contractual cash flows associated with sales of portions of an entire financial asset are excluded from the cash flows required to be allocated proportionately to participating interest holders provided payment for such services are both:

- ▶ Senior in priority to the proportionate cash flows allocated to the participating interest holders, and
- ▶ Not significantly above an amount that would fairly compensate a substitute service provider, should one be required, which includes the profit that would be demanded in the marketplace. This criterion is the same as "adequate compensation" as defined in Statement 140, as amended by Statement 166

The FASB included the second criterion listed above to prevent abuse. Without this qualification, the FASB reasoned that an entity could easily subvert the condition of a participating interest. Specifically, the entity could avoid the requirement that all cash flows received from the entire financial asset be divided among the participating interest holders in proportion to their share of ownership by simply documenting an excess interest spread retained in the entire financial asset as a servicing fee. In other words, servicing fee payments that are significantly above "adequate compensation" essentially entitle the recipient to a disproportionate interest in the contractual cash flows of the underlying financial asset. Consequently, any transfers of a portion of that individual financial asset would not meet the definition of a participating interest nor the requirements for sale accounting (i.e., the transaction would be accounted for as a secured borrowing).

Paragraph 8B(b) states that "...any cash flows received by the transferor as proceeds of the transfer of the participating interest shall be excluded from the determination of proportionate cash flows provided that the transfer does not result in the transferor receiving an ownership interest in the financial asset that permits it to receive disproportionate cash flows." In other words, each participating interest excludes the cash flows received that represent the transferor's gain or loss on the sale of a portion of a financial asset. A transferor's gain or loss may be affected by fees and costs associated with originating or acquiring the financial asset subject to participating interests. Additionally, because a participating interest in an entire financial asset may be sold after the purchase or origination of the financial asset, the contractual interest rate passed through for the portion of the financial asset sold often will differ from market interest rates at the time of sale of the participating interest. Differences between contractual and market interest rates at the time of sale, which may result from changes in the risk-free rate (or benchmark), changes in credit spreads (either issuer specific or sector related) or other factors considered by market participants (e.g., liquidity), will likely result in portions of financial assets being sold at either discounts or premiums to the face amount of the participating interest.

In certain transfers, recourse is provided to the transferee that requires the transferor to reimburse any premium paid by the transferee if the underlying financial asset is prepaid within 90 days of the transfer date. This recourse does not meet the definition of standard representations and warranties and, therefore, precludes the transferred portion from meeting the definition of a participating interest. However, once the 90-day recourse provision expires, the transfer is reevaluated to determine if it meets the participating interest definition. Credit guarantees offered by a transferor in conjunction with the sale of a portion of an entire financial asset also is a form of recourse that would preclude derecognition for failing to meet the requirements of a participating interest. However, recourse in the form of a third-party guarantee is considered a separate unit of account that is excluded from the evaluation of whether the participating interest definition is met. Similarly, cash flows allocated to a third-party guarantor (e.g., premiums or fees) are excluded from the determination of whether the cash flows are divided proportionately among the participating interest holders.

As discussed in the amendments to the isolation requirements of paragraph 9(a) below, the FASB clarified that in the event of bankruptcy or receivership of the transferor, setoff rights of the borrower do not prevent a transfer of a portion of a financial asset from meeting the isolation requirements of Statement 166. Setoff rights also will not preclude a sale of a portion of an entire financial asset from meeting the requirements of a participating interest as long as each participating interest holder is contractually entitled to share in any setoff benefits received by any participating interest holder.

Among the requirements of a participating interest is the condition that transfer(s) represent a proportionate ownership interest in an entire financial asset, and that each portion of the financial asset held continues to meet the definition of a participating interest while the entire financial asset remains outstanding. The following examples illustrate these requirements.

Example 1

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

Months later, Bank A transfers an additional 20% participating interest in the remaining original loan to Trust D. Because of the second transfer, Bank A, Investor C and Trust D are legally entitled to 50%, 30% and 20%, respectively, of the original loan's remaining contractual principal and interest cash flows. In this example, both the initial and subsequent transfers meet the requirements of a participating interest and are accounted for as sales assuming the derecognition requirements of paragraph 9 of Statement 166 have been met.

Example 1(a)

Assume the same facts as in Example 1, except that the second transfer conveys 20% of the original loan's remaining principal balance, but only 19% of the remaining interest cash flows. In this instance, the transfer would not meet the definition of a participating interest because the transfer would not convey to Trust D (a transferee) a proportionate ownership interest in an entire financial asset. Additionally, a transfer of a portion of an entire financial asset that fails to meet the requirements of a participating interest will cause all other transfers associated with the same entire financial assets to fail the requirements of a participating interest. Such a change also would result in Bank A (the transferor) not being able to meet the derecognition criteria of Statement 166 for any of the transferred interests because the participating interest criteria are a prerequisite for being able to apply paragraph 9 to transfers of portions of an entire financial asset.

After that change, the transferor recognizes in its financial statements the previously transferred financial assets (i.e., the portions of an entire financial asset that previously qualified as a participating interest) with corresponding liabilities to the former transferee(s). The transferor initially measures the "reacquired" financial assets and related liabilities at fair value on the date of the change, as if the transferor purchased the transferred financial assets and assumed the liabilities on that date. In our example, Bank A would report on its balance sheet the entire Company B loan (70% of which would be measured at historical carrying value, and 30% would be measured based on its fair value at the date of the change) as an asset, with corresponding non-recourse liabilities for its contractual obligation to pass-through portions of the loan's cash flows to both Investor C and Trust D.

Example 1(b)

Assume the same facts as in Example 1(a), except that Bank A transfers its remaining 50% and 51% ownership interest in the contractual principal and interest cash flows of the Company B loan to Hedge Fund E. At this point, because Bank A has transferred all of its ownership interest in the entire loan, and assuming it has met all of the derecognition requirements in paragraph 9 of Statement 166, it would derecognize the loan receivable, eliminate the liabilities to Investor C and Trust D, recognize the cash proceeds from Hedge Fund E and recognize any resulting gain or loss on sale. Assuming that the servicing rights continue to represent a market return for servicing (i.e., adequate compensation, as defined in Statement 140 as amended by Statement 166), a separate servicing asset or servicing liability will not be recognized.

Legal isolation

Since the issuance of Statement 125, GAAP has required that transferred financial assets be isolated from the transferor, even in bankruptcy or other receivership, before the transferor could derecognize the transferred financial asset from its balance sheet. Based on questions raised by constituents and inconsistencies in practice, the FASB decided it was necessary to clarify the guidance on isolation. In so doing, the FASB amended paragraph 9(a) of Statement 140 as follows [Added text is underlined]:

Excerpt from Statement 140, as amended by Statement 166 – Paragraph 9(a)

9(a) The transferred financial assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership. Transferred financial assets are isolated in bankruptcy or other receivership only if the transferred financial assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its consolidated affiliates included in the financial statements being presented. For multiple step transfers, an entity that is designed to make remote the possibility that it would enter bankruptcy or other receivership (bankruptcy-remote entity) is not considered a consolidated affiliate for purposes of performing the isolation analysis. Notwithstanding the isolation analysis, each entity involved in the transfer is subject to the applicable guidance on whether it must be consolidated (paragraphs 27-28 and 80-84).

Statement 166 clarifies the existing isolation requirements for derecognition by bringing-forward guidance that previously existed in the implementation guidance and basis for conclusion to Statement 140 and by incorporating some of the guidance developed by the Audit Issues Task Force of the AICPA in AU Section 9336.¹² The significant clarifications regarding the legal isolation criterion are summarized as follows:

- ▶ Transferred financial assets must be placed beyond the reach of *all consolidated affiliates*, other than certain bankruptcy-remote entities, included in the financial statements being presented. In order to properly evaluate this criterion, the process presupposes that the transferor has correctly consolidated all its subsidiaries in accordance with applicable consolidation guidance, including all variable interest entities in accordance with FIN 46(R)
- ▶ When evaluating whether transferred financial assets have been isolated, the transferor (and its consolidated affiliates) must consider all arrangements and agreements made contemporaneously with, or in contemplation of, the transfer (see also the discussion of repurchase financings under the heading "Effective control")
- ▶ The nature and extent of supporting evidence that is necessary to conclude that transferred financial assets have been isolated depend on the facts and circumstances. All available evidence that either supports or questions a conclusion must be considered, including whether the contract or circumstances permit the transferor to revoke the transfer. It also may include consideration of the legal consequences of the transfer in the jurisdiction where bankruptcy or other receivership would take place, whether a transfer of financial assets would likely be deemed a true sale at law or otherwise isolated, whether the transferor is affiliated with the transferee, and other factors pertinent under applicable law
- ▶ Under US bankruptcy law, a true sale opinion and, in the case of transfers to affiliated entities, a non-consolidation opinion, often would be required to support a conclusion that a transferred financial asset had been isolated from the transferor, its consolidated affiliates included in the financial statements being presented, and its creditors. A similar legal analysis often would be required for a transfer occurring in jurisdictions outside the US to support a conclusion about whether a transferred financial asset has been isolated. The FASB also clarified that a legal opinion should not be required if a transferor could determine through other means what the legal conclusion would be if a legal opinion was requested. For example, the transferor might conclude that a transfer qualifies as a sale without consulting an attorney if it had no continuing involvement in the transferred financial assets or had experience with other transfers with the same facts and circumstances under similar applicable laws and regulations
- ▶ A transfer of financial assets may meet the legal isolation and other requirements for derecognition at the transferor entity level but fail the test when the transferor's continuing involvement with the transferred financial assets, if any, are combined with those of its parent and other affiliates within a consolidated group of reporting entities. In such cases, the transferred financial assets would be reported as a sale within the separate financial statements of the transferor, but as a secured borrowing within the consolidated financial statements of the parent

Setoff rights

The FASB also considered the implications of setoff rights before concluding that the isolation requirement should continue to be based on a legal analysis. A setoff right is a common law right of a party that is both a debtor and a creditor to the same counterparty to reduce its obligation to that counterparty if that counterparty fails to pay its obligation. Attorneys told the FASB that in the event of the bankruptcy or receivership of either the obligor of the financial asset or the transferor of the financial asset, both parties could retain the ability to exercise a setoff right involving a financial asset that had been transferred. In the event of the bankruptcy of the transferor, the transferee may only have an unsecured claim against the transferor for its share of the amount setoff.

¹² AU Section 9336, *Using the Work of a Specialist: Auditing Interpretations of Section 336*

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

Because it may not be possible to sever setoff rights for financial assets, the FASB ultimately decided that setoff rights would not be an impediment to meeting the legal isolation requirement for derecognition or the definition of a participating interest.

Bankruptcy remote entities

Paragraph 9(a) of Statement 140, as amended by Statement 166, states that “[F]or multiple step transfers, an entity that is designed to make remote the possibility that it would enter bankruptcy or other receivership (bankruptcy-remote entity [or BRE]) is not considered a consolidated affiliate for purposes of performing the isolation analysis.” This exception from the legal isolation requirements was provided to accommodate the difficulties in isolating transferred financial assets for the benefit of investors and the need to create an instrument that is appealing to investors. These difficulties resulted in the evolution of a more complex securitization structure that utilizes two transfers to isolate transferred financial assets from the transferor and its creditors while providing a credit enhanced interest for investors. A typical two-step structure is constructed as follows:

- ▶ First, the transferor transfers a group of financial assets to a BRE that, although wholly owned, is designed so that the possibility is remote that the transferor, its other consolidated affiliates (that are not BREs) included in the financial statements being presented, or its creditors could reclaim the financial assets. This first transfer is designed to be judged a true sale at law, in part because the transferor does not provide “excessive” credit protection. In addition, the BRE typically has a board of directors that is independent of the transferor and is not permitted by its charter to undertake any other business or to incur any liabilities. Its dedication to a single transaction and the other circumstances surrounding it make it extremely unlikely that it would enter bankruptcy and, even if it did, that a receiver could reclaim the transferred financial assets. This transfer is intended to legally isolate the transferred financial assets from the transferor.
- ▶ Second, the BRE transfers the group of financial assets to a trust or other type of entity, and provides the credit enhancement necessary to obtain the high credit rating sought by third-party investors on their interests (e.g., asset-backed securities). The credit enhancement is provided by the BRE’s junior (subordinated) beneficial interest in the transferred financial assets or other means. Because of the credit enhancement provided in the second transfer, it might not be judged to be a true sale at law. Thus, a bankruptcy trustee for the BRE could, at least in theory, reach the transferred financial assets. However, the transaction has been designed to make remote the possibility that the BRE would enter bankruptcy, either by itself or by substantive consolidation into a bankruptcy of the original transferor, should that occur.

A conclusion that an affiliate would not be substantively consolidated in bankruptcy is required whenever the transferee is an affiliate of the transferor or its consolidated affiliates (that are not BREs) included in the financial statements presented, as is the case in the above described two-step securitization. Substantive consolidation occurs when a bankruptcy judge views the assets of an affiliate of a bankrupt company as being available to meet the claims of the creditors of the bankrupt company, thereby “consolidating” the assets of the affiliate into the bankrupt entity. Substantive consolidation is a legal concept addressed by attorneys in their legal opinions used as support for the legal isolation criteria of Statement 140, as amended by Statement 166; it does not represent the accounting concept of consolidation.

The FASB indicates in Statement 166 that it understands that this two-step securitization, taken as a whole, would meet the legal isolation criterion because it would be judged under present US law as having isolated the financial assets beyond the reach of the transferor, its consolidated affiliates (that are not BREs) included in the financial statements presented, and its creditors, even in bankruptcy or other receivership. However, even if the transaction is structured in such a manner, the determination of whether the financial assets are legally isolated from the transferor is a legal determination that must be made by qualified professionals.

A common practice question is whether a BRE in a two-step securitization transaction is required to account for the second step transfer as a secured borrowing when, as typically occurs, the BRE is not able to obtain a true sale opinion for its transfer of financial assets to the securitization entity. More importantly, what does the transferor include in its consolidated financial statements when it is required to consolidate the BRE? The answer depends on the facts and circumstances. Despite the fact that legal isolation may not have been achieved between the BRE and the securitization entity (for reasons mentioned above), the BRE and transferor will account for the second step transfer as an accounting sale when each of the following conditions are met:

- ▶ The transferor has obtained a true sale and substantive non-consolidation opinion for the transfer to the BRE (i.e., step one in the two-step transfer described above),
- ▶ The transferor has obtained a substantive non-consolidation opinion regarding the securitization entity (assuming the securitization entity is deemed to be an affiliate), and
- ▶ The transferor is not required to consolidate the securitization entity in accordance with applicable consolidation accounting guidance, including FIN 46(R), as amended by Statement 167

Constraints on transferability

As noted above, the FASB decided to eliminate the concept of a qualifying SPE and the exception for qualifying SPEs within the derecognition criteria of Statement 140. The FASB then debated whether the ability of a transferee to pledge or exchange the assets it receives should continue to be a condition for sale accounting. The FASB concluded that the ability of a transferee to pledge or exchange the financial asset it receives is an important indication that a transferor has surrendered control over the transferred financial asset. However, the FASB realized that in cases in which a financial asset is transferred to a securitization entity, a constraint on the ability of the transferee to pledge or exchange its assets is usually, but not always, necessary if the transferee intends to issue beneficial interests. Therefore, the FASB concluded that such a constraint would not indicate that the transferor has maintained effective control in circumstances in which the sole purpose of the transferee entity is to engage in securitization or asset-backed financing activities. However, in other cases, a constraint on the ability of the transferee to pledge or exchange its assets may indicate that the transferor has maintained effective control and, therefore, the transferor would be precluded from derecognizing the transferred financial assets. Accordingly, the FASB amended paragraph 9(b) of Statement 140 as follows [Added text is underlined and deleted text is ~~struck out~~.]:

Excerpt from Statement 140, as amended by Statement 166 – Paragraph 9(b)

9(b) Each transferee (or, if the transferee is an entity whose sole purpose is to engage in securitization or asset-backed financing activities and that entity is constrained from pledging or exchanging the assets it receives ~~a qualifying SPE (paragraph 35)~~, each third-party holder of its beneficial interests) has the right to pledge or exchange the assets (or beneficial interests) it received, and no condition both constrains the transferee (or third-party holder of its beneficial interests) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor (paragraphs 29-33~~29-34~~).

In the 2008 Exposure Draft, the FASB proposed that a constraint on the ability of the transferee to pledge or exchange its assets indicates that a transferor maintains effective control over a transferred asset unless such a constraint is designed primarily to provide the transferee with a benefit. Most of the respondents to the 2008 Exposure Draft believed that the FASB's proposed amendment was not clear or operational. Accordingly, the FASB decided to retain the existing language in paragraph 9(b) with modification for the removal of the qualifying SPE concept. Additionally, the FASB decided to clarify when a transferor should look through to the beneficial interest holders, rather than look to the transferee, in evaluating the conditions of paragraph 9(b).

The FASB noted that certain transferees issue beneficial interests of various types (e.g., characterized as debt, participations, residual interests, or otherwise as required by the transfer agreements). To issue the beneficial interests, the transferee is typically restricted from pledging or exchanging the assets it holds because it is effectively transferring ownership rights in those assets. This transaction is typically executed through the establishment of a separate legal entity that merges the contractual rights in the transferred financial assets and allocates ownership interests in them through the issuance of 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 financial assets themselves. Accordingly, a constraint on the transferee that issues those beneficial interests would not necessarily indicate that the transferor has retained control over the transferred financial assets. As a result, the FASB concluded that in cases in which (a) a financial asset is transferred to an entity whose sole purpose is to facilitate a securitization or asset-backed financing and (b) the transferee entity is constrained from pledging or exchanging the asset it receives, the transferor should evaluate whether the beneficial interest holders have the ability to pledge or exchange their beneficial interests.

Effective control

One of the requirements for sale accounting is that the transferor must not maintain effective control over the transferred financial assets through a unilateral ability to reclaim the transferred financial assets. The implementation guidance in Statement 140 and the FASB Special Report,¹³ provides guidance on whether the transferor has maintained effective control of the transferred financial assets. That guidance addresses specific arrangements and has resulted in numerous requests to clarify whether other arrangements result in the transferor maintaining effective control.

While deliberating Statement 166, the FASB decided that it was not feasible to provide specific guidance on all of the possible arrangements that could be made between the various parties to a transfer of financial assets. As a result, the FASB decided to amend paragraph 9(c) to include a principle that the transferor cannot retain effective control over the transferred financial assets and account for the transfer as a sale, and provided illustrative examples of effective control. The FASB also clarified that the transferor should evaluate whether it has maintained effective control over the transferred financial assets by considering any continuing involvement through direct involvement with the transferred financial assets by the transferor, its consolidated affiliates or agents. The FASB also concluded that the application of paragraph 9(c) should consider the transferor's indirect continuing involvement with the transferred financial assets that could enable it to maintain effective control over the transferred financial assets through an arrangement made with beneficial interest holders of the transferred financial assets.

¹³ FASB Special Report, *Q&A 140—A Guide to Implementation of Statement 140 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FASB ASC Topic 860, *Transfers and Servicing*)

Accordingly, the FASB amended paragraph 9(c) of Statement 140 as follows [Added text is underlined and deleted text is ~~struck out~~.]:

Excerpt from Statement 140, as amended by Statement 166 – Paragraph 9(c)

9(c) The transferor, its consolidated affiliates included in the financial statements being presented, or its agents ~~does~~ not maintain effective control over the transferred financial assets or third-party beneficial interests related to those transferred assets (paragraph 46A). Examples of a transferor's effective control over the transferred financial assets include, but are not limited to: ~~through either~~ (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (paragraph 47-49), ~~or~~ (2) an agreement that provides the transferor with both the ability to unilaterally unilateral ability to cause the holder to return specific financial assets and a more-than-trivial-benefit attributable to that ability, other than through a cleanup call (paragraphs 50-54), ~~or~~ (3) an agreement that permits the transferee to require the transferor to repurchase the transferred financial assets at a price that is so favorable to the transferee that it is probable that the transferee will require the transferor to repurchase them (paragraph 54A).

Judgment is required to assess whether the transferor maintains effective control over transferred financial assets. When the transferee issues beneficial interests in the transferred financial assets, the evaluation of whether the transferor maintains effective control over the transferred financial assets also should consider whether the transferor maintains effective control over the transferred financial assets through its control over the third-party beneficial interests.

To assess whether the transferor maintains effective control over the transferred financial assets, all continuing involvement by the transferor, its consolidated affiliates included in the financial statements being presented, or its agents should be considered continuing involvement by the transferor. When assessing effective control, the transferor only considers the involvement of the agent when the agent acts for and on behalf of the transferor. In other words, if the transferor and transferee have the same agent, the agent's activities on behalf of the transferee would not be considered in the transferor's evaluation of whether it has effective control over a transferred financial asset. For example, an investment manager may act as a fiduciary (agent) for both the transferor and the transferee. In this instance, the transferor need only consider the involvements of the investment manager when it is acting on its behalf.

A transferor maintains effective control over transferred financial assets when the transferor has the unilateral ability to cause the holder to return specific financial assets and that ability provides more than a trivial benefit to the transferor. A cleanup call,¹⁴ however, is an exception to that general principle that would not represent effective control.

Examples of continuing involvement that may entitle or obligate the transferor to reclaim the transferred financial asset include options written (i.e., a written put option) or held (i.e., a purchase call option) and agreements to purchase or redeem transferred financial assets (e.g., repurchase agreements, forward purchase contracts and securities lending arrangements).

A call on a transferred financial asset provides the transferor with effective control over that financial asset if, under its price and other terms, the call (a) provides the transferor with the unilateral ability to reclaim the transferred financial asset and (b) 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. For example, a call on a specific transferred financial asset at a price fixed at its principal amount maintains the transferor's effective control over the financial asset subject to that call. Similarly, effective control over transferred financial assets can be present even if the right

¹⁴ Paragraph 364 of Statement 166 defines a cleanup call as "An option held by the servicer or its affiliate, which may be the transferor, to purchase the remaining transferred financial assets, or the remaining beneficial interests not held by the transferor, its affiliates, or its agents in an entity (or in a series of beneficial interests in transferred financial assets within an entity), if the amount of outstanding financial assets or beneficial interests falls to a level at which the cost of servicing those assets or beneficial interests becomes burdensome in relation to the benefits of servicing."

to reclaim is indirect. That is, if a call allows a transferor to buy back the beneficial interests at a fixed price, then the transferor may maintain effective control of the financial assets underlying those beneficial interests. For example, if the transferee is an entity whose sole purpose is to engage in securitization or asset-backed financing activities, that entity may be constrained from choosing to pledge or exchange the transferred financial assets. In that circumstance, any call held by the transferor on third-party beneficial interests is effectively an attached call on the transferred financial assets. Depending on the price and other terms of the call, the transferor may maintain effective control over the transferred financial assets because the third-party holders of the beneficial interests may be constrained from pledging or exchanging their interests in the securitization entity. Additionally, such a constraint may provide the transferor with more than a trivial benefit.

A fair value call option empowers a transferor with the unilateral ability to reclaim transferred financial assets. However, such an option, in and of itself, does not necessarily provide the transferor with more than a trivial benefit. For example, if the transferred financial assets are readily obtainable in the marketplace the call option would provide no more than a trivial benefit. Therefore, the existence of such arrangements does not prevent the transferor from satisfying the derecognition requirements of paragraph 9 (c) of Statement 166. However, a transferor must also evaluate whether the combination of multiple arrangements provides it with effective control of transferred financial assets. For example, an ability to reclaim specific transferred financial assets at the termination of a securitization entity (the transferee) by paying their "fair value" in a liquidation auction generally does not maintain effective control when it does not convey a more than trivial benefit to the transferor. However, if the transferor also holds the residual interest in the transferred financial assets (i.e., the residual beneficial interest issued by the securitization entity), then sale accounting would be precluded for the transfer of those specific financial assets it can reclaim. Such circumstances provide the transferor with a more than trivial benefit and effective control over the financial assets because the transferor can pay any price it chooses in the auction and recover any excess paid over fair value through its residual interest in the transferred financial assets.

Repurchase financings

When evaluating the effective control criterion for derecognition an entity must also consider the accounting guidance of FSP FAS 140-3,¹⁵ which was issued in February 2008. FSP FAS 140-3 is effective for financial statements issued for fiscal years beginning after 15 November 2008 (or 1 January 2009 for calendar-year companies), and interim periods within those fiscal years. The objective of FSP FAS 140-3 is to provide guidance on when a transferor and transferee should account separately for an initial transfer of a financial asset and a related repurchase financing under Statement 140. For transactions occurring in fiscal years beginning after 15 November 2009, effected entities will need to consider the guidance of Statement 166, which amends Statement 140.

FSP FAS 140-3 presumes that an initial transfer of a financial asset and a repurchase financing with the same counterparty are part of the same arrangement (linked transactions). The fundamental premise of FSP FAS 140-3 is that a transferor and transferee do not separately account for a transfer of a financial asset and a related repurchase financing unless:

- ▶ the two transactions have a valid and distinct business or economic purpose for being entered into separately and
- ▶ the repurchase financing does not result in the initial transferor regaining control over the financial asset.

The FASB developed specific factors to distinguish between those transactions that should be considered together (linked) and those that should not (unlinked). These factors require consideration of:

- ▶ the transactions' contractual relationship (both explicit and implicit),
- ▶ whether market risk has been transferred to, and retained by, the transferee as a result of the transactions,

¹⁵ FASB Staff Position FAS 140-3, *Accounting for Transfers of Financial Assets and Repurchase Financing Transactions* (FASB ASC Topic 860-10, *Transfers and Servicing-Overview*)

- ▶ the marketability of the underlying financial asset, and
- ▶ the timing and terms of the transactions (e.g., the maturity date of the financial asset relative to the final settlement date of the repurchase agreement).

FSP FAS 140-3 presumes that involvement of a transferor with the transferred financial assets is linked to the transfer, even if that involvement arises after a transfer has been completed (assuming the subsequent involvement is in contemplation of or contingent upon the initial transfer). However, if certain criteria are met, the initial transfer and repurchase financing should not be evaluated as a linked transaction, but should instead be evaluated separately under Statement 140.

Prior to the issuance of FSP FAS 140-3, many entities believed that it was appropriate to account separately for a transfer of a financial asset and a repurchase agreement with the same counterparty. In doing so, the transferor and transferee first analyzed the initial transfer for sale and purchase accounting, which includes performing the legal isolation analysis under paragraph 9(a) of Statement 140 (or Statement 166 for transactions occurring subsequent to the effective date of that Statement - hereafter simply referred to as the requirements of paragraph 9(a)), without considering the effect of the repurchase agreement. The repurchase agreement was separately analyzed as a transfer of a financial asset (as collateral) with an agreement to repurchase the financial asset. However, when the two transactions are considered part of the same arrangement, the rights obtained by the initial transferor through the repurchase agreement would generally preclude a conclusion that the assets have been put presumptively beyond the reach of the initial transferor and its creditors as required by paragraph 9(a). Although the Bankruptcy Code has special "safe harbors" protecting the rights of the secured lender in a repurchase agreement, those provisions generally would not protect the rights of the initial transferee/borrower in the bankruptcy of the initial transferor/lender. Consequently, if the initial transfer and repurchase agreement are considered linked, the assets transferred by the initial transferor would likely fail the legal isolation requirements of paragraph 9(a) and derecognition by the initial transferor would not be permissible. The implication for the transferee of the financial assets is that the transaction is initially recognized as a forward purchase transaction.

Refer to our Technical Line No. 2009-2 on FSP FAS 140-3¹⁶ for additional guidance regarding the accounting for repurchase financings.

Initial measurement of a transfer that qualifies for sale accounting

Measurement of assets obtained and liabilities incurred

Excerpt from Statement 140, as amended by Statement 166 – Paragraph 11

[Added text is underlined and deleted text is ~~struck out~~.]

11. Upon completion³ of a transfer of an entire financial asset or a group of entire financial assets that satisfies the conditions to be accounted for as a sale (paragraph 9), the transferor (seller) shall:
 - a. Derecognize ~~all the transferred financial 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 assets and servicing liabilities, if applicable (paragraphs 56, 57, and 61-67)

¹⁶ EY Technical Line 2009-02, FSP FAS 140-3 – Accounting for Transfers of Financial Assets and Repurchase Financing Transactions

c. ~~Recognize and initially measure at fair value servicing assets, servicing liabilities, and any other assets obtained (including the transferor's beneficial interest in the transferred financial assets) and liabilities incurred^{3a} in the sale (paragraphs 56, 57, and 61-65) a sale 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).~~

³ See footnote 2a [which is included with paragraph 10 of Statement 140, as amended by Statement 166]. ~~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.~~

^{3a} ~~Some assets that might be obtained and liabilities that might be incurred include cash, put or call options that are 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), and swaps (for example, provisions that convert interest rates from fixed to variable).~~

Prior to Statement 166, US GAAP required that beneficial interests held by a transferor be measured by allocating the carrying amount of the transferred financial assets between the financial assets sold and the financial assets retained based on their relative fair values on the date of transfer. The FASB previously concluded that even though beneficial interests in transferred financial assets are different from the original financial assets, surrender of control has not occurred for the retained beneficial interests because those interests never left the possession of the transferor. However, this principle did not apply to other assets obtained in transactions accounted for as sales even though the assets obtained often related to the transferred financial assets (e.g., servicing assets).

After the FASB decided to require that Statement 140's conditions for sale accounting only be applied to transfers of an entire financial asset, transfers of groups of entire financial assets, and transfers of a participating interest in an entire financial asset, the FASB reconsidered the nature of a transferor's beneficial interest in a transferred financial asset. The FASB concluded that any beneficial interest or other asset obtained in a transfer accounted for as a sale should be considered proceeds from the sale because a clear exchange has occurred and, thus, initial measurement of all assets obtained and liabilities incurred at fair value was warranted.

Illustration – Recording transfers with proceeds of cash, beneficial interests, and other liabilities

[For purposes of this illustration, the transaction described below is assumed to meet the conditions for sale accounting in paragraph 9 of Statement 166. Additionally, it is assumed that the transferor is not required to consolidate the transferee under the guidance of Statement 167. There is no assurance or presumption that such a transaction would actually meet the conditions for derecognition and non-consolidation.]

ABC Bank transfers a group of loans in their entirety with a carrying amount of \$1,000,000 to a trust (ABC 2009-6 Trust or the transferee) in exchange for net proceeds of \$1,070,000. The transferee is an entity whose sole purpose is to engage in securitization or asset backed financing activities. For tax and credit rating purposes, among other reasons, the transferee is constrained from selling or pledging the transferred loans. To finance the acquisition, ABC 2009-6 Trust issues three different classes of beneficial interests (BIs) in the transferred loans. The beneficial interests include, in order of repayment priority; senior certificates with an aggregate fair value of \$880,000, mezzanine certificates with an aggregate fair value of \$165,000 and residual interests with an aggregate fair value of \$55,000. Investors in the beneficial interests issued by ABC 2009-6 Trust are not constrained from selling or pledging their BIs. In exchange for the transferred loans, ABC Bank obtains 20% of the senior certificates issued by the trust and \$924,000 in cash. ABC Bank undertakes no servicing responsibilities and assumes a limited recourse obligation to repurchase delinquent loans.

The transaction is accounted for as a sale because each of the derecognition criteria of paragraph 9 of Statement 166 are assumed to have been met. That is, the transferred financial assets have been legally isolated from ABC Bank, its consolidated affiliates and its creditors – even in bankruptcy, the beneficial interest holders have an unrestricted right to pledge or exchange their respective interests in the transferred financial assets, and neither the transferor, nor its consolidated affiliates or agents, maintains effective control over the transferred financial assets or third party beneficial interests related to those transferred financial assets.¹⁷ Additionally, ABC Bank is not considered the primary beneficiary of the trust because it is not empowered with the ability to direct the activities of the trust that could most significantly impact the economic performance of the trust. Accordingly, ABC Bank does not consolidate ABC 2009-6 Trust in accordance with the consolidation guidance of Statement 167.

Net proceeds received by ABC Bank	Fair value amount
Cash received	\$ 924,000
Plus: Senior certificates received ¹⁸	176,000
Less: Assumed recourse obligation ¹⁹	<u>(30,000)</u>
Net proceeds	<u>\$ 1,070,000</u>
Gain on sale calculation	
Net proceeds	\$ 1,070,000
Carrying amount of loans sold	<u>1,000,000</u>
Gain on sale	<u>\$ 70,000</u>

Journal entry recorded by ABC Bank

	<u>Debit</u>	<u>Credit</u>
Cash	\$ 924,000	
Senior certificates	176,000	
Loans		\$ 1,000,000
Recourse obligation		30,000
Gain on sale		70,000

Note: To record transfer of loans accounted for as a sale, including recognition of senior certificates obtained, and liability for estimated recourse obligation incurred

¹⁷ The option held by ABC 2009-6 Trust that entitles it to put back delinquent loans to ABC Bank does not preclude ABC Bank from derecognizing the transferred loans because exercise of the put option is conditional and beyond ABC Bank's control. Additionally, it is assumed the extent of the guarantee does not prevent the transferor from meeting the legal isolation requirements for sale accounting.

¹⁸ Paragraph 11 of Statement 166 requires that all proceeds, including beneficial interests obtained, and reductions from proceeds, including guarantees or recourse obligations, be initially measured at fair value. This treatment is different than the requirements under Statement 140, which required an allocation of the previous carrying amount of the transferred financial assets between the assets sold, if any, and the interests that continue to be held by the transferor, if any, based on their relative fair values at the date of transfer.

¹⁹ Represents the initial fair value amount of the recourse obligation ABC Bank is required to recognize under Statement 166 and FIN 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (FASB ASC Topic 460, *Guarantees*).

Measurement of a transferor's participating interest

Excerpt from Statement 140, as amended by Statement 166 – Paragraph 10

10. Upon completion^{2a} of a transfer of participating interests that satisfies the conditions to be accounted for as a sale (paragraph 9), the transferor (seller) shall:
- Allocate the previous carrying amount of the entire financial asset between the participating interests sold and the participating interest that continues to be held by the transferor on the basis of their relative fair values at the date of the transfer
 - Derecognize the participating interest or interest(s) sold
 - Recognize and initially measure at fair value servicing assets, servicing liabilities, and any other assets obtained and liabilities incurred in the sale (such as cash)
 - Recognize in earnings any gain or loss on the sale
 - Report any participating interest or interests that continue to be held by the transferor as the difference between the previous carrying amount of the entire financial asset and the amount derecognized.

The transferee shall recognize the participating interest(s) obtained, other assets obtained, and any liabilities incurred and initially measure them at fair value.

^{2a} Although a transfer of securities may not be considered to be completed until the settlement date, this Statement does not modify other generally accepted accounting principles (GAAP), 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.

In considering the measurement of a transferor's participating interest, the FASB noted that the transferor's participating interest is not transferred. Rather, only the participating interest sold to third parties is transferred and, therefore, the transferor has surrendered control over only those transferred participating interests. Consequently, the FASB decided that the carrying amount of the underlying financial asset should continue to be allocated between the participating interests sold and the transferor's participating interest based on their relative fair values.

Illustration—Recording Transfers of Participating Interests

[For purposes of this illustration, the transaction described below is assumed to meet the requirements of a participating interest and the conditions for sale accounting in paragraphs 8B and 9 of Statement 166, respectively. There is no assurance or presumption that such a transaction would actually meet the conditions for derecognition.]

Bankers XYZ originates a loan to Company ABC on 1 February 2007. The loan is for \$200,000, has a stipulated interest rate of 6.5%, becomes due on 31 January 2017 and is collateralized by various franchise equipment. Interest is paid monthly while the loan is outstanding and principal repayment is due only at maturity (a balloon mortgage payment). Fees earned by Bankers XYZ in connection with originating this loan, net of costs incurred, totaled \$1,500, and are comprised of the following:

Points	\$ 3,000
Application processing	250
Equipment appraisal	(750)
Legal and other	<u>(1,000)</u>
Net loan origination fees	<u>\$ 1,500</u>

As of 1 February 2007, the carrying amount of the loan is \$198,500 (\$200,000 loan – \$1,500 net origination fees). The net origination fees will be amortized over the life of the loan.

On 30 November 2008, Bankers XYZ, facing pressure from its primary regulator to increase its capital reserves and liquid assets, decides to sell some of its loans. On 29 December 2008, Bankers XYZ reaches an agreement with Investment Group to sell a 40% fully participating interest in the Company ABC loan. On 30 November 2008, the fair value of the Company ABC loan is estimated to be \$207,500 because market interest rates for comparable loans (e.g., comparable credit quality and duration) have fallen to 5.9%. The transaction is accounted for as a sale because the transfer represents a participating interest as defined in paragraph 8B of Statement 166 and because all of the derecognition criteria of paragraph 9 of that Statement have also been met. Bankers XYZ retains servicing rights and in exchange is entitled to a 15 basis points fee. No servicing asset or servicing liability is initially recognized because Bankers XYZ estimates that the servicing fee is just adequate to compensate it for its servicing responsibilities. At the time of sale, the carrying value of the loan recorded on Bankers XYZ's balance sheet is \$198,788.

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

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

Fair values

Cash proceeds for four-tenths participating interest sold [$\$207,500 \times [4/10]$]	\$ 83,000
Six-tenth participating interest that continues to be held by Bankers XYZ [$[\$207,500 \times [6/10]]$]	124,500

Allocated carrying amount based on relative fair values

	<u>Fair Value</u>	Percentage of Total <u>Fair Value</u>	Allocated Carrying <u>Amount</u>
Four-tenths participating interest sold	\$ 83,000	40%	\$ 79,515
Six-tenth participating interest that continues to be held by Bankers XYZ	<u>124,500</u>	<u>60</u>	<u>119,273</u>
Total	<u>\$ 207,500</u>	<u>100%</u>	<u>\$ 198,788</u>

Gain on sale calculation

Proceeds	\$ 83,000
Allocated carrying amount of loan sold	<u>79,515</u>
Gain on sale	<u>\$ 3,485</u>

Journal entry recorded by Bankers XYZ

	<u>Debit</u>	<u>Credit</u>
Cash	\$ 83,000	
Loan		\$ 79,515
Gain on sale		3,485

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

Removal of fair value practicability exception

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. Constituents expressed 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.

Prior to Statement 166, the FASB concluded that if it is not practicable to estimate the fair values of assets obtained and liabilities incurred in sales with continuing involvement, assets should be measured at zero and liabilities at the greater of (a) the amount called for under Statement 5,²⁰ as interpreted by FIN 14,²¹ or (b) 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 (i.e., the liabilities should be valued at an amount that would result in no gain being recognized from the transfer of financial assets). That requirement was intended to prevent recognition of nonexistent gains by underestimating liabilities.

As discussed in the basis for conclusions in Statement 157,²² the FASB decided to retain the practicability exceptions for fair value measurements in certain accounting pronouncements within the scope of that Statement, including the exception provided in Statement 140. However, during the re-deliberations on the proposed amendments to Statement 140, the FASB reconsidered the original basis for the practicability exception in that Statement and concluded that the concerns that led to the exception in Statement 140 were addressed with the issuance of Statement 157. Additionally, the FASB observed that the conditions to apply the practicability exception were rarely met in practice. Accordingly, the FASB decided to remove the fair value practicability exception in Statement 140 in its entirety.

Disclosures

In developing the incremental disclosures included in Statement 166, the FASB noted that existing US GAAP already requires numerous disclosures related to transfers of financial assets, risks and uncertainties, credit concentrations, derivatives and assets measured at fair value. However, the FASB concluded that some of these disclosures could be enhanced and incorporated directly into Statement 140 to improve compliance, transparency, and enforcement. To enhance the disclosures already required by Statement 140, the FASB considered recommendations from constituents, existing SEC disclosure requirements, existing or contemplated disclosure requirements of other standard setters (including the IASB) and various other studies on the topic. For example, the FASB considered certain disclosures included in the April 2008 Senior Supervisors Group Report, *Leading-Practice Disclosures for Selected Exposures*, which was issued by banking commissions and regulators from five countries.

²⁰ FASB Statement No. 5, *Accounting for Contingencies* (FASB ASC Topic 450, *Contingencies*)

²¹ FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss* (FASB ASC Topic 450, *Contingencies*)

²² FASB Statement No. 157, *Fair Value Measurement* (FASB ASC Topic 820, *Fair Value Measurements and Disclosures*)

The disclosures required by Statement 166 are similar to those included in FSP FAS 140-4 and FIN 46(R)-8, which is superseded by this Statement. Refer to our Hot Topic Publication on FSP FAS 140-4 and FIN 46(R)-8²³ for further details. While most of the disclosures are identical to those included in the FSP, the FASB decided to enhance certain disclosures included in the FSP and expand their scope to all transfers of financial assets within the scope of Statement 140 and not just for securitizations and asset-backed financing arrangements, as required by the FSP. Additionally, unlike the FSP, which applies only to public entities, the disclosure requirements of Statement 166 apply to both public and non-public entities.

The FASB concluded that the four objectives of the disclosures should provide preparers with the guidance necessary to provide financial statement users with an understanding of:

- ▶ A transferor's continuing involvement in transferred financial assets
- ▶ The nature of any restriction on assets reported by a transferor in its statement of financial position, including the carrying amounts of such assets
- ▶ How servicing assets and servicing liabilities are reported by a transferor under Statement 140, as amended by this Statement 166, and
- ▶ How a transfer of financial assets affects an entity's financial position, financial performance, and cash flows

The FASB decided to include overall objectives for the disclosures because it is not possible to develop specific disclosure requirements that would anticipate all existing and future transactions. The FASB acknowledged that certain disclosures in Statement 166 are rules based (e.g., those related to a transferor's continuing involvement with securitizations and asset-backed financing arrangements); however, they believe such specific requirements are needed to supplement the overall objectives and meet user requests for certain types of information. It should be noted that the disclosure objectives apply even if no specific disclosure requirement applies or if the specific disclosures do not adequately meet the objectives. Entities should also consider disclosures required by other US GAAP when determining whether the disclosure objectives of Statement 166 have been met. Refer to Appendix A for a complete listing of the Statement 166 disclosure requirements.

The disclosures required by Statement 166 may be reported in the aggregate for similar transfers if separate reporting of each transfer would not provide information that is more useful to the financial statement users. Based on an entity's specific facts and circumstances, the entity should determine how much detail it should provide to satisfy the objectives and requirements of Statement 166, how much emphasis it places on different aspects of the disclosure requirements, and how it aggregates information for assets with different risk characteristics. A proper balance must also be struck to avoid obscuring important information because of too much aggregation or overburdening financial statements with excessive detail that may not assist users of the financial statements to understand the entity's financial position.

For securitizations, asset-backed financing arrangements and similar transfers accounted for as sales when the transferor has continuing involvement with the transferred financial assets, the FASB decided to specifically require disclosure of the maximum exposure to loss relating to a transferor's continuing involvement. The FASB also decided to require further disclosure about the characteristics of the assets obtained and liabilities incurred in a transfer of financial assets in which the transferor has continuing involvement. The FASB concluded that an entity should disclose the nature of the proceeds received in the transfer, and the inputs and valuation techniques used to initially measure those proceeds at fair value. The FASB decided that those disclosures would provide useful information about how the gain or loss from the sale of transferred financial assets was determined.

²³ EY Hot Topic No. 2008-40, *FASB issues FSP on disclosures about transfers of financial assets and interests in variable interest entities*

Effective date and transition

The recognition and measurement provisions of Statement 166 are effective as of the beginning of the reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. That is, Statement 166 is effective 1 January 2010 for calendar-year reporting entities. Earlier application is prohibited.

Additionally, in the reporting entity's first fiscal year that begins after 15 November 2009, all existing qualifying SPEs must be evaluated for consolidation by all reporting entities in accordance with the applicable consolidation guidance. If the evaluation results in consolidation, the reporting entity must apply the transition guidance provided in the pronouncement that requires consolidation.

The disclosures required by Statement 166 are effective for the first reporting period (interim or annual) beginning after 15 November 2009, and will be applied to both transfers that occurred before and after the effective date of Statement 166. The disclosures will apply for each annual and interim reporting period thereafter. An entity is encouraged, but not required, to disclose comparative information for periods earlier than the effective date for disclosures that were not previously required by Statement 140 for nonpublic entities or by FSP FAS 140-4 and FIN 46(R)-8 for public entities. In periods after initial adoption, comparative disclosures for those disclosures that were not previously required by Statement 140 for nonpublic entities or by FSP FAS 140-4 and FIN 46(R)-8 for public entities are required only for periods subsequent to the effective date of the disclosure requirements.

Effects of Statement 166

Statement 166 will have a significant effect on existing securitizations that use qualifying SPEs, as well as future securitizations. Currently, transferors of financial assets to qualifying SPEs do not consolidate the special-purpose entity (SPE) by virtue of the SPEs "qualifying" status, in spite of the fact that the transferor might retain a significant residual interest in the qualifying SPE's transferred financial assets. Now that the concept of a qualifying SPE is removed from Statement 140, along with the related scope exception in FIN 46(R), as amended by Statement 167, many existing securitization vehicles likely will be consolidated by the transferor, servicer or guarantor of the transferred financial assets when the new consolidation rules become effective (e.g., 1 January 2010 for calendar-year entities). Affected entities will need to determine how they will obtain the necessary financial information for the newly consolidated SPEs and how this might affect relevant financial ratios, debt covenants or regulatory capital requirements, where applicable.

With respect to the removal of the exception for guaranteed mortgage securitizations, entities that enter into these transactions will no longer be able to re-characterize the transferred financial assets, or separately recognize a related servicing asset or liability, unless they meet the sale criteria of Statement 140, as amended by Statement 166, and are not the primary beneficiary of the securitization SPE, as defined in FIN 46(R), as amended by Statement 167.

Assuming a transfer of financial assets meets the requirements for sale accounting and that consolidation of the securitization SPE is not required, the requirement to now initially recognize and measure all assets obtained (including the transferor's beneficial interests) and liabilities incurred at fair value will affect the amount of gain or loss to be recognized in future securitizations as well as the amount of future income to be recognized on the beneficial interest obtained.

The conditions established in Statement 166 related to transfers of a portion (or portions) of financial assets will affect many transfers to commercial paper conduits, as those conduits currently hold senior undivided interests in the related receivables, as opposed to the receivables themselves. Going forward, in order for those transfers to receive sale accounting, the entire receivables will need to be transferred to the commercial paper conduit or the interests in those receivables held by the conduit will need to conform to the requirements of a participating interest.

In certain transactions, the transferor is entitled to repurchase a transferred amortizing, individual (specific) financial asset when its remaining principal balance reaches some specified amount; for example 40% of the original balance. To exercise that call, the transferor would pay the remaining principal balance. Under Statement 140 such a transfer would be accounted for as a part sale and part secured borrowing because the previous FASB reasoned that the fixed price call allows the transferor to maintain effective control only over the portion of the transferred financial assets subject to that call (i.e., the 40%). Under Statement 166, such a transaction would be accounted for entirely as a secured borrowing because permitting partial sale/partial secured borrowing treatment would be inconsistent with the definition of a participating interest.

Prior to Statement 166, portions of financial assets were often sold with a stipulated interest factor based on market interest rates at the time of sale. Going forward, to qualify as a participating interest, Statement 166 requires that all cash flows (e.g., both contractual principal and interest payments) received from an entire financial asset be divided among the participating interest holders in proportion to their share of ownership. Because a participating interest in an asset may be sold after the purchase or origination of the asset, often the contractual interest rate passed through for the portion of the asset sold will differ from market interest rates at the time of sale of the participating interest. Differences between contractual and market interest rates at the time of sale will likely result in portions of financial assets being sold at either discounts or premiums to the face amount of the participating interest. These purchase discounts or premiums will expose investors to additional prepayment risks. Consequently, it remains unclear how market participants will react to these changes.

In certain transfers that qualify as sales, an entity may transfer a group of debt securities classified as available for sale securities (AFS) under Statement 115 into a securitization vehicle while retaining a portion of the beneficial interests of the securitization vehicle. These transactions are sometimes referred to as “re-securitizations” as the original debt securities are transferred to the securitization vehicle and different securities (beneficial interests) are obtained in return. Often the primary objective of the re-securitization is to reduce the credit risk inherent in the retained securities. For example, an entity may transfer a group of mortgage-backed securities to a newly created securitization vehicle (typically a qualifying SPE) and retain all of the senior beneficial interests issued by the securitization vehicle while third-party investors purchase the subordinated interests.

Prior to Statement 166, US GAAP required that beneficial interests held by a transferor following a transfer of financial assets that qualifies for sale accounting be measured by allocating the carrying amount of the transferred financial assets between the financial assets sold and the financial assets retained based on their relative fair values on the date of transfer. In other words, the FASB previously concluded that a transferor’s beneficial interests in transferred financial assets do not constitute newly created assets that should initially be measured and recognized at fair value. Because of this provision under Statement 140, there were mixed views in practice as to whether a decision to execute a re-securitization transaction of the original AFS debt securities triggers an other-than-temporary impairment (OTTI) loss under Statement 115 and FSP FAS 115-2 and FAS 124-2²⁴ for the portion of the securities represented by the retained interests. Statement 166 eliminates this accounting diversity and requires an approach focused on the entire original AFS debt security (versus only a portion of a single security) because Statement 166:

- ▶ modifies the financial-components approach used in Statement 140 and limits the circumstances in which a transferor derecognizes a portion or component of a financial asset. Specifically, it amends the unit of account eligible for sale accounting as either; a) an entire financial asset, b) a group of entire financial assets, or c) a participating interest, as defined, in an entire financial asset and
- ▶ requires that all proceeds received, including beneficial interests, in a transfer that qualifies for sale accounting be recognized at fair value, not allocated carry-over basis

²⁴ FSP FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments* (FASB ASC Topic 320, *Investments - Debt and Equity Securities*), which is effective for interim and annual periods ending after 15 June 2009, with early adoption permitted for periods ending after 15 March 2009.

Consequently, for re-securitization transactions occurring after the first fiscal year beginning after 15 November 2009, an entity should recognize an OTTI loss equal to the entire difference between the debt security's amortized cost basis and its fair value at the balance sheet date when an entity intends to sell (i.e., re-securitize) an impaired debt security.

IFRS convergence

Statement 166 is designed to make short-term improvements to Statement 140 until such time as convergent standards on derecognition and consolidation are developed with the IASB. In the meantime, Statement 166 improves convergence with IFRS by eliminating the concept of a qualifying SPE, including the exception for qualifying SPEs from the consolidation guidance of FIN 46(R), as amended by Statement 167, and by limiting the portions of financial assets that are eligible for derecognition. Additionally, Statement 166 eliminates the special provisions in Statement 140 for guaranteed mortgage securitizations (GMS). These changes help converge US GAAP with IFRS because the special accounting provisions and exceptions previously afforded GMS transactions and qualifying SPEs under Statement 140 do not exist in IAS 39²⁵ or SIC-12.²⁶

Convergence between US GAAP and IFRS may also be advanced with recent proposals to change the accounting for transfers of financial instruments under IFRS. In March 2009, the IASB published for public comment an exposure draft (ED) of proposals to improve the derecognition requirements for financial instruments. The IASB believes its proposed approach is similar in some respects to Statement 166. For example, the ED replaces the current mixed derecognition model under IAS 39, which combines elements of risks-and-rewards and control, with a single element model that gives primacy to control. Therefore, like US GAAP, the proposed approach under IFRS assesses derecognition based on control, and evaluates control in a somewhat similar manner. A major difference between the derecognition requirements of Statement 166 and the proposed approach in the IASB ED is that Statement 166 requires that transferred financial assets have been isolated from the transferor, any of its consolidated affiliates and its creditors, even in bankruptcy. The approach proposed in the IASB ED does not require such a test. A final amendment of the IAS 39 derecognition guidance is expected to be issued sometime during 2010.

Now that the FASB has completed its short-term amendments to Statement 140, the two Boards have committed to work jointly to ultimately issue a converged derecognition standard.

²⁵ IAS 39, *Financial Instruments: Recognition and Measurement*

²⁶ SIC 12, *Consolidation – Special Purpose Entities*

Appendix A – Statement 166 disclosure provisions

Statement 166 Excerpt from Statement 140, as amended by Statement 166 – Paragraph 16 and 17

16A. The principal objectives of the disclosures required by this Statement are to provide users of the financial statements with an understanding of all of the following:

- a. A transferor's continuing involvement (as defined in the glossary of this Statement), if any, with transferred financial assets
- b. The nature of any restrictions on assets reported by an entity in its statement of financial position that relate to a transferred financial asset, including the carrying amounts of those assets
- c. How servicing assets and servicing liabilities are reported under this Statement
- d. For transfers accounted for as sales when a transferor has continuing involvement with the transferred financial assets and for transfers of financial assets accounted for as secured borrowings, how the transfer of financial assets affects a transferor's financial position, financial performance, and cash flows.

Those objectives apply regardless of whether this Statement requires specific disclosures. The specific disclosures required by this Statement are minimum requirements and an entity may need to supplement the required disclosures specified in paragraph 17 depending on the facts and circumstances of a transfer, the nature of an entity's continuing involvement with the transferred financial assets, and the effect of an entity's continuing involvement on the transferor's financial position, financial performance, and cash flows. Disclosures required by other U.S. generally accepted accounting principles (GAAP) for a particular form of continuing involvement shall be considered when determining whether the disclosure objectives of this Statement have been met.

Paragraphs 16B-16E are added as follows:

16B. Disclosures required by this Statement may be reported in the aggregate for similar transfers if separate reporting of each transfer would not provide more useful information to financial statement users. A transferor shall disclose how similar transfers are aggregated. A transferor shall distinguish transfers that are accounted for as sales from transfers that are accounted for as secured borrowings. In determining whether to aggregate the disclosures for multiple transfers, the reporting entity shall consider quantitative and qualitative information about the characteristics of the transferred financial assets. For example, consideration should be given, but not limited, to the following:

- a. The nature of the transferor's continuing involvement, if any
- b. The types of financial assets transferred
- c. Risks related to the transferred financial assets to which the transferor continues to be exposed after the transfer and the change in the transferor's risk profile as a result of the transfer
- d. The requirements of FSP SOP 94-6-1, *Terms of Loan Products That May Give Rise to a Concentration of Credit Risk*.

16C. The disclosures shall be presented in a manner that clearly and fully explains to financial statement users the transferor's risk exposure related to the transferred financial assets and any restrictions on the assets of the entity. An entity shall determine, in light of the facts and circumstances, how much detail it must provide to satisfy the disclosure requirements of this Statement and how it aggregates information for assets with different risk characteristics. The entity must strike a balance between obscuring important information as a result of too much aggregation and excessive detail that may not assist financial statement users to understand the entity's financial position. For example, an entity shall not obscure important information by including it with a large amount of insignificant detail. Similarly, an entity shall not disclose information that is so aggregated that it obscures important differences between the different types of involvement or associated risks.

16D. The disclosures in paragraph 17(f) of this Statement apply to transfers accounted for as sales when the transferor has continuing involvement with transferred financial assets as a result of a securitization, asset-backed financing arrangement, or a similar transfer. If specific disclosures are required for a particular form of the transferor's continuing involvement by other U.S. GAAP, the transferor shall provide the information required in paragraphs 17(f)(1)(a) and 17(f)(2)(a) of this Statement with a cross-reference to the separate notes to financial statements so a financial statement user can understand the risks retained in the transfer. The entity need not provide each specific disclosure required in paragraphs 17(f)(1)(b), 17(f)(2)(a)(i)-(iv), and 17(f)(2)(b)-(e) if the disclosure is not required by other U.S. GAAP and the objectives of paragraph 16A are met. For example, if the transferor's only form of continuing involvement is a derivative, the entity shall provide the disclosures required in paragraphs 17(f)(1)(a) and 17(f)(2)(a) of this Statement and the disclosures about derivatives required by applicable U.S. GAAP. In addition, the entity would evaluate whether the other disclosures in paragraph 17(f) are necessary for the entity to meet the objectives in paragraph 16A.

16E. To apply the disclosures in paragraph 17, an entity shall consider all involvements by the transferor, its consolidated affiliates included in the financial statements being presented, or its agents to be involvements by the transferor.

Paragraph 17, as amended, and its related footnotes 6-9a:

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 amounts and classifications of both those assets and associated liabilities as of the date of the latest statement of financial position presented, including qualitative information about the relationship(s) between those assets and associated liabilities. For example, if assets are restricted solely to satisfy a specific obligation, the carrying amounts of those assets and associated liabilities, including a description of the nature of restrictions placed on the assets, shall be disclosed.
- (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. For in-substance defeasance of debt:

- (1) 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 125⁶, a general description of the transaction and the amount of debt that is considered extinguished at the end of each period that debt remains Outstanding.

c. For all servicing assets and servicing liabilities:

- (1) Management's basis for determining its classes of servicing assets and servicing liabilities (paragraph 13A).
- (2) A description of the risks inherent in servicing assets and servicing liabilities and, if applicable, the instruments used to mitigate the income statement effect of changes in fair value of the servicing assets and servicing liabilities. (Disclosure of quantitative information about the instruments used to manage the risks inherent in servicing assets and servicing liabilities, including the fair value of those instruments at the beginning and end of the period, is encouraged but not required.)

- (3) The amount of contractually specified servicing fees, late fees, and ancillary fees earned for each period for which results of operations are presented, including a description of where each amount is reported in the statement of income.
 - (4) Quantitative and qualitative information about the assumptions used to estimate the fair value (for example, discount rates, anticipated credit losses, and prepayment speeds). (An entity that provides quantitative information about the instruments used to manage the risks inherent in the servicing assets and servicing liabilities, as encouraged by paragraph 17(c)(2), also is encouraged, but not required, to disclose quantitative and qualitative information about the assumptions used to estimate the fair value of those instruments.)
- d. For servicing assets and servicing liabilities subsequently measured at fair value:
- (1) For each class of servicing assets and servicing liabilities, the activity in the balance of servicing assets and the activity in the balance of servicing liabilities (including a description of where changes in fair value are reported in the statement of income for each period for which results of operations are presented), including, but not limited to, the following:
 - (a) The beginning and ending balances
 - (b) Additions (through purchases of servicing assets, assumptions of servicing obligations, and recognition of servicing obligations that result from transfers of financial assets)
 - (c) Disposals
 - (d) Changes in fair value during the period resulting from:
 - (i) Changes in valuation inputs or assumptions used in the valuation model
 - (ii) Other changes in fair value and a description of those changes
 - (e) Other changes that affect the balance and a description of those changes.
- e. For servicing assets and servicing liabilities subsequently amortized in proportion to and over the period of estimated net servicing income or loss and assessed for impairment or increased obligation:
- (1) For each class of servicing assets and servicing liabilities, the activity in the balance of servicing assets and the activity in the balance of servicing liabilities (including a description of where changes in the carrying amount are reported in the statement of income for each period for which results of operations are presented), including, but not limited to, the following:
 - (a) The beginning and ending balances
 - (b) Additions (through purchases of servicing assets, assumptions of servicing obligations, and recognition of servicing obligations that result from transfers of financial assets)
 - (c) Disposals
 - (d) Amortization
 - (e) Application of valuation allowance to adjust carrying value of servicing assets
 - (f) Other-than-temporary impairments
 - (g) Other changes that affect the balance and a description of those changes.

- (2) For each class of servicing assets and servicing liabilities, the fair value of recognized servicing assets and servicing liabilities at the beginning and end of the period.
 - (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 by class in any valuation allowance for impairment of recognized servicing assets—including beginning and ending balances, aggregate additions charged and recoveries credited to operations, and aggregate write-downs charged against the allowance—for each period for which results of operations are presented.
- f. For securitizations, asset-backed financing arrangements, and similar transfers accounted for as sales when the transferor has continuing involvement (as defined in the glossary) with the transferred financial assets:
- (1) For each income statement presented:
 - (a) The characteristics of the transfer (including a description of the transferor's continuing involvement with the transferred financial assets, the nature and initial fair value of the assets obtained as proceeds and the liabilities incurred in the transfer and the gain or loss from sale of transferred financial assets. For initial fair value measurements of assets obtained and liabilities incurred in the transfer, the following information:
 - (i) The level within the fair value hierarchy (as described in FASB Statement No. 157, Fair Value Measurements) in which the fair value measurements in their entirety fall, segregating fair value measurements using quoted prices in active markets for identical assets or liabilities (Level 1), significant other observable inputs (Level 2), and significant unobservable inputs (Level 3)
 - (ii) The key inputs and assumptions⁷ used in measuring the fair value of assets obtained and liabilities incurred as a result of the sale that relate to the transferor's continuing involvement (including, at a minimum, but not limited to, and if applicable, quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable financial assets,⁸ and anticipated credit losses, including expected static pool losses^{8a})^{8b}
 - (iii) The valuation technique(s) used to measure fair value.
 - (b) Cash flows between a transferor and transferee, (including proceeds from new transfers, proceeds from collections reinvested in revolving-period transfers, purchases of previously transferred financial assets, servicing fees, and cash flows received from a transferor's beneficial interests
 - (2) For each statement of financial position presented, regardless of when the transfer occurred:
 - (a) Qualitative and quantitative information about the transferor's continuing involvement with transferred financial assets that provides financial statement users with sufficient information to assess the reasons for the continuing involvement and the risks related to the transferred financial assets to which the transferor continues to be exposed after the transfer and the extent that the transferor's risk profile has changed as a result of the transfer (including, but not limited to, credit risk, interest rate risk, and other risks), including:
 - (i) The total principal amount outstanding, the amount that has been derecognized, and the amount that continues to be recognized in the statement of financial position

- (ii) The terms of any arrangements that could require the transferor to provide financial support (for example, liquidity arrangements and obligations to purchase assets) to the transferee or its beneficial interest holders, including a description of any events or circumstances that could expose the transferor to loss and the amount of the maximum exposure to loss
- (iii) Whether the transferor has provided financial or other support during the periods presented that it was not previously contractually required to provide to the transferee or its beneficial interest holders, including when the transferor assisted the transferee or its beneficial interest holders in obtaining support, including:
 - (1) The type and amount of support
 - (2) The primary reasons for providing the support
- (iv) Information is encouraged about any liquidity arrangements, guarantees, and/or other commitments provided by third parties related to the transferred financial assets that may affect the transferor's exposure to loss or risk of the related transferor's interest.
- (b) The entity's accounting policies for subsequently measuring assets or liabilities that relate to the continuing involvement with the transferred financial assets
- (c) The key inputs and assumptions^{8c} used in measuring the fair value of assets or liabilities that relate to the transferor's continuing involvement (including, at a minimum, but not limited to, and if applicable, quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable financial assets,^{8d} and anticipated credit losses, including expected static pool losses,⁹)^{9a}
- (d) For the transferor's interests in the transferred financial assets, a sensitivity analysis or stress test showing the hypothetical effect on the fair value of those interests (including any servicing assets or servicing liabilities) of two or more unfavorable variations from the expected levels for each key assumption that is reported under paragraph 17(f)(2)(c) 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
- (e) Information about the asset quality of transferred financial assets and any other assets that it manages together with them. This information shall be separated between assets that have been derecognized and assets that continue to be recognized in the statement of financial position. This information is intended to provide financial statement users with an understanding of the risks inherent in the transferred financial assets as well as in other assets and liabilities that it manages together with transferred financial assets. For example, information for receivables shall include, but is not limited to:
 - (i) Delinquencies at the end of the period
 - (ii) Credit losses, net of recoveries, during the period.

g. Disclosure requirements for transfers of financial assets accounted for as secured borrowings:

- (1) The carrying amounts and classifications of both assets and associated liabilities recognized in the transferor's statement of financial position at the end of each period presented, including qualitative information about the relationship(s) between those assets and associated liabilities. For example, if assets are restricted solely to satisfy a specific obligation, the carrying amounts of those assets and associated liabilities, including a description of the nature of restrictions placed on the assets.

⁶ Statement 125 applied 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.

⁷ If an entity has aggregated multiple transfers during a period in accordance with paragraphs 16B and 16C, it may disclose the range of assumptions.

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.

^{8a} 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.

^{8b} The timing and amount of future cash flows for transferor's interests in transferred financial assets are commonly uncertain, especially if those interests are subordinate to more senior beneficial interests. Thus, estimates of future cash flows used for a fair value measurement depend heavily on assumptions about default and prepayment of all the financial assets transferred, because of the implicit credit or prepayment risk enhancement arising from the subordination.

^{8c} See footnote 7.

^{8d} See footnote 8.

⁹ See footnote 8a.

^{9a} See footnote 8b.

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