RELATED AUTHORITATIVE LITERATURE

This document addresses the effect of FASB Statement No. 156, *Accounting for Servicing of Financial Assets*, on authoritative accounting literature included in categories(b)–(d) in the GAAP hierarchy discussed in AICPA Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles. Included are Q&As from the Special Report on Statement 140 on accounting for transfers and servicing of financial assets and extinguishments of liabilities, EITF Issues and Topics, and Statement 133 Implementation Issues that have been affected by the issuance of Statement 156.

Special Report on Statement 140 on accounting for transfers and servicing of financial assets and extinguishments of liabilities

Index of All Q&As Affected by Statement 156
As of March 17, 2006

Q&A Number
58
59
60
64
65
66
67
68
71
73
74
75
77
81
82
90
92
94
95
96
97
99
100
101
105
107
113
122

EITF Issues

Index of All Issues Affected by Statement 156
As of March 17, 2006

Issue Number	Title	Special Notes
85-13	Sale of Mortgage Service Rights on Mortgages Owned by Others	
87-34	Sale of Mortgage Servicing Rights with a Subservicing Agreement	
88-11	Allocation of Recorded Investment When a Loan or Part of a Loan Is Sold	Nullified
88-22	Securitization of Credit Card and Other Receivable Portfolios	
89-2	Maximum Maturity Guarantees on Transfers of Receivables with Recourse	
90-18	Effect of a "Removal of Accounts" Provision on the Accounting for a Credit Card Securitization	
90-21	Balance Sheet Treatment of a Sale of Mortgage Servicing Rights with a Subservicing Agreement	
92-2	Measuring Loss Accruals by Transferors for Transfers of Receivables with Recourse	
02-9	Accounting for Changes That Result in a Transferor Regaining Control of Financial Assets Sold	
02-12	Permitted Activities of a Qualifying Special-Purpose Entity in Issuing Beneficial Interests under FASB Statement No. 140	
D-69	Recognition on Transfers of Financial Assets under FASB Statement No. 140	

Statement 133 Implementation Issues

Index of All Issues Affected by Statement 156
As of March 17, 2006

Q&A 140—A Guide to Implementation of Statement 140 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities

Issued: February 2001
Revised: September 2001; April 2002; March 2006
Authored by: Halsey G. Bullen, Victoria A. Lusniak, and Stephen J. Young*

INTRODUCTION

In September 2000, the Financial Accounting Standards Board (FASB) issued Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, which replaces Statement 125 but carries over most of its provisions without reconsideration.

Questions of implementation on a new standard are often raised with the FASB staff by preparers, auditors, and others. The staff determined that this Special Report should be issued as an aid in understanding and implementing Statement 140 because of the relatively high number of inquiries received on that Statement and Statement 125.

The questions and answers in this Special Report are organized by the general topics in Statement 140 to which they relate. This Special Report is a cumulative document: it incorporates both new questions and answers and updated questions and answers from the first, second, and third editions of the Special Report, *A Guide to Implementation of Statement 125 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, and questions and answers from EITF Topic No. D-94, “Questions and Answers Related to the Implementation of FASB Statement No. 140,” and EITF Topic No. D-99, “Questions and Answers Related to Servicing Activities in a Qualifying Special-Purpose Entity under FASB Statement No. 140.”

In March 2006, the FASB issued FASB Statement No. 156, *Accounting for Servicing of Financial Assets*. Statement 156 requires all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable, and permits an entity to subsequently measure those servicing assets and servicing liabilities at fair value. The questions and answers in this Special Report have been updated to reflect changes resulting from the issuance of Statement 156.

Q&A 140

58. ***Q***—How should transferred components of financial assets and interests that continue to be held by a transferor ~~the transferred and retained components of financial assets~~ be accounted for upon completion of a transfer? [Revised 3/06.]

***A*—**Upon completion of a transfer, the transferor continues to carry in its statement of financial position any ~~retained~~ interests it continues to hold in the transferred assets, including ~~servicing assets,~~ beneficial interests in assets transferred to a qualifying SPE in a securitization~~,~~ and ~~retained~~ undivided interests,~~ in its statement of financial position~~ pursuant to paragraph 10 of Statement 140. ~~That paragraph requires that the transferor allocate the previous carrying amount between the assets sold, if any, and the retained interests, if any, based on their relative fair values at the date of transfer.~~ Paragraph 10 also requires upon completion of a transfer of financial assets that a transferor initially recognize and measure at fair value, if practicable, servicing assets and servicing liabilities that require recognition under paragraph 13 of Statement 140. It also requires that the transferor allocate the previous carrying amount 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. [Revised 3/06.]

Paragraph 11 of Statement 140 requires that assets obtained and liabilities incurred in consideration as proceeds of a sale be recognized at fair value unless it is not practicable to do so. Paragraph 56 of Statement 140 states that proceeds from a sale of financial assets consist of the cash and any other assets obtained, including separately recognized servicing assets, in the transfer less any liabilities incurred, including separately recognized servicing liabilities. [Revised 3/06.]

~~Retained i~~Interests that continue to be held by a transferor and assets obtained and liabilities incurred upon completion of a transfer of financial assets should be recognized separately. Statement 140 focuses "principally on the initial recognition and measurement of assets and liabilities that result from transfers of financial assets~~ [Statement 140] does not address subsequent measurement except for servicing assets and servicing liabilities and financial assets subject to prepayment…~~" (paragraph 306 of Statement 140). Statement 140 addresses subsequent measurement for servicing assets and servicing liabilities in paragraphs 13A and 13B and 63(d)–63(g). ~~Therefore, o~~Other assets and liabilities recognized upon completion of a transfer should be subsequently measured according to other existing accounting pronouncements and related guidance. For example:

- ~~Servicing assets and liabilities should be initially recognized in accordance with paragraphs 63(a), 63(b), and 63(d) and subsequently measured in accordance with paragraphs 63(f)–63(h).~~
- Interest-only strips, ~~retained~~ interests that continue to be held by a transferor in securitizations, loans, other receivables, or other financial assets that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment (except for instruments that are within the scope of Statement 133) should be initially recognized according to paragraphs 10 and 11 of Statement 140 and, pursuant to paragraph 14 of Statement 140, subsequently measured like investments in debt securities classified as available-for-sale or trading under Statement 115, as amended by Statement 140.
- Equity securities that have readily determinable fair values should be initially recognized according to paragraphs 10 of Statement 140 (if they are ~~retained~~ interests that continue to be held by a transferor) and 11 of Statement 140 (if they are received as proceeds of the transfer) and subsequently measured in accordance with Statement 115.
- Debt securities should be initially recognized according to paragraph 10 of Statement 140 (if they are ~~retained~~ interests that continue to be held by a transferor) or paragraph 11 of Statement 140 (if they are received as proceeds of the transfer) and subsequently measured in accordance with Statement 115, FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, as amended by FASB Statement No. 134, *Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise*, FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*, and EITF Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets," as applicable.
- Derivative financial instruments should be initially recognized at fair value (according to paragraph 56 of Statement 140) and subsequently measured in accordance with existing accounting pronouncements and related guidance on derivative instruments including Statement 133. [Revised 3/06.]

59. ***Q***—How does a transferor account for a beneficial interest in transferred financial assets if it cannot determine whether that beneficial interest is a new asset or an ~~retained~~ interest that continues to be held by a transferor? [Revised 3/06.]

A—Paragraph 58 states that "if a transferor cannot determine whether an asset is an ~~retained~~ interest that continues to be held by a transferor or proceeds from the sale, the asset shall be treated as proceeds from the sale. . . ." Paragraph 56 states that "all proceeds and reductions of proceeds from a sale shall be initially measured at fair value, if practicable." [Revised 3/06.]

60. ***Q—***In certain securitization transactions, more than one transferor contributes assets to a single qualifying SPE. Those transactions are sometimes referred to as securitization transactions that “commingle” assets. For example, Transferor A transfers a Treasury bond and Transferor B transfers a zero-coupon corporate bond to the same qualifying SPE. At the date of the transfers, the fair value of the Treasury bond and the zero-coupon corporate bond are equal. In exchange, each transferor receives a 40 percent beneficial interest in the qualifying SPE entitling each participant to a 40 percent interest in each cash flow (that is, each beneficial interest holder receives the same tranche of the trust certificates and is entitled to 40 cents of each dollar collected). Investor C (who is not an affiliate or agent of either transferor) invests cash in return for the last beneficial interest (which gives it the right to receive 20 cents of each dollar collected). The cash invested by Investor C is distributed pro rata to Transferors A and B at the transfer date. [Revised 4/02.]

What is the basis for determining whether a beneficial interest in transferred financial assets is a new asset or an ~~retained~~ interest that continues to be held by a transferor in a securitization structure that commingles assets? [Revised 3/06.]

A—A transferor should treat the beneficial interests as new assets to the extent that the sources of the cash flows to be received by the transferor are assets transferred by another entity. Any beneficial interests whose cash flows are derived from assets transferred by the transferor should be treated as ~~retained~~ interests that continue to be held by the transferor. Any derivatives, guarantees, or other contracts entered into by the qualifying SPE to “transform” the transferred assets are considered to be new assets, not commingled assets, because they were entered into by the qualifying SPE rather than transferred into the qualifying SPE by another entity. [Revised 3/06.]

In the example provided, Transferor A would treat 50 percent of its beneficial interests as ~~retained~~ interests that continue to be held by the transferor and 50 percent of its beneficial interests as new assets (proceeds from the transfer). Transferor A would also treat the cash received at the transfer date as proceeds. [Revised 3/06.]

~~Paragraph 272~~The Board acknowledges that determining whether a beneficial interest in a securitization is a new asset or an ~~retained~~ interest that continues to be held by a transferor may be difficult. Paragraph 272 explains: ~~That paragraph explains:~~ [Revised 3/06.]

> ~~Respondents to the Exposure Draft of Statement 125 asked the Board to provide more detailed guidance on how they should differentiate between an asset or liability that is part of the proceeds of a transfer and a retained interest in transferred assets. The Board acknowledges that, at the margin, it may be difficult to distinguish between a retained interest in the asset transferred and a newly created asset.~~ The Board believes that it is impractical to provide detailed guidance that would cover all possibilities. A careful examination of cash flows, risks, and other provisions should provide a basis for resolving most questions. However, the Board agreed that it would be helpful to provide guidance if an entity cannot determine how to classify an instrument and decided that in that case the instrument should be considered to be a new asset and thus part of the proceeds of the sale initially measured at fair value.

As part of its response to those issues, the Board decided to include in paragraph 58 the default provision that "if a transferor cannot determine whether an asset is an ~~retained~~ interest that continues to be held by a transferor or proceeds from the sale, the asset shall be treated as proceeds from the sale. . . ." In the case of commingled transfers from different transferors, each transferor to a qualifying SPE is eligible to apply the consolidation guidance in paragraph 46 of Statement 140. Refer to Question 36. [Revised 3/06.]

64. ***Q—***Assume an entity transfers a bond to a qualifying SPE for cash and beneficial interests. When the transferor purchased the bond, it paid a premium for it (or bought it at a discount), and that premium (or discount) was not fully amortized (or accreted) at the date of the transfer. In other words, the carrying amount of the bond included a premium (or discount) at the date of the transfer. Would that previously existing premium (or discount) continue to be amortized (or accreted)?

A—Yes, but only to the extent a sale has not occurred because the transferor ~~retained~~ continues to hold beneficial interests in the bond. Paragraph 10 of Statement 140 requires that, upon completion of any transfer, a transferor (a) continue to carry in its statement of financial position any ~~retained~~ interest it continues to hold in the transferred assets and (b) allocate the previous carrying amount between the assets sold, if any, and the ~~retained~~ interests that continue to be held by the transferor, if any, based on their relative fair values at the date of transfer. That allocation process may change the amount of the premium (or discount) that is amortized (or accreted) thereafter as an adjustment of yield pursuant to FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*. Issue 99-20 may also apply in certain circumstances. [Revised 3/06.]

65. ***Q***—In a transfer of financial assets in which the transferor ~~retains~~continues to hold beneficial interests in 80 percent of the transferred assets, should the remaining 20 percent of transferred assets be treated as sold, assuming that all the criteria in paragraph 9 have been met? [Revised 3/06.]

A—Yes. Paragraph 9 of Statement 140 specifies that "a transfer of financial assets (or all or a portion of a financial asset) in which the transferor surrenders control over those financial assets shall be accounted for as a sale *to the extent* that consideration other than beneficial interests in the transferred assets is received in exchange" (emphasis added).

66. ***Q***—Does the fair value measurement of an ~~retained~~ interest that continues to be held by the transferor in a securitization that is classified as either available-for-sale or trading under Statement 115 include the estimated cash flows associated with ~~the retained~~those interests that are generated from receivables that do not yet exist but that will be originated and transferred during the revolving period (such as in securitizations with *revolving features* or *prefunding provisions*)? [Revised 3/06.]

A—No. Paragraph 78 of Statement 140 explains that "gain or loss recognition for revolving-period receivables sold to a securitization trust is limited to receivables that exist and have been sold."

67. ***Q***—Can the method used by the transferor for providing "recourse" affect the accounting for the transfer?

***A*—**Yes. However, before the method of recourse can be evaluated for the appropriate accounting treatment, the entity must first determine whether a sale has occurred because in some jurisdictions recourse might mean that the transferred assets have not been isolated beyond the reach of the transferor and its creditors.

A transferor may ~~retain~~continue to hold all or some portion of the credit risk associated with transferred financial assets. For example, a transferor may incur a liability to reimburse the transferee, up to a certain limit, for a failure of debtors to pay when due (a recourse liability). In that case, a liability should be separately recognized and initially measured at fair value. That liability should be subsequently measured according to accounting pronouncements for measuring similar liabilities. In other cases, a transferor may provide credit enhancement by ~~retaining~~continuing to hold a beneficial interest in the transferred assets that is paid to the transferor after other investors in the transferred assets are paid, thereby absorbing much of the related credit risk. If there is no liability beyond those~~ transferor's retained~~ subordinated interests, then ~~the retained~~ interests that continue to be held by the transferor should be initially recognized according to paragraph 10 of Statement 140 and should be subsequently measured like other ~~retained~~ interests ~~held~~ that continue to be held by the transferor in the same form. Therefore, no recourse liability would be needed. [Revised 3/06.]

68. ***Q*—**What should the transferor consider when determining whether retained credit risk is a separate liability or part of a ~~retained~~ beneficial interest that continues to be held by the transferor ~~in the asset~~? [Revised 3/06.]

***A*—**The transferor should focus on the source of cash flows in the event of a claim by the transferee. If the transferee can only "look to" cash flows from the underlying financial assets, the transferor has retained a portion of the credit risk only through ~~its retained~~ the interest it continues to hold and a separate obligation should not be recognized. Credit losses from the underlying assets would affect the measurement of the ~~transferor's retained~~ interest that the transferor continues to hold. In contrast, if the transferor could be obligated for more than the cash flows provided by the ~~its retained~~ interest it continues to hold and, therefore, could be required to "write a check" to reimburse the transferee for credit-related losses on the underlying assets, the transferor would record a separate liability rather than an asset valuation allowance on the date of the transfer. [Revised 3/06.]

71. ***Q***—Paragraph 71 <u>of Statement 140 </u>provides guidance on accounting for assets and liabilities in cases in which, at the date of transfer, it is not practicable to estimate their fair values. However, if at a later date the transferor can estimate the fair value of an asset or liability for which it was not practicable at the date of the transfer (that is, it becomes practicable), should that asset or liability be remeasured?

A—If it becomes practicable for the transferor to estimate the fair value of the affected asset at a later date, the transferor would not remeasure the asset or the resulting gain or loss under Statement 140. <u>Paragraph 13A of Statement 140 requires that if it is not practicable to initially measure a servicing asset or servicing liability at fair value, the transferor shall initially recognize the servicing asset or servicing liability in accordance with paragraph 71 of Statement 140 and shall include it in a class of servicing assets and servicing liabilities that is subsequently measured using the amortization method.</u> ~~However, if the affected asset is a servicing asset, Statement 140 requires that it be evaluated for impairment.~~ <u>Paragraphs 63(g) and 63(h) of Statement 140 require servicing assets and servicing liabilities subsequently measured using the amortization method to be evaluated for impairment or increased obligation.</u> In other cases, the transferor may be required to subsequently adjust that asset's carrying amount depending on the accounting pronouncement that addresses its subsequent measurement. One possible result is that an asset may be initially recognized at zero or a liability may be initially recognized at something other than fair value because of the practicability exception in Statement 140 and then subsequently measured at an estimate of fair value with changes in fair value recognized according to the requirements of the relevant pronouncement. For example, some assets may be required to be subsequently measured at fair value even if it is not practicable to estimate their fair value at the date of transfer (for example, Statement 115 does not provide a practicability exception). If it becomes practicable for the transferor to estimate the fair value of an affected liability at a later date, the transferor would remeasure that liability under Statement 140 only if it is a servicing liability. [Revised 3/06.]

The transferor would remeasure a servicing liability but not below the amortized measurement of its initially recognized amount. <u>Paragraph 13A requires an entity that has elected to subsequently measure a class of separately recognized servicing assets and servicing liabilities using the amortization method to amortize servicing liabilities in proportion to and over the</u>

period of estimated net servicing loss, and assess servicing liabilities for increased obligation based on fair value at each reporting date. Paragraph 63(~~h~~g) of Statement 140 requires~~ servicers to~~:

> ~~Subsequently measure servicing liabilities by amortizing the amount recognized in proportion to and over the period of estimated net servicing loss—the excess of servicing costs over servicing revenues. However~~For servicing liabilities subsequently measured using the amortization method, if subsequent events have increased the fair value of the liability above the carrying amount, . . . the servicer shall revise its earlier estimates and recognize the increased obligation as a loss in earnings. . . .

[Revised 3/06.]

For other liabilities, other accounting pronouncements that address subsequent measurement may require that the transferor subsequently adjust an affected liability's carrying amount.

73. ***Q—***Does Statement 140 require disclosures about the assumptions used to estimate fair values of ~~retained~~ interests that continue to be held by a transferor in securitized financial assets or of assets obtained and liabilities incurred as proceeds in a transfer? [Revised 3/06.]

A—Yes. Paragraph 17(~~f~~h)(3) of Statement 140 requires the disclosure of "the key assumptions used in measuring the fair value of ~~retained~~ interests that continue to be held by the transferor and servicing assets or servicing liabilities, if any, at the time of securitization…" (footnote omitted). Paragraph 17(~~g~~i)(2) of Statement 140 requires disclosure of "the key assumptions used in subsequently measuring the fair value of those ~~[retained]~~ interests…" held at the most recent balance sheet date. Finally, paragraph 17(~~g~~i)(3) of Statement 140 requires a sensitivity analysis or stress test showing the hypothetical effect of changes in those assumptions on the fair value of ~~the retained~~those interests (including any servicing assets or servicing liabilities). [Revised 3/06.]

Paragraph 17(d) of Statement 140 requires that "if it is not practicable to estimate the fair value of certain assets obtained or liabilities incurred in transfers of financial assets during the period," an entity shall disclose "a description of those items and the reasons why it is not practicable to estimate their fair value."

74. ***Q—***A transferor transfers loans with a fair value of $100 to a qualifying SPE in exchange for cash of $100. However, to enhance the credit rating of the beneficial interests in the qualifying SPE, a *cash reserve* account is created in connection with the transfer. That cash reserve account is funded with $20 of the transferor's proceeds and $20 of additional cash contributed by the transferor. The cash will be returned to the transferor at some date in the future provided that a certain level of collections occurs but will be reduced to the extent that collections fall short of that level.

Are proceeds (in a transfer that is accounted for as a sale) that are placed in a cash reserve account (as a form of a credit enhancement) a new asset or an ~~retained~~ interest that continues to be held by the transferor in transferred assets? [Revised 3/06.]

A—The proceeds that are placed in a cash reserve account are an ~~retained~~ interest that continues to be held by the transferor. Paragraph 58 of Statement 140 specifies that a *cash reserve* account is an ~~retained~~ interest that continues to be held by the transferor. That answer also would apply if the seller collects the proceeds and then deposits a portion of those proceeds in the cash reserve account. Refer to Questions 75–77. [Revised 3/06.]

75. *Q*—How should a transferor initially and subsequently measure ~~its retained~~the interest it continues to hold in credit enhancements provided in a transfer if the balance that is not needed to make up for credit losses is ultimately to be paid to the transferor? [Revised 3/06.]

A—Some credit enhancements (for example, cash reserve accounts and subordinated beneficial interests) should be measured at the date of the transfer by allocating the previous carrying amount between ~~those retained~~ the interests that the transferor continues to hold in the transferred assets and the assets sold, based on their relative fair values. Other credit enhancements (for example, financial guarantees and credit derivatives) are liabilities that are initially measured at their fair values. Question 68 discusses how to determine whether a credit enhancement is a new asset or an ~~retained~~ interest that continues to be held by the transferor. Questions 76 and 77 discuss techniques for estimating the fair value of an~~retained~~ interest~~s~~ that continues to be held by the transferor. [Revised 3/06.]

Statement 140 does not specifically address the subsequent measurement of credit enhancements. How much cash the transferor will receive from, for example, a cash reserve account and when it will receive cash inflows depends on the performance of the transferred assets. Entities should regularly review those assets for impairment because of their nature. Entities must look to other guidance for subsequent measurement including impairment[15] based on the nature of the credit enhancement.

77. *Q*—Paragraphs 69 and 70 of Statement 140 indicate that the Board believes that an expected present value technique is superior to traditional "best estimate" techniques in measuring the fair value of ~~retained~~ interests that continue to be held by the transferor in securitized assets. How might the expected present value technique be applied to such measurements? [Revised 3/06.]

A—Expected present value techniques are discussed and illustrated in general terms in FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*. Those techniques consider the likelihood of possible outcomes directly, rather than indirectly through the use of a risk-adjusted discount rate. The following illustration indicates one way in which those techniques might be applied in measuring the fair value, using a cash-out method, of an ~~retained~~ interest that continues to be held by the transferor in a securitization that was subordinated to investors' interests through a "credit enhancement account," a type of cash reserve account. [Revised 3/06.]

Illustration—Value of ~~retained~~ interest that continues to be held by the transferor in securitization of $1,000 of 15-year prepayable mortgages, in the form of a credit enhancement account that protects senior beneficial interests [Revised 3/06.]

Present values of future inflows to transferor under indicated scenario

	Year	Very Bad	Unfavorable	Most Likely	Favorable	Total
	1	0	0	0	0	
	2	0	0	2	16	
	3	0	1	24	31	
	4	0	13	20	25	
	5	0	7	15	18	
	6	0	9	14	15	
	7	0	8	12	12	
	8	0	7	10	9	
	9	0	6	8	7	
	10	0	5	7	6	
	11	0	4	5	5	
	12	1	3	4	4	
	13	1	3	4	3	
	14	1	2	3	2	
	15	6	12	11	6	
Total		9	79	138	159	
Probability		10%	20%	50%	20%	100%
Probability-weighted totals		$0.9	$15.8	$69.2	$31.7	$117.7

Total expected present value: **$118**

Notes: Values derive from supporting scenario worksheets, one of which is shown on the following page. ~~Working models of those scenario worksheets are available on the FASB website.~~

Expected Cash Flow Illustration—Very Bad Scenario

Year	Beginning Principal	Prepays	Interest	Total Cash In	Chargeoffs	Investors' Share of: Interest	Investors' Share of: Prepays	Investors' Share of: Chargeoffs	Due to Investors	CEA (Shortfall)	CF out to Investors	To/(From) CEA	CEA Balance (Deficit)	CEA Target	CF out to T'or	Yield Curve	PV of CF to T'or
1	1,000	0	98	98	35	71	0	32	102	(4)	98	0	(4)	48	0	6.0%	0
2	965	97	90	186	34	65	87	30	182	4	186	0	0	42	0	6.1%	0
3	835	83	78	161	29	56	75	26	157	0	157	4	4	36	0	6.2%	0
4	722	72	67	140	25	48	65	23	136	0	136	3	8	31	0	6.3%	0
5	625	62	58	120	33	42	56	30	127	0	127	(7)	1	26	0	6.4%	0
6	529	53	49	102	19	36	48	17	100	0	100	2	3	23	0	6.5%	0
7	458	46	43	88	16	31	41	14	86	0	86	2	5	20	0	6.6%	0
8	396	40	37	77	14	27	36	12	75	0	75	2	7	17	0	6.7%	0
9	343	34	32	66	12	23	31	11	65	0	65	2	8	15	0	6.8%	0
10	296	30	28	57	10	20	27	9	56	0	56	1	10	13	0	6.9%	0
11	256	26	24	50	9	17	23	8	48	0	48	1	11	11	0	7.0%	0
12	222	22	21	43	8	15	20	7	42	0	42	1	12	10	2	7.1%	1
13	192	19	18	37	7	13	17	6	36	0	36	1	10	8	2	7.2%	1
14	166	17	15	32	6	11	15	5	31	0	31	1	9	7	2	7.3%	1
15	144	138	7	146	5	5	125	5	134	0	134	11	19	0	19	7.4%	6
Totals		747			261						1,379						9

Very Bad Scenario

Contract terms and valuation assumptions:	
Interest on loans	**10%**
Interest due investors	**8%**
Investors share	**90%**
Target credit enhancement account (% of ending principal)	**5%**
Est. chargeoffs (per year, except 50% higher in year 5)	**3.5%**
Est. prepays (per year, after year 1)	**10%**

Explanation:

In this securitization, credit enhancement is provided to investors in senior beneficial interests using a credit enhancement account (CEA), sometimes called a "cash collateral account."

Investors are entitled to cash payment of interest, their share of prepayments, and reimbursement for chargeoffs of uncollectible loans, to the extent that cash is available from either the cash inflows from borrowers or the balance of the credit enhancement account.

Shortfalls in the CEA reimbursement are made up from future available cash inflows.

Remaining cash inflows are deposited in the credit enhancement account, until its balance exceeds the agreed targeted percentage of the remaining outstanding principal balance. Amounts in excess of the targeted balance may be withdrawn by the transferor.

The amounts that will be withdrawn by the transferor are its cash inflows from its ~~retained~~ interest that it continues to hold in the transferred assets. [Revised 3/06.]

Simplifications for purposes of illustration:

Here, the chargeoff and prepayment rates are assumed to be uniform over the life of the securitization, except for a larger chargeoff in year five. Under realistic assumptions, they would vary.

The loans are non-amortizing, prepayable, 15-year loans. Amortizing loans are more common in the United States.

While prepayments and chargeoffs are assumed to occur evenly throughout the year, CEA calculations are made only at the end of the year.

Only four scenarios are modeled (one of which is illustrated here). Realistic valuations would include more scenarios.

81. ***Q***—Assume that a transferor undertakes an obligation to service mortgage loans that it originated and subsequently sold. The transferor believes that the benefits of that servicing slightly exceed "adequate compensation" and, therefore, that a small servicing asset should be recorded. However, on the date of the sale, the servicer receives an unsolicited bid from a third-party servicer that is a major market participant to purchase the right to service for a much larger sum. After due diligence, the transferor determines that the bid is legitimate. Which amount, the transferor's earlier estimate of fair value or the amount of the bid, should be the basis for the initial measurement of ~~allocation of the previous carrying amount of the transferred mortgages between~~ the servicing asset~~retained and the~~ ~~loans sold~~? [Revised 3/06.]

A—Paragraphs 13 and 62 of Statement 140 require~~s~~ that ~~an allocated portion of the previous carrying amount of the transferred mortgage loans be recorded as~~ a separately recognized servicing asset be initially measured at its fair value.~~ based on the *relative fair value* of the portion of the asset retained (the right to service) and the portion of the asset sold.~~ The transferor should use the unsolicited bid from the third party as the basis for determining the ~~relative~~ fair value of servicing as it represents a quoted market price for its asset. Paragraph 68 of Statement 140 states that "*if a quoted market price is available*, the fair value is the product of the number of trading units times that market price" (emphasis added). [Revised 3/06.]

82. ***Q***—Assume that a transferor undertakes an obligation to service loans that it originated and subsequently sold. In connection with that transaction, the transferor believes that the benefits of servicing exactly equal adequate compensation and, therefore, no servicing asset or liability should be recorded. To substantiate its assertion and because the market is shallow, the transferor contacts a broker and asks it to provide an estimate of the value of the transferor's servicing. The broker estimates that the transferor's servicing has substantial value (that is, the servicing should be recorded as a significant asset) but does not make or transmit a bid. ~~What amount (zero or an allocated portion of the previous carrying amount of the transferred mortgages based on the amount of the estimate) should be recorded~~How should the fair value of servicing be determined? [Revised 3/06.]

A—As discussed in Question 81, paragraphs 13 and 62 of Statement 140 require~~s~~ that ~~an allocated portion of the previous carrying amount of the transferred mortgage be recorded as a~~

~~servicing asset based on the *relative fair value* of the portion of the asset retained (the right to service) and the portion of the asset sold.~~ a separately recognized servicing asset be initially measured at its fair value. Quoted market price in active markets is the best evidence of fair value. If a quoted market price is not available, the estimate of fair value shall be based on the best information available in the circumstances. This question highlights the potential for significantly different estimates of fair value of servicing when a quoted market price in an active market is not available. The difference between the two estimates suggests a need to perform more analysis to determine the best estimate of fair value. [Revised 3/06.]

Paragraph 68 of Statement 140 states that "quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available." However, an estimate of fair value (that is not a bid) from a single third party in an inactive or shallow market does not constitute a quoted market price even though it raises questions about the reasonableness of the transferor's estimated fair value of zero. The objective for any estimate of fair value is to determine "the amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale" (paragraph 68). The transferor should analyze all available facts and circumstances, including the information provided by the broker about its estimate of the value of the transferor's servicing asset, in determining its best estimate of the fair value of the servicing contract. Some factors to consider include:

- The legitimacy of the offer
- The third party's specific knowledge about factors relevant to the fair value estimate
- The experience of the broker in purchases of similar servicing contracts
- Whether other parties have demonstrated interest in purchasing the servicing contract at a similar price.

90. ***Q***—If market rates for servicing a specific type of asset change subsequent to the initial recognition of a servicing asset or liability, does Statement 140 include any requirement to adjust the recorded asset or liability?

A—Yes, in certain circumstances. Paragraphs 13A and 63 of Statement 140 address~~es~~ the subsequent measurement of servicing assets and servicing liabilities. Under paragraphs 13A and 63, ~~after a servicing asset is recognized, it~~ if an entity elects to subsequently measure a class of servicing assets and servicing liabilities using the fair value measurement method, changes in fair value are reported in earnings in the period in which the changes occur. If an entity elects to subsequently measure a class of servicing assets and servicing liabilities using the amortization method, each stratum within that class should be evaluated for impairment or increased obligation at each balance sheet date. ~~Paragraph 63 also requires that i~~If subsequent events increase the fair value of a stratum of servicing liabilities~~y~~ within a class that an entity has elected to subsequently measure using the amortization method, that increase must be recognized in earnings as a loss. [Revised 3/06.]

92. ***Q***~~—Paragraph 13 states:~~

> ~~Each time an entity undertakes an obligation to service financial assets it shall recognize either a servicing asset or a servicing liability for that servicing contract, unless it transfers the assets to a qualifying SPE in a guaranteed mortgage securitization, retains all of the resulting securities, and classifies them as debt securities held-to-maturity in accordance with [Statement 115].~~

~~In the latter circumstances, may an entity choose to recognize a servicing asset or liability?~~

A~~—Yes. Paragraphs 61 and 62 explain that (a) servicing is inherent in all financial assets and becomes a distinct asset or liability only when contractually separated from the underlying assets and (b) if the transferor transfers the assets to a qualifying SPE in a guaranteed mortgage securitization, retains all of the resulting securities, and classifies them as held-to-maturity debt securities, the servicing asset or liability *may* be reported together with the asset being serviced. That is, in those circumstances, the entity may choose to recognize the resulting servicing asset or liability separately from the asset being serviced or to aggregate the servicing asset or liability with the assets being serviced. That decision is a matter of accounting policy.~~ [Question deleted because Statement 156 provides specific guidance that addresses this question in its amendment to paragraph 13 of Statement 140. 3/06]

94. ***Q*—**Should a loss be recognized if a servicing fee that is equal to or greater than adequate compensation is to be received but the servicer's anticipated cost of servicing would exceed the fee?

***A*—**No. Whether a servicing asset or servicing liability is recorded is a function of the marketplace, not the servicer's cost of servicing. Paragraph 62 of Statement 140 explains:

> ~~Each servicing contract results in a servicing asset or servicing liability.~~ Typically, the benefits of servicing are expected to be more than adequate compensation to the servicer for performing the servicing, and the contract results in a servicing asset. However, if the

> benefits of servicing are not expected to adequately compensate a servicer for performing the servicing, the contract results in a servicing liability.

[Revised 3/06.]

Paragraph 364 of Statement 140 defines *adequate compensation* as "the amount of benefits of servicing that would fairly compensate a substitute servicer should one be required, which includes the profit that would be demanded in the marketplace." The guidance in those two paragraphs does not consider the servicer's cost of servicing. Furthermore, the impairment provisions of paragraphs 63(f) and 63(g) of Statement 140 for classes of servicing assets and servicing liabilities subsequently measured using the amortization method are based on the fair value of the contract rather than the gain or loss from subsequently carrying out the terms of the contract; future losses may be avoided by selling the servicing to a more efficient servicer. Statement 140 supersedes paragraph 11 and footnote 4 of Statement 65, which were based on a "loss contract" accounting approach—instead of the market-based approach required by Statement 140. [Revised 3/06.]

95. ***Q—***Should an entity recognize a servicing liability if it transfers all or some of a financial asset (for example, a loan participation) and ~~retains~~undertakes an obligation to service the asset but is not entitled to receive a contractually specified servicing fee? Is the answer to this question affected by circumstances in which it is not customary for the transferor-servicer to receive a contractually specified servicing fee? [Revised 3/06.]

A—The transferor-servicer would be required to recognize a servicing liability at fair value if the benefits of servicing are less than adequate compensation. Paragraph 13 of Statement 140 states: ~~that "each time an entity undertakes an obligation to service financial assets it shall recognize either a servicing asset or a servicing liability for that servicing contract. . . ."~~

> An entity shall recognize and initially measure at fair value, if practicable, a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in any of the following situations:
>
> a. A transfer of the servicer's financial assets that meets the requirements for sale accounting
> b. A transfer of the servicer's financial assets to a qualifying SPE in a guaranteed mortgage securitization in which the transferor retains all of the resulting securities and classifies them as either available-for-sale securities or trading securities in accordance with FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*

c. An acquisition or assumption of a servicing obligation that does not relate to financial assets of the servicer or its consolidated affiliates.

An entity that transfers its financial assets to a qualifying SPE in a guaranteed mortgage securitization in which the transferor retains all of the resulting securities and classifies them as debt securities held-to-maturity in accordance with Statement 115 may either separately recognize its servicing assets or servicing liabilities or report those servicing assets or servicing liabilities together with the asset being serviced. [Revised 3/06.]

Those ~~That~~ requirements apply~~ies~~ even if it is not customary to charge a contractually specified servicing fee. Paragraph 62 of Statement 140 states that ". . . if the benefits of servicing are not expected to adequately compensate a servicer for performing the servicing, the contract results in a servicing liability." [Revised 3/06.]

96. ***Q***—Assuming that (a) an entity transfers a portion of a loan under a participation agreement that qualifies for sale accounting under Statement 140, (b) the selling entity obtains the right to receive benefits of servicing that more than adequately compensate it for servicing the loan, and (c) the selling entity would continue to service the loan, regardless of the transfer because it retains part of the participated loan, is the selling entity required to record a servicing asset?

A—Yes. The selling entity would be required to record a servicing asset for the portion of the loans it sold (paragraph 62 of Statement 140). ~~Paragraph 61 states that while "servicing is inherent in all financial assets; it becomes a distinct asset or liability only when contractually separated from the underlying assets by sale. . . ."~~ The assumption that the selling entity would service the loan because it retains part of the participated loan does not impact the requirement to recognize a servicing asset. Conversely, a selling entity could not avoid recording a servicing liability if the benefits of servicing are not expected to adequately compensate the servicer for performing the servicing. [Revised 3/06.]

97. ***Q***—An entity sells mortgage loans that it has originated and ~~retains~~ undertakes an obligation ~~the right~~ to service them. Immediately thereafter, the entity enters into an arrangement to subcontract the obligation to service with another servicer. How should the entity account for the obligation to service as a result of those transactions? [Revised 3/06.]

A—The entity should account for the two transactions separately. First, the entity should account for the transfer of mortgage loans in accordance with Statement 140—the obligation to service should be ~~accounted for~~ initially recognized and measured at fair value, if practicable, according to paragraphs 10 and 11 of Statement 140 as ~~a retained interest (if it is~~ ~~a servicing asset) or as a liability incurred as a result of the transfer (if it is a servicing liability)~~ proceeds obtained from the transfer of the mortgage loans. Second, the entity should account for the subcontract with another servicer. The latter transaction is not within the scope of Statement 140 because it does *not* involve a *transfer* of the underlying mortgage loans and, therefore, should be accounted for under other existing guidance. [Revised 3/06.]

99. ***Q***—Statement 140 requires that entities separately evaluate and measure impairment of designated strata of servicing assets within classes of servicing assets that are subsequently measured using the amortization method. Must those classes of servicing assets be stratified based on more than one predominant risk characteristic of the underlying financial assets if more than one characteristic exists? [Revised 3/06.]

A—No. Paragraph 13A of Statement 140 requires that an entity subsequently measure each class of servicing assets and servicing liabilities using either the amortization method or the fair value measurement method. Paragraph 63(~~g~~f)(1) of Statement 140 requires servicers to "stratify servicing assets within a class based on *one or more* of the predominant risk characteristics of the underlying financial assets" (emphasis added) for classes of servicing assets that a servicer elects to subsequently measure using the amortization method. Therefore, Statement 140 does not require that either the most predominant risk characteristic or more than one predominant risk characteristic be used to stratify the servicing assets for purposes of evaluating and measuring impairment. A servicer must exercise judgment when determining how to stratify servicing assets (that is, when selecting the most appropriate characteristic(s) for stratification).~~ The approach in Statement 140 for the stratification of servicing assets for purposes of evaluating and measuring impairment is consistent with the approach required by Statement 65, as amended by Statement 122.~~ [Revised 3/06.]

Pursuant to paragraph 56 of Statement 133, "at the date of initial application, mortgage bankers and other servicers of financial assets may choose [but are not required] to restratify[18] their servicing rights pursuant to ~~paragraph 37(g) of Statement 125~~ [paragraph 63(~~g~~f) of Statement

140~~]~~ in a manner that would enable individual strata to comply with the requirements of ~~this~~ Statement [133] regarding what constitutes ‘a portfolio of similar assets.’” An entity may use different stratification criteria for the purposes of Statement 140 impairment testing and for the purposes of grouping similar assets to be designated as a hedged portfolio in a fair value hedge under Statement 133. [Revised 3/06.]

100. ***Q***—Paragraph 63 (~~g~~f)(1) of Statement 140 requires a servicer to “stratify servicing assets within a class based on one or more of the predominant risk characteristics of the underlying financial assets~~.~~” for classes of servicing assets that a servicer elects to subsequently measure using the amortization method. Should the stratums selected by the servicer be used consistently from period to period? [Revised 3/06.]

A—Generally, yes. Once an entity has determined the predominant risk characteristics to be used in identifying the resulting stratums within each class of servicing assets subsequently measured using the amortization method, that decision should be applied consistently unless significant changes in economic facts and circumstances clearly indicate that the predominant risk characteristics and resulting stratums should be changed. If a significant change in economic facts and circumstances occurs, that change should be accounted for prospectively as a change in accounting estimate in accordance with paragraphs ~~31–33~~ 19–22 of ~~APB Opinion No. 20, *Accounting* Changes~~FASB Statement No. 154, *Accounting Changes and Error Corrections*. If the predominant risk characteristics and resulting stratums are changed, that fact and the reasons for those changes should be included in the disclosures about the risk characteristics of the underlying financial assets used to stratify the recognized servicing assets in accordance with paragraph 17(~~e~~g)(~~3~~4) of Statement 140. [Revised 3/06.]

101. ***Q***—Statement 140 requires impairment of servicing assets to be recognized “through a *valuation allowance* for an individual stratum” (paragraph 63(~~g~~f)(2); emphasis added) for classes of servicing assets that a servicer elects to subsequently measure using the amortization method. The *valuation allowance* should “reflect changes in the measurement of impairment subsequent to the initial measurement of impairment. Fair value in excess of the carrying amount of servicing assets for that stratum, however, shall not be recognized” (paragraph 63(~~g~~f)(3)). How should an entity recognize subsequent increases in a previously recognized *servicing liability*? [Revised 3/06.]

***A*—**Paragraph 63(g) of Statement 140 states that "for servicing liabilities subsequently measured using the amortization method, if subsequent events have increased the fair value of the liability above the carrying amount, for example, because of significant changes in the amount or timing of actual or expected future cash flows ~~from~~relative to the cash flows previously projected, the servicer shall revise its earlier estimates and recognize the increased obligation as a loss in earnings~~…~~" ~~(paragraph 63(h))~~. Similar to the accounting for changes in a valuation allowance for an impaired asset, increases in the servicing obligation may be recovered, but the obligation should not be reduced below the amortized measurement of the initially recognized servicing liability. If an entity makes an election to subsequently measure a class of servicing liabilities using the fair value measurement method, any changes in fair value should be reported in earnings in the period in which those changes occur. [Revised 3/06.]

105. *Q*—Paragraph 14 requires that interest-only strips and similar financial assets that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment subsequently be measured like investments in debt securities classified as available-for-sale or trading under Statement 115. Does that requirement result in those financial assets being included in the scope of Statement 115?

A—Whether those financial assets are included in the scope of Statement 115 depends on the form of the assets. However, in either case, the measurement principles of Statement 115, including the provisions for recognizing and measuring impairment, should be applied.

Interest-only strips and similar ~~retained~~ interests that continue to be held by a transferor that meet the definition of securities in paragraph 137 of Statement 115 are included in the scope of Statement 115; therefore, all relevant provisions of that Statement (for example, the disclosures) should be applied. Those interests should be classified as available-for-sale or trading pursuant to the provisions of paragraph 7 of Statement 115, as amended by paragraph 362 of Statement 140. [Revised 3/06.]

Interest-only strips and similar ~~retained~~ interests that continue to be held by a transferor that are not in the form of securities (as defined in Statement 115) are not within the scope of Statement 115 but should be *measured* like investments in debt securities classified as available-for-sale or trading. In that case, all of the measurement provisions, including those addressing recognition and measurement of impairment, should be followed. However, other provisions of Statement 115, such as those addressing disclosures, are not required to be applied. [Revised 3/06.]

107. ***Q***—A transferor transfers mortgage loans to a third party but undertakes an obligation to service the loans~~retains servicing~~. Subsequent to the transfer, the transferor enters into a subservicing arrangement with a third party. If the transferor's benefits of servicing exceed its obligation under the subservicing agreement, should that differential be accounted for as an interest-only strip? [Revised 3/06.]

A—No. The entity should account for the two transactions separately. First, the entity should account for the transfer of mortgage loans in accordance with Statement 140.

Paragraph 13 of Statement 140 states that:

> An entity shall recognize and initially measure at fair value, if practicable, a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in any of the following situations:
>
> a. A transfer of the servicer's financial assets that meets the requirements for sale accounting
>
> b. A transfer of the servicer's financial assets to a qualifying SPE in a guaranteed mortgage securitization in which the transferor retains all of the resulting securities and classifies them as either available-for-sale securities or trading securities in accordance with FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*
>
> c. An acquisition or assumption of a servicing obligation that does not relate to financial assets of the servicer or its consolidated affiliates.
>
> An entity that transfers its financial assets to a qualifying SPE in a guaranteed mortgage securitization in which the transferor retains all of the resulting securities and classifies them as debt securities held-to-maturity in accordance with Statement 115 may either separately recognize its servicing assets or servicing liabilities or report those servicing assets or servicing liabilities together with the asset being serviced.

~~t~~The obligation to service should be ~~accounted for~~initially recognized and measured at fair value, if practicable, according to paragraphs 10 and 11 of Statement 140 ~~as a retained interest (if it is a servicing asset) or as a liability incurred as a result of the transfer (if it is a servicing liability)~~. Second, the entity should account for the contract with the subservicer. The latter transaction is not within the scope of Statement 140 because it does *not* involve a *transfer* of the underlying mortgage loans and, therefore, should be accounted for under other existing guidance. Refer to Question 97. [Revised 3/06.]

113. *Q*—Can a residual tranche debt security in a securitization of financial assets (for example, receivables) using a qualifying SPE be classified as held-to-maturity?

A—The answer depends on the facts and circumstances. If the contractual provisions of the residual tranche debt security provide that the residual tranche can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment, the residual tranche debt security should not be accounted for as held-to-maturity in accordance with paragraph 14. In contrast, if the only way that the holder of the residual tranche would not recover substantially all of its recorded investment would be in response to a default by the borrower (debtor), then a held-to-maturity classification is acceptable as long as the conditions specified for a held-to-maturity classification in paragraph 7 of Statement 115, as amended, have been met. In that case, the borrower is the issuer of the receivables held by the qualifying SPE after the transfer has occurred.

Paragraph 173 explains that "the effect of establishing the qualifying SPE is to merge the contractual rights in the transferred assets and to allocate undivided interests in them--the beneficial interests." Paragraph 273 elaborates on that effect by explaining that a transfer of assets to a qualifying SPE in a securitization changes the nature of the asset held by the transferor. ~~Specifically that paragraph states that "*retained interests in the transferred assets continue to be assets of the transferor*, albeit assets of a different kind . . ." (emphasis added).~~ [Revised 3/06.]

Paragraph 295 states that ". . . the rationale outlined in paragraph 293 extends to any situation in which a lender would not recover substantially all of its recorded investment if borrowers were to exercise prepayment or other rights granted to them under the contracts. The Board also concluded that the provisions of paragraph 14 do not apply to situations in which events that are not the result of contractual provisions, for example, borrower default or changes in the value of an instrument's denominated currency relative to the entity's functional currency, cause the holder not to recover substantially all of its recorded investment" (emphasis added).

122. *Q*—Does Statement 140 address impairment of financial assets?

A—As discussed in paragraph 4, Statement 140 "does not address subsequent measurement of assets and liabilities, except for (a) servicing assets and servicing liabilities and (b) interest-only strips, securities, ~~retained~~ interests <u>that continue to be held by a transferor</u> in securitizations, loans, other receivables, or other financial assets that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment. . . ." Accordingly, impairment of financial assets should be measured by reference to other applicable existing guidance, such as:

- Statement 5
- FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan* (as amended by FASB Statement No. 118, *Accounting by Creditors for Impairment of a Loan--Income Recognition and Disclosures*)
- Statement 115
- <u>FASB Statement No. 134, *Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise*</u>
- <u>FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*</u>
- Related EITF Issues. [Revised 3/06.]

EITF ISSUES

Issue No. 85-13

Title: Sale of Mortgage Service Rights on Mortgages Owned by Others

Dates Discussed: March 28, 1985; May 9, 1985

References: FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*
FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
FASB Statement No. 156, *Accounting for Servicing of Financial Assets*
AICPA Audit and Accounting Guide, *Savings and Loan Associations* (1979)

ISSUE

An enterprise sells the right to service mortgage loans that are owned by other parties; the mortgages have been previously sold, with servicing retained, in a separate transaction. Because of the ability to invest the "float" that results from payments received from borrowers but not yet passed to the owners of the mortgages, the mortgage servicing rights can be sold for immediate cash or for a participation in the future interest stream of the loans.

The issues are whether a gain should be recorded on the sale of the mortgage service rights when the sale is for a participation in the future interest income stream and, if a gain is recognized, how that gain should be measured.

EITF DISCUSSION

The Task Force reached a consensus that gain recognition is appropriate at the sale date. Task Force members agreed that there are difficulties in measuring the amount of the gain if the sales price is based on a participation in future payments and that accounting rules do not specify an upper limit on the computed sales price. The seller of mortgage servicing rights should consider all available information, including the amount of gain that would be recognized if the servicing rights were to be sold outright for a fixed cash price.

STATUS

A related issue was discussed in Issue No. 89-5, "Sale of Mortgage Loan Servicing Rights." That Issue considers whether there are any circumstances in which the sale of mortgage loan servicing rights may be recognized before the date that the sale is closed. The Task Force reached a consensus on Issue 89-5 that a sale of mortgage loan servicing rights should not be recognized before the closing of the sale; that is, when title and all risks and rewards have irrevocably passed to the buyer, and there are no significant unresolved contingencies. The Task Force also reached a consensus on Issue 89-5 that a temporary subservicing agreement in which the subservicing will be performed by the seller for a short period of time would not necessarily preclude recognizing a sale at the closing date.

The consensuses in Issue 89-5 were superseded by the Task Force in Issue No. 95-5, "Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage Loan Servicing Rights." See Issue 95-5 for details of the consensus reached.

Statement 156, issued in March 2006, amends Statement 140 with respect to the accounting for separately recognized servicing assets and servicing liabilities. Statement 156 does not modify the consensus reached on this Issue. However, changes in the fair value of servicing assets or servicing liabilities subsequently measured at fair value should be included in earnings in the period in which those changes occur, with any additional change in fair value from the last measurement date to the sale date included in earnings at that time.

No further EITF discussion is planned.

Issue No. 87-34

Title: Sale of Mortgage Servicing Rights with a Subservicing Agreement

Dates Discussed: December 17, 1987; January 28, 1988

References: FASB Statement No. 13, *Accounting for Leases*

FASB Statement No. 28, *Accounting for Sales with Leasebacks*

FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*

FASB Statement No. 66, *Accounting for Sales of Real Estate*

FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*

FASB Statement No. 156, *Accounting for Servicing of Financial Assets*

FASB Technical Bulletin No. 87-3, *Accounting for Mortgage Servicing Fees and Rights*

ISSUE

An enterprise that services mortgage loans ("transferor") enters into a transaction to transfer the mortgage servicing rights to an unrelated entity ("transferee") at a gain. The transferee either does not have the facilities or elects not to perform the required servicing functions and, accordingly, enters into a subservicing agreement with the transferor. The subservicing agreement provides that the transferor will perform the loan servicing for a fixed dollar amount per loan that is equal to or greater than the transferor's estimated cost of servicing. Significant risks and rewards of ownership related to the mortgage servicing right are transferred to the transferee.

The issues are whether the transfer of the mortgage servicing rights and the simultaneous agreement to provide subservicing should be reported by the transferor as a sale or a financing and, if reported as a sale, how the gain should be recognized.

EITF DISCUSSION

The Task Force reached a consensus that income should not be recognized immediately as a result of the transaction. Whether the transaction should be accounted for as a sale with the gain amortized or as a financing would depend on the specific facts and circumstances. [Note: See STATUS section.] Attributes of the transferee (for example, ability to perform servicing) would not be significant to the accounting for the transaction. Some Task Force members stated that the mortgage servicing rights have been sold; however, gain recognition should be deferred. Those members noted that it is difficult to determine what portion of the purchase price relates to the mortgage servicing rights sold and what portion relates to the future servicing obligations. They stated that the transferor should amortize the gain on the sale over the estimated lives of the underlying loans.

Other Task Force members stated that income should not be recognized because they view the transaction as a financing. They indicated that the transaction has only changed the cash flows relating to the servicing rights and the transferor is still required to perform the servicing.

The Task Force agreed that a loss should be recognized currently if the transferor determines that prepayments of the underlying mortgage loans may result in performing the future servicing at a loss. The Task Force also agreed that the consensus does not apply to a temporary subservicing agreement in which the subservicing will be performed by the transferor for only a short period of time.

STATUS

On December 31, 1987, the FASB issued Technical Bulletin 87-3. However, that Technical Bulletin does not address the above issue.

A related issue was discussed in Issue No. 89-5, "Sale of Mortgage Loan Servicing Rights." That Issue considers whether there are any circumstances in which the sale of mortgage loan servicing rights may be recognized before the date that the sale is closed. The Task Force reached a consensus on Issue 89-5 that a sale of mortgage loan servicing rights should not be recognized before the closing of the sale.

The consensuses in Issue 89-5 were superseded by the Task Force in Issue No. 95-5, "Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage Loan Servicing Rights." See Issue 95-5 for details of the consensus reached.

Another related issue was discussed in Issue No. 90-21, "Balance Sheet Treatment of a Sale of Mortgage Servicing Rights with a Subservicing Agreement." That Issue considers whether the transaction discussed in Issue 87-34 should be accounted for as a financing or as a sale with the gain deferred. The Task Force reached a consensus on Issue 90-21 that a sale of mortgage servicing rights with a subservicing agreement should be treated as a sale with gain deferred if substantially all the risks and rewards inherent in owning the mortgage servicing rights have been effectively transferred to the buyer. The risks and rewards associated with a seller performing purely administrative functions under a subservicing agreement would not necessarily preclude sales treatment.

Statement 156, issued in March 2006, amends Statement 140 with respect to the accounting for separately recognized servicing assets and servicing liabilities. Statement 156 does not modify the consensus reached on this Issue. However, changes in the fair value of servicing assets or servicing liabilities subsequently measured at fair value should be included in earnings in the period in which those changes occur, with any additional change in fair value from the last measurement date to the date of the transaction included in earnings at that time. An assumption of a servicing obligation does not result in separate recognition of a servicing asset or servicing liability unless substantially all the risks and rewards inherent in owning the servicing asset or servicing liability have been effectively transferred (as discussed in Issue 90-21).

No further EITF discussion is planned.

Title: Allocation of Recorded Investment When a Loan or Part of a Loan Is Sold

[Nullified by Statement 125 and Statement 140, as amended by Statement 156]

Dates Discussed: June 2, 1988; August 25-26, 1988; January 12-13, 1989; April 6, 1989; June 29, 1989; August 10, 1989

References: FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*

FASB Statement No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse*
FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*
FASB Statement No. 122, *Accounting for Mortgage Servicing Rights*
FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
FASB Statement No. 156, *Accounting for Servicing of Financial Assets*
FASB Technical Bulletin No. 87-3, *Accounting for Mortgage Servicing Fees and Rights*

ISSUE

An enterprise may acquire a loan either by originating or by purchasing the loan. That loan may be any type of receivable or debt security, including a mortgage-backed security, a corporate bond, or a Treasury bill, note, or bond. The enterprise may (a) retain the loan until repayment, (b) sell the entire loan including all of the contractual interest and principal payments, or (c) sell only a portion of the loan, that is, sell the interest payments, the principal payments, or a portion of either or both.

When a portion of the loan is sold, the seller's right to some or all future cash flows may be subordinate to the buyer's right to future cash collections or the seller may otherwise allocate credit risk disproportionately between the portion sold and the portion retained (for example, the seller may promise to reimburse the buyer for losses), with or without disproportionate sharing of other rights or risks inherent in the loan. If servicing is retained, the stated servicing fee may be equal to, above, or below a normal servicing fee or no servicing fee may be stated.

The issue is how the enterprise's recorded investment in a loan should be allocated between the portion of the loan sold (for purposes of determining the gain or loss on the sale) and the portion retained (for purposes of determining the remaining recorded investment).

EITF DISCUSSION

Modifying a previous consensus on this Issue, the Task Force reached a consensus that an enterprise that sells the right to receive the interest payments, the principal payments, or a portion of either or both relating to a loan should allocate the recorded investment in that loan between the portion of the loan sold and the portion retained based on the relative fair values of those portions on the date that the loan was acquired, adjusted for payments and other activity from the date of acquisition to the date of sale. [Note: This consensus has been nullified by Statement 125 and Statement 140, as amended by Statement 156. See Issue 1 in the STATUS section.] The Task Force acknowledged that it may not be practicable to determine fair values as of the date of acquisition. In that case, the allocation should be based on the relative fair values of the portion sold and the portion retained on the date of sale. The recorded investment to be allocated for such purposes should exclude consideration of any amounts included in an allowance for loan losses. The amount of any gain recognized when a portion of a loan is sold should not exceed the gain that would be recognized if the entire loan was sold. If *excess servicing* is retained, a portion of the recorded investment should be allocated to excess servicing based on its relative fair value. This consensus modifies the consensus reached at the April 6, 1989 Task Force meeting which excluded transactions in which the only difference in the characteristics of the portion of the loan sold and the portion retained is disproportionate credit risk. [Note: This consensus has been nullified by Statement 125 and Statement 140, as amended by Statement 156. See Issue 1 in the STATUS section.]

The Task Force also reached a consensus that the guidance of the FASB staff in Issue No. 84-21, "Sale of a Loan with a Partial Participation Retained," applies to transactions involving the sale of the entire principal balance at a price at or near par, including transactions in which the seller passes through either a fixed or variable rate of interest that differs from the coupon rate of the loan. In applying the guidance of the FASB staff in Issue 84-21 to those transactions, the seller should measure excess servicing (or the deficiency in normal servicing) in accordance with paragraph 11 of Statement 65 which states that "the amount of the adjustment shall be the difference between the actual sales price and the estimated sales price that would have been obtained if a normal servicing fee rate had been specified" (footnote reference omitted). The Task Force reached a consensus that, under footnote 4 to that paragraph, the difference between normal servicing fees and stated servicing fees, if any, over the estimated life of the loan should be calculated using prepayment, default, and interest rate assumptions that market participants would use for similar financial instruments subject to prepayment, default, and interest rate risks and should be discounted using an interest rate that a purchaser unrelated to the seller of such a financial instrument would demand. [Note: This consensus has been nullified by Statement 125 and Statement 140, as amended by Statement 156. See Issue 2 in the STATUS section.]

Task Force members noted that transactions under Issue 88-11 that provide for recourse to the seller should meet the conditions of paragraph 5 of Statement 77 to be accounted for as a sale. Task Force members further noted that the seller should evaluate the adequacy of the allowance for credit losses considering the collectibility of the remaining recorded investment relating to the portion of the loan retained and any recourse obligation relating to the portion of the loan sold in accordance with paragraph 6 of Statement 77. [Note: This consensus has been nullified by Statement 125 and Statement 140, as amended by Statement 156. See Issue 3 in the STATUS section.]

Some Task Force members noted that the sale of part of a loan may raise questions about the enterprise's intent and ability to hold the remaining portion of the loan.

The SEC Observer indicated that questions have been raised regarding the applicability of the April 6, 1989 consensus that required the use of the relative fair value allocation method unless the only difference is disproportionate credit risk. The SEC staff has taken the position that for transactions completed after April 6, 1989, such as those involving the sale of part of a loan or pool of loans with no disproportionate interest rates, but with disproportionate credit *and* prepayment risk, the relative fair value method is required. The SEC staff also requires prominent disclosure of the financial statement impact of the application of that method to transactions in earlier periods, if material.

The SEC Observer further indicated that the SEC staff had objected to the use of a pro rata method for certain sales transactions (principally involving interest differentials) prior to the initial June 2, 1988 consensus and, depending on the facts and circumstances, will continue to object to that method for those types of transactions.

STATUS

A related issue was discussed in Issue No. 92-2, "Measuring Loss Accruals by Transferors for Transfers of Receivables with Recourse," which addresses what the appropriate basis is for determining the amount of credit losses to be included in the measurement of a recourse obligation and whether it is appropriate for the transferor to recognize its obligation under the recourse provision on a present value basis in complying with the requirement of paragraph 6 of Statement 77.

Another related issue was discussed by the Task Force in Issue No. 94-9, "Determining a Normal Servicing Fee Rate for the Sale of an SBA Loan." That Issue addresses how, for the purpose of applying the consensus in Issue 88-11, a financial institution should determine a normal servicing fee rate for a loan, a portion of which has been guaranteed by the U.S. Small Business Administration (an SBA loan), under Technical Bulletin 87-3 in the absence of a major secondary market maker. See Issue 94-9 for details of the consensus reached.

In May 1995, the FASB issued Statement 122, which amends Statement 65 to require that a mortgage banking enterprise recognize as separate assets rights to service mortgage loans for others, however those rights are acquired. When applying the consensus in this Issue to the sale of a portion of a mortgage loan, the Board anticipates that a mortgage banking enterprise generally would allocate a portion of the recorded investment in that loan to mortgage servicing rights.

Statement 125, which superseded Statements 77 and 122, was issued in June 1996. Statement 125 was replaced by Statement 140 in September 2000. Statement 140 carries forward the supersession of Statements 77 and 122. ~~This Issue was partially affirmed by Statement 125 and was further affected by the issuance of Statement 140.~~

Issue 1—Under both Statements 125 and 140, a transfer of loans with partial interests retained that meets the conditions of paragraph 9 is accounted for as a sale. Paragraph 10 of both Statements 125 and 140 requires upon completion of a transfer of financial assets that the transferor follow the same allocation principles as the first consensus of Issue 88-11 but modifies the consensus by requiring allocated carrying value based on fair value at the date of transfer rather than the date of acquisition. ~~While the conditions in paragraph 9 have been revised in connection with Statement 140, the application of paragraphs 9, 10, and 11 to this Issue have not changed.~~ <u>As a result of including the accounting guidance related to transfers of financial assets in Statement 125, the consensus on this Issue is no longer necessary and has been nullified. Statement 156 revises paragraph 10 of Statement 140.</u>

Issue 2—Statement 125 nullifies the consensus that the guidance of the FASB staff in Issue 84-21 applies to transactions involving the sale of the entire principal balance at a price at or near par, including transactions in which the seller passes through either a fixed or variable rate of interest that differs from the coupon rate of the loan. ~~In addition, Statement 125 eliminated the distinction between normal and excess servicing by requiring recognition of servicing assets and liabilities in accordance with paragraphs 10, 13, and 35-41 (paragraphs 10, 13, and 61-67 of Statement 140).~~ Statement 125 and Statement 140, as amended by Statement 156, did not further affect that guidance.

Statements 125 and 140 deleted ~~partially affirm the consensus concerning~~ footnote 4 of paragraph 11 of Statement 65. Statement 125 requires that servicing assets retained in a sale of financial assets be initially measured at their previous carrying amount allocated based on their relative fair values. Statement 125's definition of fair value requires incorporating interest rate, default, and prepayment assumptions that market participants would use. Statement 140 did not reconsider this matter. As a result of eliminating the distinction between normal and excess servicing in Statement 125, the consensus reached on this portion of the Issue is no longer necessary and therefore is nullified.

Under Statements 125 and 140, all entities that undertake the obligation to service financial assets for others recognize either a servicing asset or servicing liability for each servicing contract in accordance with paragraphs 10, 13, and 35-41 of Statement 125 (paragraphs 10, 13, and 61-67 of Statement 140).

Issue 3—Paragraph 9 of both Statements 125 and 140 contains criteria for sale treatments. If a transfer of financial assets meets the criteria in paragraph 9, a sale would be recorded along with any recourse provisions. If the fair value of the recourse provisions cannot be reliably measured, alternative procedures specified in paragraph 45 of Statement 125 (paragraph 71 of Statement 140) would be applied. Because this guidance is included in both Statements 125 and 140, the consensus reached on this Issue is no longer necessary and therefore is nullified. Statement 156 did not further affect this guidance.

FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*, which was issued in February 2006, amends FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. Statement 155 indicates that interest-only and principal-only strips exempt from the bifurcation requirements of Statement 133 are limited to a narrowly defined set of such instruments.

Statement 156, issued in March 2006, amends Statement 140 and is effective as of the beginning of an entity's first fiscal year that begins after September 15, 2006. Paragraphs 10 and 11 of Statement 140 provide revised guidance for accounting for interests that continue to be held by the transferor upon completion of a transfer of financial assets, and paragraph 13A provides new guidance on subsequent measurement of servicing assets and servicing liabilities. Statement 125 and Statement 140, as amended by Statement 156, nullify the consensuses in this Issue.

No further EITF discussion is planned.

Issue No. 88-22

Title: Securitization of Credit Card and Other Receivable Portfolios

Dates Discussed: October 6, 1988; November 17, 1988; January 12-13, 1989

References: FASB Statement No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse*
FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
FASB Statement No. 156, *Accounting for Servicing of Financial Assets*
FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*
FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*
FASB Technical Bulletin No. 85-2, *Accounting for Collateralized Mortgage Obligations* (CMOs)
FASB Staff Position FIN46-6, "Effective Date of FASB Interpretation No. 46"
AICPA Audit and Accounting Guide, *Audits of Investment Companies*

ISSUE

A bank or other financial institution (the Bank) forms a pool of receivables from credit card accounts in its portfolio and transfers the receivables to a trust. [Note: The Task Force subsequently agreed to broaden the scope of this Issue. See STATUS section.] The Bank then sells undivided participation interests in the trust's receivables or in the trust and retains the remaining undivided participation interest in the receivables or in the trust. [Note: See STATUS section.] (This Issue does not address securitizations structured as borrowings secured by the receivables.)

The investors will receive interest computed by multiplying a specified rate of interest by the outstanding participation balance of the credit card receivables. Typically, the Bank will service the credit card accounts for the trust and may receive a higher rate of interest from the credit card customers than the interest rate passed through to the investors. During a specified reinvestment period (usually 18 to 36 months), the trust will purchase additional credit card receivables generated by the selected accounts. The Bank's and the investors' participation interests in the receivables in the trust will increase or decrease depending on the aggregate outstanding principal balances of the selected accounts resulting from charge and payment activities. However, during the reinvestment period, the investors' dollar investment remains constant because principal payments allocated to the investors' interest are reinvested in additional credit card receivables.

After the reinvestment period, a period of liquidation occurs during which the investors receive an allocated portion of principal payments relating to receivables in the trust. The liquidation method used to allocate the principal payments to the investors may vary depending on the terms of the agreement and may be a participation method (payout allocation rate may be fixed, preset, or floating) or a controlled amortization method (payout based on a predetermined schedule).

Under the fixed participation method, all principal payments on the receivables in the trust are allocated to the investors based on their respective participation interests in the credit card receivables in the trust at the end of the reinvestment period. The preset participation method is similar to the fixed participation method except that the percentage used to determine the principal payments allocated to the investors is preset higher than the investors' expected participation interests in the receivables in the trust at the end of the reinvestment period. (This method results in a faster payout to the investors than the fixed participation method because a higher percentage of the principal payments is allocated to the investors.) Under the floating participation method, principal payments allocated to the investors are based on the investors' actual participation interests in the receivables in the trust each month. (Each month, investors' participation interests in the credit card receivables in the trust are redetermined for that month's allocation of principal payments.)

Under the controlled amortization method, a predetermined monthly payment schedule is established so that payout to the investors will occur over a specified liquidation period. Principal payments are allocated to the investors based on their participation interests in the receivables in the trust, using one of the liquidation methods (fixed, preset, or floating) described above. Principal payments in excess of the predetermined monthly payment, if any, are allocated to the Bank and increase the investors' ownership interests. If the principal payments allocated to the investors are insufficient to cover the predetermined monthly payment, that payment is reduced by the amount of the deficiency. If the principal payments allocated to the investors in subsequent months exceed the predetermined monthly payment, the deficiency is recovered.

Generally, the investors are allocated credit losses on receivables in the trust based on their actual floating participation interest regardless of the liquidation method specified in the securitization agreement. In addition, credit card securitizations typically involve some form of credit enhancement to mitigate expected credit losses allocated to investors. For example, a third party may issue a letter of credit in an amount estimated to be in excess of expected credit losses.

The issues are:

1. Whether the Bank should account for amounts received from transferring to investors a participating interest in the credit card receivables in the trust as a sale or as a financing transaction

2. Whether the type of liquidation method specified in the credit card securitization agreement should affect the accounting for the transfer

3. If the transfer is reported as a sale, how the gain or loss on the sale should be calculated.

EITF DISCUSSION

The Task Force reached a consensus on the first issue that the Bank should account for amounts received from transferring to investors a participating interest in the credit card receivables in the trust as a sale when the conditions specified in paragraph 5 of Statement 77 are met. [Note: This consensus has been nullified by Statement 140. See Issue 1 in the STATUS section.]

The Task Force reached a consensus on the second issue that the type of liquidation method specified in the credit card securitization agreement should not affect the accounting for the transfer except when the percentage of principal payments allocated to the investors exceeds the investors' ownership interests in the receivables in the trust at the beginning of the liquidation period. In those cases, the transfer of receivables would not qualify as a sale under Statement 77 because the investor (buyer of the receivables) would have, in effect, the ability to require the seller to repurchase some of the receivables. [Note: This consensus has been nullified by Statement 140. See Issue 2 in the STATUS section.]

The Task Force reached a consensus on the third issue that any gain on the sale of receivables should be limited to amounts related to those receivables that exist at the date of the sale and should not include amounts related to future receivables that are expected to be sold during the reinvestment period. The Task Force generally agreed that, based on their knowledge of certain transactions, the gain generally would not be significant due to the relatively short life of the receivables sold, the high cost of servicing credit card loans as evidenced by industry statistics, and the yields currently required by investors in the current interest rate environment. Task Force members noted that the terms of a transaction should be reviewed to determine whether a loss should be recognized for the costs expected to be incurred for all future servicing obligations, including costs for receivables not yet sold. Some Task Force members observed that transaction costs relating to the sale of the receivables may be recognized over the initial and reinvestment periods in a rational and systematic manner unless the transaction results in a loss. [Note: See Issue 3 in the STATUS section.]

STATUS

The Task Force subsequently agreed to change the title of Issue 88-22 to "Securitization of Credit Card and Other Receivable Portfolios." At the July 20-21, 1995 EITF meeting, a question was raised as to whether the consensuses in Issue 88-22 should be applied to sales of other types of receivables. The SEC Observer indicated that the SEC staff believes that the consensuses in Issue 88-22 should be applied to securitizations of other types of receivables under arrangements similar to those described in the Issue. The Task Force concurred with the SEC Observer and agreed to amend the title of Issue 88-22.

A related issue was discussed in Issue No. 88-11, "Allocation of Recorded Investment When a Loan or Part of a Loan Is Sold." That Issue considers how an enterprise's recorded investment in a loan should be allocated between the portions of the loan sold (for purposes of determining the gain or loss on the sale) and the portions that continue to be held by a transferor ~~retained~~ (for purposes of determining the remaining recorded investment).

Another related issue was discussed in Issue No. 90-18, "Effect of a 'Removal of Accounts' Provision on the Accounting for a Credit Card Securitization." That Issue considers whether credit card securitizations with certain "removal of accounts" provisions may be recognized as sale transactions under Statement 77.

Statement 125 was issued in June 1996. Statement 125 was replaced by Statement 140 in September 2000.

Issue 1—On the first issue, Statement 140 carries forward the supersession of Statement 77 and requires sale treatment if, and only if, the transferor has surrendered control in accordance with paragraph 9. Assuming that the criteria in paragraph 9 are met, the transfer would be accounted for as a sale and the bank would:

1. Recognize and measure a servicing asset in accordance with paragraphs 58-63 of Statement 140

2. Continue to carry ~~its retained~~ interests that continue to be held by the transferor in the assets transferred to the SPE

3. Allocate the previous carrying amount of the credit card and other receivables transferred to the SPE between assets sold and ~~its retained~~ interests that continue to be held by the transferor based on their relative fair value at the date of transfer

4. Recognize an asset or liability for the forward commitment to transfer future receivables.

As a result, the consensus on the first issue is nullified by Statement 140.

Issue 2—Under Statement 140, the method of trust liquidation would not affect the determination of whether the transferor would receive sale treatment under paragraph 9 or secured borrowing treatment under paragraphs 12 and 15. Liquidation methods may allocate receipts of principal or interest between investors and transferors in different proportions than their stated percentage of ownership interests. Those agreed-upon allocations should be taken into consideration in determining the relative fair values of the portion of trust assets beneficially owned by the investors and the seller, which is the basis for allocating the previous carrying amount between the portion of receivables sold to investors and the ~~seller's retained~~ interests that continue to be held by the transferor. The right to the portion of receivables that will remain in the trust after investors have been completely paid off is part of the interests that ~~the seller~~

~~retained~~ continue to be held by the transferor at the outset and hence, was never sold to investors. As a result, the second issue is nullified by Statement 140.

Issue 3—Under paragraph 75 of Statement 140, any gain or loss recognition for revolving-period receivables sold to a securitization trust is limited to receivables that exist and have been sold. As a result, Statement 140 affirms the consensus in the third issue.

In addition, it affirms the Task Force members' notes that:

1. The terms of a transaction should be recognized for the costs expected to be incurred for all future servicing obligations, including costs for receivables not yet sold. Statement 140 requires that a servicer recognize a servicing liability if the benefits of servicing are not expected to adequately compensate the servicer for performing the services, which may well be the case if the work was expected to be performed at a loss. Adequate compensation is defined in paragraph 364 of Statement 140.

2. Transaction costs relating to the sale of the receivables may be recognized over the initial and reinvestment periods in a rational and systematic manner unless the transaction results in a loss.

According to Statement 140, transaction costs for a past sale are not an asset and thus are part of the gain or loss on sale. In a credit card securitization, however, some of the transaction costs incurred at the outset relate to the future sales that are to occur during the revolving period, and thus can qualify as an asset. Therefore, the observations of Task Force members relating to transaction costs is consistent with Statement 140.

Interpretation 46 and Interpretation 46(R) address consolidation by business enterprises of variable interest entities, which include many trusts that are not qualifying special-purpose entities under Statement 140. Interpretation 46 and Interpretation 46(R) require a variable interest entity to be consolidated by an enterprise if that enterprise will absorb a majority of the entity's expected losses or is entitled to receive a majority of the entity's expected residual returns or both.

Interpretation 46 was issued in January 2003. The consolidation requirements of Interpretation 46 apply immediately to variable interest entities created after January 31, 2003. The consolidation requirements apply to older entities in the first fiscal year or interim period beginning after June 15, 2003. Certain of the disclosure requirements apply in all financial statements issued after January 31, 2003, regardless of when the variable interest entity was established.

FSP FIN46-6 deferred the effective date for applying the provisions of Interpretation 46 for:

1. Interests held by a public entity in variable interest entities created before February 1, 2003, if the public entity has not issued financial statements reporting that interest in accordance with Interpretation 46. The application of Interpretation 46 to those interests is deferred until the end of the first period ending after December 15, 2003.

2. Nonregistered investment companies accounting for their investments in accordance with the specialized accounting guidance in the investment company Guide.

Interpretation 46(R) was issued on December 24, 2003, and replaced Interpretation 46. An enterprise with an interest in an entity to which the provisions of Interpretation 46 were not applied as of December 24, 2003, must apply the effective date and transitions provisions in Interpretation 46(R) to that entity. Application by public companies of Interpretation 46 or Interpretation 46(R) to entities commonly referred to as special-purpose entities is required no later than as of the end of the first reporting period that ends after December 15, 2003. Public enterprises must apply Interpretation 46(R) to all entities no later than the end of the first reporting period that ends after March 15, 2004 (public enterprises other than small business issuers) or December 15, 2004 (small business issuers). Nonpublic enterprises must apply Interpretation 46(R) to entities created after December 31, 2003, immediately and to all other entities by the beginning of the first annual period beginning after December 15, 2004. An enterprise that has applied Interpretation 46 to an entity prior to the effective date of Interpretation 46(R) shall either continue to apply Interpretation 46 until the effective date of Interpretation 46(R) or apply Interpretation 46(R) at an earlier date.

<u>Statement 156, issued in March 2006, amends Statement 140 with respect to the accounting for separately recognized servicing assets and servicing liabilities. Statement 156 does not affect any of the consensuses reached in this Issue; however this Issue reflects the Board's decision in Statement 156 to replace the term *retained interests* with *interests that continue to be held by a transferor.*</u>

No further EITF discussion is planned.

Issue No. 89-2

Title: Maximum Maturity Guarantees on Transfers of Receivables with Recourse

Dates Discussed: January 12-13, 1989; February 23, 1989

References:
FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*
FASB Statement No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse*
FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*
FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
FASB Statement No. 156, *Accounting for Servicing of Financial Assets*
FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*
FASB Special Report, *A Guide to Implementation of Statement 140 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities: Questions and Answers*

ISSUE

An enterprise (seller) that owns receivables or certificates representing ownership of pools of receivables transfers the receivables, with recourse, in a transaction that purports to be a sale under Statement 77. The purchaser has the right to sell (put) the remaining receivables back to the seller, or the seller has the right to purchase (call) the receivables, at a specified date at which the remaining receivable balances are expected to be a minor percentage of the original amount transferred based on the seller's estimate of principal prepayments. Statement 77 permits a transfer of receivables with recourse to be accounted for as a sale if the seller is permitted or required to repurchase the remaining receivables when the outstanding balances are minor to keep the cost of servicing those receivables from becoming unreasonable.

The issue is whether the seller may account for the transfer of the receivables as a sale if the purchaser has an option to put the receivables back to the seller (or the seller has an option to call the receivables) at a specified future date at which the outstanding balances are expected to be minor based on the seller's estimate of prepayments but are not minor based on contractual payment terms.

EITF DISCUSSION

The Task Force reached a consensus that a transfer of receivables should not be accounted for as a sale if the purchaser has an option to put the receivables back to the seller (or the seller has an option to call the receivables) at a specified future date at which the outstanding balances are expected to be minor based on the seller's estimate of prepayments but are not minor based on contractual payment terms. [Note: See STATUS section.] However, the transfer may be accounted for as a sale if the purchaser's option to put the receivables back to the seller (or the seller's option to call the receivables) is exercisable at a future date when the outstanding balances are expected to be minor based on the contractual payment schedule of the underlying receivables. [Note: See STATUS section.] The Task Force did not address what constitutes *minor*. [Note: See STATUS section.]

STATUS

Statement 125, issued in June 1996, nullified the consensuses in this Issue. However, Statement 125 was replaced by Statement 140 in September 2000. Under Statement 140, the accounting depends on whether the option is a put or a call.

If the purchaser (transferee) has an option to put the receivables back to the seller (transferor), the transferor would account for the transfer of the receivables as a sale, assuming the criteria in paragraphs 9(a) and 9(c) of Statement 140 are met, if the transferee either (a) is a qualifying SPE or (b) has the right to pledge or exchange the receivables, and the put option does not constrain the transferee from taking advantage of that right and provide more than a trivial benefit to the transferor. Paragraph 32 of Statement 140 discusses how to judge whether a put option constrains a transferee.

In contrast, if the transferor has an option to call the receivables at a specified future date at which the outstanding balances are expected to be more than minor based on the contractual terms of the receivables, the transferor would account for the transfer of the portion of the future cash flows from the pool of receivables expected to be collected by that future date (based on expected cash flows—refer to Question 49 of the Special Report on Statement 140) as a sale, assuming the criteria in paragraphs 9(a) and 9(b) are met. The transferor would account for its rights to the remaining portion of the future cash flows from the pool of receivables as ~~a retained~~ interests that continue to be held by a transferor.

Under Statement 140, the accounting is not affected by whether the outstanding balance at the specified future date is expected to be *minor*. However, a call option that is a *cleanup call* does not preclude sale accounting for the entire pool of receivables.

Interpretation 45, which was issued in November 2002, requires a guarantor to recognize, at inception of the guarantee, a liability for the obligation undertaken in issuing the guarantee. The Interpretation also elaborates on the disclosures to be made by a guarantor. The purchaser's put option in a transfer of receivables accounted for as a sale by the transferor would be considered a guarantee by the transferor under paragraph 3(a)(2) of the Interpretation and would be subject to its initial recognition, initial measurement, and disclosure requirements. If the put option prevents the transferor from accounting for the transaction as a sale, then that put option is not subject to the Interpretation in accordance with paragraph 6(f) of that Interpretation.

Statement 156, issued in March 2006, amends Statement 140 with respect to the accounting for separately recognized servicing assets and servicing liabilities. Statement 156 does not affect any of the consensuses reached in this Issue; however this Issue reflects the Board's decision in Statement 156 to replace the term *retained interests* with *interests that continue to be held by a transferor*.

No further EITF discussion is planned.

Issue No. 90-18

Title: Effect of a "Removal of Accounts" Provision on the Accounting for a Credit Card Securitization

Date Discussed: September 7, 1990

References: FASB Statement No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse*
FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
FASB Statement No. 156, *Accounting for Servicing of Financial Assets*

ISSUE

Credit card securitizations, as described in Issue No. 88-22, "Securitization of Credit Card Portfolios," may include a removal-of-accounts provision. Periodically during the reinvestment period, this provision permits the seller under certain conditions, and with Trustee approval, to withdraw individual accounts from the pool of receivables securitized. The conditions of the securitization frequently require that (1) accounts be selected on a random basis, (2) the removal be limited to no more than one per month, (3) the amount of any one removal be limited to a specified fixed percentage of receivables in the pool, (4) the removal cannot materially and adversely affect the interests of an investor or third-party credit enhancer, and (5) the pool of receivables have specified minimum credit characteristics prior to a proposed removal. The effect of the withdrawal reduces the seller's interest (and increases the investors' relative interests) in the remaining account balances.

The issue is whether credit card securitizations with certain removal-of-accounts provisions should be recognized as sale transactions under Statement 77.

EITF DISCUSSION

The Task Force reached a consensus that a credit card securitization with a removal-of-accounts provision that otherwise meets the conditions of paragraph 5 of Statement 77 should be recognized as a sales transaction provided (1) removal of such individual accounts is within the specified terms of the securitization and cannot reduce the amount the investor has invested in the pool and (2) the seller's relative percentage interest in the pool is not decreased below that specified by the contractual terms of the securitization. [Note: See STATUS section.]

STATUS

At the July 20-21, 1995 EITF meeting, a question was raised as to whether the consensuses in Issue 88-22 should be applied to sales of other types of receivables. The SEC Observer indicated that the SEC staff believes that the consensuses in Issue 88-22 should be applied to securitizations of other types of receivables under arrangements similar to those described in Issue 88-22. The Task Force concurred with the SEC Observer and agreed to amend the title of Issue 88-22 to "Securitization of Credit Card and Other Receivable Portfolios."

Statement 125, which superseded Statement 77, was issued in June 1996. Statement 125 was replaced by Statement 140, which carries forward the supersession of Statement 77, in September 2000.

Under Statement 140, whether a removal-of-accounts provision (ROAP) precludes sale accounting depends on whether the ROAP results in the transferor's maintaining effective control over the transferred assets. A transferor maintains effective control over transferred assets if it has the ability to unilaterally cause the transferee to return specific assets. Paragraph 83 of Statement 140 provides examples of ROAPs that preclude transfers from being accounted for as sales (for example: unconditional ROAPs or ROAPs conditioned only on a transferor's decision). Paragraph 84 of Statement 140 provides examples of ROAPs that do not preclude transfers from being accounted for as sales (for example: random removals if limited to the amount of the ~~transferor's retained~~ interests that continue to be held by a transferor and limited to one removal per month). As a result, the Task Force consensus is partially affirmed by the issuance of Statement 140.

Statement 156, issued in March 2006, amends Statement 140 with respect to the accounting for separately recognized servicing assets and servicing liabilities. Statement 156 does not affect any of the consensuses reached in this Issue; however this Issue reflects the Board's decision in Statement 156 to replace the term *retained interests* with *interests that continue to be held by a transferor.*

No further EITF discussion is planned.

Issue No. 90-21

Title: Balance Sheet Treatment of a Sale of Mortgage Servicing Rights with a Subservicing Agreement

Dates Discussed: November 8, 1990; May 9, 1991; July 11, 1991; September 12, 1991

References: FASB Statement No. 13, *Accounting for Leases*

FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*

FASB Statement No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse*

FASB Statement No. 98, *Accounting for Leases: Sale-Leaseback Transactions Involving Real Estate, Sales-Type Leases of Real Estate, Definition of the Lease Term, and Initial Direct Costs of Direct Financing Leases*

FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*

FASB Statement No. 156, *Accounting for Servicing of Financial Assets*

FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*

SEC Staff Accounting Bulletin No. 30, *Accounting for Divestiture of a Subsidiary or Other Business Operation*

SEC Staff Accounting Bulletin No. 82, *Certain Transfers of Nonperforming Assets*

ISSUE

In Issue No. 87-34, "Sale of Mortgage Servicing Rights with a Subservicing Agreement," the Task Force reached a consensus that income should not be recognized immediately as a result of the sale of mortgage servicing rights with a subservicing agreement. However, the Task Force agreed that a loss should be recognized currently if the transferor determines that prepayments of the underlying mortgage loans may result in performing the future servicing at a loss. The Task Force did not address whether the transaction should be accounted for as a financing or as a sale with the gain deferred.

This Issue addresses whether the transaction described in Issue 87-34 should be accounted for as a financing or as a sale with the gain deferred.

EITF DISCUSSION

The Task Force reached a consensus that a sale of mortgage servicing rights with a subservicing agreement should be treated as a sale with gain deferred if substantially all the risks and rewards inherent in owning the mortgage servicing rights have been effectively transferred to the buyer. The risks and rewards associated with a seller performing purely administrative functions under a subservicing agreement would not necessarily preclude sales treatment. [Note: See STATUS section.]

The SEC Observer noted that, in the view of the SEC staff, a transaction that, in substance, transfers only a portion of the servicing revenues does not result in transfer of substantially all of the risks and rewards of ownership and the accounting for those transactions should be guided by the consensus in Issue No. 88-18, "Sales of Future Revenues."

In addition, the Task Force reached a consensus that substantially all the risks and rewards inherent in owning the mortgage servicing rights have not been transferred to the buyer and, therefore, the transaction should be accounted for as a financing if one or more of the following factors are present:

1. The seller/subservicer directly or indirectly guarantees a yield to the buyer. For example, the seller/subservicer guarantees prepayment speeds or maximum loan default ratios to the buyer.
2. The seller/subservicer is obligated to advance a portion or all of the servicing fees on a nonrecoverable basis to the buyer prior to receipt of the loan payment from the mortgagor.
3. The seller/subservicer indemnifies the buyer for damages due to causes other than failure to perform its duties under the terms of the subservicing agreement.
4. The seller/subservicer absorbs losses on mortgage loan foreclosures not covered by FHA, VA, or other guarantors, if any, including absorption of foreclosure costs and costs of managing foreclosed property.
5. Title to the servicing rights is retained by the seller/subservicer.

The Task Force also reached a consensus that the presence of the following factors creates a rebuttable presumption that substantially all the risks and rewards inherent in owning the mortgage servicing rights have not been transferred to the buyer and that the transaction should be accounted for as a financing:

1. The seller/subservicer directly or indirectly provides financing or guarantees the buyer's financing. Nonrecourse financing, for example, would indicate that risks have not been transferred to the buyer.
2. The terms of the subservicing agreement unduly limit the buyer's ability to exercise ownership control over the servicing rights or result in the seller's retaining some of the risks and rewards of ownership. For example, if the buyer cannot cancel or decline to renew the

subservicing agreement after a reasonable period of time, the buyer is precluded from exercising certain rights of ownership. Conversely, if the seller cannot cancel the subservicing agreement after a reasonable period of time, the seller has not transferred substantially all of the risks of ownership.

3. The buyer is a special-purpose entity without substantive capital at risk.

Some Task Force members observed that there may be factors other than those noted above that might also indicate that substantially all the risks and rewards inherent in owning the mortgage servicing rights have not been transferred to the buyer. [Note: See STATUS section.]

STATUS

A related issue was discussed in Issue No. 95-5, "Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage Loan Servicing Rights."

Interpretation 45, which was issued in November 2002, requires a guarantor to recognize, at inception of the guarantee, a liability for the obligation undertaken in issuing the guarantee. The Interpretation also elaborates on the disclosures to be made by a guarantor.

Statement 156, issued in March 2006, amends Statement 140 with respect to the accounting for separately recognized servicing assets and servicing liabilities. Statement 156 does not modify the consensus reached on this Issue. However, changes in the fair value of servicing assets and servicing liabilities subsequently measured at fair value are included in earnings in the period in which those changes occur, with any additional change in fair value from the last measurement date to the sale date included in earnings at that time.

No further EITF discussion is planned.

Issue No. 92-2

Title: Measuring Loss Accruals by Transferors for Transfers of Receivables with Recourse

Dates Discussed: July 23, 1992; September 24, 1992

References: FASB Statement No. 5, *Accounting for Contingencies*
FASB Statement No. 76, *Extinguishment of Debt*
FASB Statement No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse*
FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
FASB Statement No. 133, *Accounting for Derivative Instruments and hedging Activities*
FASB Statement No. 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133*
FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*
FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*
FASB Statement No. 156, *Accounting for Servicing of Financial Assets*
FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*
FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*
FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*
APB Opinion No. 21, *Interest on Receivables and Payables*

ISSUE

An enterprise (transferor) may transfer receivables to an unrelated third party (transferee) and retain an obligation to compensate the transferee for the failure of the debtors to pay when due. The transfer meets all the conditions of paragraph 5 of Statement 77 to be recognized as a sale. One of those conditions is that the amount of the transferor's obligation under the recourse provisions must be able to be reasonably estimated at the date of sale. Paragraph 6 of Statement 77 states that "if a transfer qualifies to be recognized as a sale, all probable adjustments in connection with the recourse obligations to the transferor shall be accrued in accordance with FASB Statement No. 5, *Accounting for Contingencies*."

The issues are (1) what the appropriate basis is for determining the amount of credit losses to be included in the measurement of the recourse obligation and (2) whether it is appropriate for the transferor to recognize its obligation under the recourse provision on a present value basis in complying with the requirement of paragraph 6 of Statement 77, and if so, what discount rate to use in the present-value-based measurement and how to subsequently account for the recourse obligation.

EITF DISCUSSION

The Task Force reached a consensus that the obligation recorded at the date of sale in connection with the recourse provisions of the transfer should include all probable credit losses over the life of the receivables transferred and not only those measured and recognized in accordance with Statement 5 prior to the date of transfer. [Note: See STATUS section.]

The Task Force also reached a consensus that recognition of the recourse obligation on a present value basis would be acceptable if the timing of the estimated cash flows can be reasonably estimated. If the obligation is recognized on a present value basis, subsequent accruals to the discounted amount should be at the rate inherent in determining the initial obligation. Also, if the effect of the discounting is material, the financial statements should disclose the undiscounted amount of the recourse obligation and the interest rate used. [Note: See STATUS section.]

The SEC Observer stated that, ideally, the objective at the date of the sale transaction is to measure the fair value of the retained recourse obligation. Accordingly, the rate used to discount the recourse obligation should be the rate at which the recourse obligation could be settled in an arm's-length transaction with a third party. The SEC staff will object to the use of an interest rate higher than the rate on monetary assets that are essentially risk free, as described in paragraph 4 of Statement 76, and that have maturities comparable to those of the recourse obligation. Further, the recourse obligation should be measured and reported separately as a liability and should not be offset against assets unless a right of setoff exists consistent with Interpretation 39. [Note: See STATUS section.]

The SEC Observer also stated that if a right of setoff exists and the seller's recourse obligation is contractually limited to and paid from an escrow account that accumulates cash representing the excess of the coupon interest on the transferred receivables over the interest passed through to the buyer, then the value of the retained net asset should be determined as required by Issue No. 88-11, "Allocation of Recorded Investment When a Loan or Part of a Loan Is Sold." Consistent with the discussion of excess servicing in Issue 88-11, the net cash flows from the retained net asset should be discounted using an interest rate, commensurate with the risk, that market participants unrelated to the seller would demand. That discount rate normally would be expected to be higher than the rate used to discount excess servicing (usually an interest-only security rate is used to discount excess servicing) because the retained net asset includes the incremental risk inherent in the recourse obligation. In such circumstances, it would be acceptable to measure the recourse liability separately, as described above, from the excess servicing asset, before netting the recourse liability and excess servicing asset. [Note: See STATUS section.]

STATUS

Statement 125 was issued in June 1996. Statement 125 was replaced by Statement 140 in September 2000, without reconsideration of this matter except for the SEC Observer comments.

Statement 125 affirms the Task Force consensus on the appropriate basis for determining credit losses to be included in measuring recourse provisions. Statement 125 defines recourse as the right of a transferee to receive payment from the transferor of those receivables, for (a) failure of debtors to pay when due, (b) the effects of prepayments, or (c) adjustments resulting from defects in the eligibility of the transferred receivables. That definition includes all probable credit losses over the life of the receivables transferred.

Statement 125 affirms, does not affect, and nullifies portions of the Task Force consensus on recognition of obligations under recourse provisions. Statement 125 requires the recognition of recourse obligations in transfers of financial assets qualifying for sale treatment. Those obligations are required to be measured *at fair value*. Paragraph 40 of Statement 125 (paragraph 66 of Statement 140) states that the valuation techniques used shall be consistent with the objective of measuring fair value. Fair value under paragraph 43 of Statement 125 (paragraph 69 of Statement 140) includes the use of present value techniques. However, that paragraph requires that the discount rate be commensurate with the risks involved, which might require recognizing different amounts under Statement 125 than some may have recognized under the Task Force guidance in Issue 92-2. Statement 125 does not address subsequent measurement of the retained recourse obligation, therefore it does not affect that part of the Task Force consensus. Statement 125 does however nullify the part of the consensus that requires disclosure of the undiscounted amount of the recourse obligation and the interest rate used because Statement 125 does not require disclosure of the undiscounted amount of the recourse obligation.

Statement 125 resolves and affirms portions of the SEC Observer comment on the interest rate used to discount the recourse obligation. Statement 125 superseded Statement 76 (Statement 140 carries forward this supersession) and requires use of a rate commensurate with the risks involved. In measuring financial liabilities and servicing liabilities at fair value by discounting estimated future cash flows, an objective is to use discount rates at which those liabilities could be settled in an arm's-length transaction. Paragraph 69 of Statement 140 discusses an expected cash flow approach, based on assumptions about the range of possible estimated cash flows and their respective probabilities, as described in Concepts Statement 7. Statement 140 suggests that the expected cash flow approach to estimating present value is perhaps a more effective tool than the traditional "best estimate" approach discussed in Issue 92-2. It also provides that, in measuring financial liabilities and servicing liabilities at fair value by discounting estimated future cash flows, an objective is to use discount rates at which those liabilities could be settled in an arm's-length transaction.

In addition, paragraph 11 of both Statements 125 and 140 affirms the SEC Observer's comment that the recourse obligation should not be offset unless the right of setoff exists under Interpretation 39. Paragraph 11 specifically requires all liabilities, including recourse obligations, to be separately recognized and measured.

Statement 125 affirms and resolves portions of the SEC Observer's comment on right of setoff and interest rate to be used in discounting net cash flows.

Statement 125 resolves the SEC Observer's comment that if a right to setoff exists and the seller's recourse obligation is contractually limited to and paid from an escrow account with the characteristics described in this Issue, then the value of the retained net asset should be determined as required by Issue 88-11. <u>Statement 140 and p</u>~~P~~aragraph 10 of Statement 125 require~~s~~ that ~~retained~~ interests <u>that continue to be held by a transferor</u>, including such an escrow account if the balance remaining is ultimately paid to the seller, continue to be recognized as the seller's asset and be initially measured at the allocated previous carrying amount. However, the allocation method required by Statements 125 and 140 differs from that required by Issue 88-11. FASB Interpretation 39 sets forth criteria for determining whether items can be offset.

Statement 125 also resolves the SEC Observer's comment that the net cash flows from the retained net asset should be discounted using an interest rate, commensurate with the risk, that market participants unrelated to the seller would demand. Statement 125 nullifies the consensuses in Issue 88-11. Also, it defines servicing assets differently than the meaning of "excess servicing" implied in this Issue and eliminates the distinction between excess servicing and normal servicing by requiring the recognition of servicing assets or servicing liabilities, whether originated or purchased separately.

In addition, Statement 125 affirms the SEC Observer's comment that the discount rate normally would be expected to be higher than the rate used to discount excess servicing because the retained net asset includes the incremental risk inherent in the recourse obligation. Paragraph 43 of Statement 125 requires the use of a discount rate that is commensurate with the risks involved. Paragraph 69 of Statement 140 also observes that, under either the expected cash flow approach or the traditional "best estimate" approach, measuring the fair value of ~~retained~~ interests that continue to be held by a transferor such as this escrow account that are subordinate to more senior beneficial interests, depends heavily on assumptions about default and prepayment of all the assets transferred.

Statement 125 resolves the SEC Observer's comment that in such circumstances, it would be acceptable to measure the recourse liability separately, as described above, from the excess servicing asset before netting the recourse liability and excess servicing asset. Under Statement 140 and paragraph 10 of Statement 125, the net asset representing the seller's interest in the escrow is ~~a retained~~ interests that continue to be held by a transferor in the transferred assets, to be measured at previous carrying amount allocated in proportion to relative fair value.

Statement 133 was issued in June 1998 and was amended by Statements 137, 138, and 149. The effective date for Statement 133, as amended, is for all fiscal quarters of all fiscal years beginning after June 15, 2000.

The terms of the recourse arrangement should be analyzed to determine whether it meets the definition of a derivative under Statement 133 and whether it is subject to Statement 133 (See paragraph 10(d)).

Refer to Statement 133 Implementation Issue No. C7, “Certain Financial Guarantee Contracts,” for further guidance.

Interpretation 45, which was issued in November 2002, requires a guarantor to recognize, at inception of the guarantee, a liability for the obligation undertaken in issuing the guarantee. The Interpretation also elaborates on the disclosures to be made by a guarantor. The recourse obligation of the transferor may be a guarantee under paragraph 3 of the Interpretation and, therefore, subject to that Interpretation’s initial recognition, initial measurement, and disclosure requirements. Statement 140 requires a liability to be recognized at fair value for the recourse obligation, and the initial measurement guidance in Interpretation 45 is consistent with Statement 140. Interpretation 45 requires additional disclosures to those required by Statement 140. Interpretation 45 does not impact any of the consensuses reached in this Issue.

Statement 156, issued in March 2006, amends Statement 140 with respect to the accounting for separately recognized servicing assets and servicing liabilities. Statement 156 does not affect any of the consensuses reached in this Issue; however this Issue reflects the Board’s decision in Statement 156 to replace the term *retained interests* with *interests that continue to be held by a transferor.*

No further EITF discussion is planned.

EITF ABSTRACTS

Issue No. 02-9

Title: Accounting for Changes That Result in a Transferor Regaining Control of Financial Assets Sold

Dates Discussed: September 11–12, 2002; November 21, 2002; January 23, 2003; March 20, 2003; July 31, 2003

References:
FASB Statement No. 5, *Accounting for Contingencies*
FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*
FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*
FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*
FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*
FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
FASB Statement No. 141, *Business Combinations*
FASB Statement No. 156, *Accounting for Servicing of Financial Assets*
FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*
FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*
FASB Special Report, *A Guide to Implementation of Statement 115 on Accounting for Certain Investments in Debt and Equity Securities: Questions and Answers*
FASB Special Report, *A Guide to Implementation of Statement 140 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities: Questions and Answers*
APB Opinion No. 16, *Business Combinations*
APB Opinion No. 20, *Accounting Changes*
AICPA Audit and Accounting Guide, *Banks and Savings Institutions*
SEC Staff Accounting Bulletin No. 61, *Adjustments of Allowances for Business Combination Loan Losses—Purchase Method Accounting*
International Accounting Standard 39, *Financial Instruments: Recognition and Measurement*

ISSUE

1. A key concept in Statement 140 is that a transferred asset that has been accounted for as sold is accounted for as "re-purchased" if the basis for that sale accounting becomes invalid subsequent to the initial accounting for the transaction. That concept is articulated in paragraph 55 of Statement 140, which states:

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

Two circumstances that have raised questions about the application of paragraph 55 occur when the provisions of paragraph 55 are triggered because (a) a qualifying special-purpose entity (SPE) becomes nonqualifying and (b) the transferor holds a contingent right such as a contingent call option on the transferred financial assets (for example, a removal of accounts provision or "ROAP") and the contingency has been met.

2. A qualifying SPE may become nonqualifying or "tainted" for several reasons, including a decision by the outside beneficial interest holders to grant the SPE decision-making powers that are prohibited for qualifying SPEs. Under the requirements of paragraph 55, the disqualification of a formerly qualifying SPE will generally result in the "re-purchase" by the transferor of *all* assets sold to and still held by the SPE because the transferee (the SPE that is no longer qualifying) is constrained from pledging or exchanging the financial assets and this condition provides more than a trivial benefit to the transferor (refer to paragraph 9(b) of Statement 140). This Issue considers the application of the guidance in paragraph 55 prior to any consideration of

whether the transferee (for example, an SPE) should be consolidated and, therefore, prior to considering any eliminating entries that may result from consolidation.

3. Under Statement 140, rights held by the transferor (typically in the form of purchased options or forward purchase contracts) only preclude sale accounting under paragraph 9(c)(2) if they provide the transferor with the *unilateral* right to cause the holder to return *specific* transferred assets. One class of contingent rights (including certain ROAPs[1]) does not preclude sale accounting because it does not include unilateral rights. The most common type of ROAP is a default ROAP, which gives the holder the right but not the obligation to purchase (call) a loan that is in default (the meaning of default typically is specifically defined in each transaction). Such rights are common in credit card securitizations and in securitizations sponsored by the Government National Mortgage Association (GNMA)[2] and other governmental or quasi-governmental agencies. Once the contingency is met (in this case, when a given loan goes into default), the call option on that asset (loan) is no longer contingent. At that point, the transfer fails the criterion in paragraph 9(c)(2) of Statement 140 because the transferor has the unilateral right to purchase a specific transferred asset. Under the requirements of paragraph 55, when a contingency related to a transferor's contingent right has been met, the transferor generally must account for the "re-purchase" of *a specific subset* of the assets transferred to and held by the qualifying SPE. The transferor must do so *regardless of whether it intends to exercise its call option*.

4. The issues are:

Issue 1—How the transferor should account for ~~retained~~ beneficial interests that continue to be held by the transferor when the underlying assets are re-recognized under the provisions of paragraph 55 because the transferor's contingent right (for example, a ROAP or other contingent call option on the transferred financial assets) becomes exercisable, including whether any gain or loss should be recognized by the transferor when paragraph 55 is applied

Issue 2—How assets re-recognized by the transferor that were previously sold to an SPE that was formerly considered qualifying should be accounted for when the entire SPE

[1] Although this Issue uses ROAPs as an example, the guidance is not limited to ROAPs. Contingent rights can arise in many other fact patterns. Refer to Question 49 of the Statement 140 Special Report for more information.
[2] GNMA ROAPs are actually held by the servicer of the transferred loans. However, when the servicer is the transferor, the provisions of Statement 140 apply to the ROAP.

becomes nonqualifying under the provisions of paragraph 55, including whether any gain or loss should be recognized by the transferor when paragraph 55 is applied

Issue 3—Whether under any circumstances a loan loss allowance should initially be recorded for loans that do not meet the definition of a *security* when they are re-recognized under the provisions of paragraph 55

Issue 4—How re-recognition under paragraph 55 of assets sold affects the accounting for the related servicing asset

Issue 5—After a paragraph 55 event, how the transferor should account for ~~its retained~~ the interests that continue to be held by the transferor ~~(other than the servicing asset)~~.

EITF DISCUSSION

5. The Task Force reached a consensus on Issue 1 that upon application of paragraph 55, no gain or loss should be recognized in earnings with respect to any beneficial interests ~~retained~~ that continue to be held by the transferor. Beneficial interests should be evaluated periodically for possible impairment, including at the time paragraph 55 is applied. A gain or loss may be recognized upon the exercise of a ROAP or similar contingent right with respect to the "re-purchased" portion of the transferred assets that were sold if the ROAP or similar contingent right held by the transferor is not accounted for as a derivative under Statement 133 and is not at-the-money, resulting in the fair value of those repurchased assets being greater or less than the related obligation to the transferee.

6. The Task Force reached a consensus on Issue 2 that in the event the entire SPE becomes nonqualifying upon application of paragraph 55, no gain or loss should be recognized with respect to the "re-purchase" by the transferor of the financial assets originally sold that remain outstanding in the SPE (or the portion thereof if the transferor continues to hold ~~retained~~ an ~~partial~~ interest in those assets). The fair value of the re-recognized assets will equal the fair value of the liability assumed by the transferor because the transferor is contractually required to pass on 100 percent of the cash flows from the re-recognized assets to the SPE for distribution in accordance with the contractual documents governing the SPE. The process of determining the fair value of both the re-recognized assets and the assumed liability may require a careful

analysis of all of the expected cash flows of the securitization vehicle, including cash flows of assets within the vehicle that are not subject to paragraph 55 (for example, proceeds that are temporarily reinvested by the SPE). In performing that analysis, the transferor would need to consider both the timing and the amounts of the expected cash flows and also which party has rights to such expected cash flows at the time of the paragraph 55 event.

7. The Task Force reached a consensus on Issue 3 that under no circumstances should a loan loss allowance be initially recorded for loans that do not meet the definition of a *security* when they are re-recognized pursuant to paragraph 55.

8. The Task Force reached a consensus on Issue 4 that when a paragraph 55 event occurs, the accounting for the servicing asset related to the previously sold financial assets does not change as a result of the application of paragraph 55. That is, even though the transferor has regained control over the previously sold assets, the cash flows from those assets will contractually be paid to the SPE, which will then distribute the proceeds to satisfy its contractual obligations (including obligations to the beneficial interest holders). Because the transferor, as servicer, is still contractually required to collect the asset's cash flows for the benefit of the SPE and otherwise service the assets, it should continue to recognize the servicing asset and assess the asset for impairment if subsequently measured using the amortization method as required by Statement 140.

9. The Task Force reached a consensus on Issue 5 that when a paragraph 55 event occurs, the transferor should continue to account for ~~its retained~~ the interests that continue to be held by the transferor in those assets apart from any re-recognized assets. That is, the ~~retained~~ interests that continue to be held by the transferor should not be combined with and accounted for with the re-recognized assets. However, a subsequent event that results in the transferor reclaiming those assets from the transferee—for example, the exercise of a ROAP or the consolidation by the transferor of the SPE in accordance with applicable generally accepted accounting principles, including Interpretation 46—would result in a recombination of the ~~retained~~ interests that continue to be held by the transferor with the underlying assets.

10. The consensuses in this Issue should be applied prospectively to paragraph 55 events occurring after April 2, 2003.

11. Examples illustrating the application of the consensuses in this Issue are provided in Exhibit 02-9A.

Board Ratification

12. At its April 2, 2003 meeting, the Board ratified the consensuses reached by the Task Force in this Issue.

STATUS

13. Statement 156, issued in March 2006, amends Statement 140 with respect to the accounting for separately recognized servicing assets and servicing liabilities. Statement 156 does not affect any of the consensuses reached in this Issue; however this Issue reflects the Board's decision in Statement 156 to replace the term *retained interests* with *interests that continue to be held by a transferor*. The application section of this Issue has been revised to initially measure separately recognized servicing assets at fair value.

14. No further EITF discussion is planned.

Exhibit 02-9A

EXAMPLES OF THE APPLICATION OF THE EITF CONSENSUSES ON ISSUE 02-9

Issue 1—Accounting for a Paragraph 55 Event—A Contingent ROAP Becomes Unconditional

Example 1~~—Retained~~ Interest That Continues to Be Held by Transferor That Is Accounted for as Available-for-Sale Security

On January 1, 20X1, Transferor transfers to a qualify[3]ing SPE a loan that has a par value and an initial fair value of $100. Assume that Transferor receives cash of $82 from the qualifying SPE and a beneficial interest with an initial fair value of $18, and that no servicing asset or liability is created as a result of the transfer.[3] A third party holds the senior beneficial interest, entitling it to the first $82 of loan principal collected plus interest (initial fair value of $82). The beneficial interest that continues to be held ~~retained~~ by Transferor, representing the remaining cash flows from the loan (initial fair value of $18), is subordinate to the senior beneficial interest (that is, the subordinate ~~retained~~ interest that continues to be held by Transferor bears credit losses first before the senior beneficial interest is affected).

Transferor initially classifies the ~~its retained~~ interest that it continues to hold as available-for-sale and will subsequently account for it under the guidance in Statement 115 and Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets." Transferor holds a default ROAP with a fixed strike price equal to the loan's par value that gives Transferor the right (but not the obligation) to reacquire the loan from the qualifying SPE if it is in default. The following journal entry would be made:

---

[3] Although most transactions result in a servicing asset or servicing liability, including one here would result in a gain or loss being recognized on this sale. For this example, the FASB staff decided not to include entries relating to servicing in order to focus on the question in Issue 1, which is unrelated to servicing. A separate example that includes a servicing asset is provided in Example 4.

January 1, 20X1

Cash	$82	
~~Retained i~~Interest in qualifying SPE that continues to be held by Transferor	18	
Loan		$100

To record transfer accounted for as a sale.

Six months after the transfer, Transferor anticipates that the qualifying SPE will collect only $85 plus interest on the transferred loan, a $15 loss. Transferor records the decrease in the fair value of the ~~its residual~~ ~~retained~~ interest that it continues to hold from $18 to $3 under Statement 115.[4] The following journal entry would be made:

January 1, 20X1–June 30, 20X1

Other comprehensive income	$15	
~~Retained i~~Interest in qualifying SPE that continues to be held by Transferor		$15

To record decrease in fair value of the ~~retained~~ interest that continues to be held by Transferor.

On December 1, 20X1, the loan goes into default. At that date, the loan has an estimated fair value of:

Scenario A: $85

Scenario B: $70

Scenario C: $90

[4] The decline in the fair value of the senior beneficial interest that might result from the reduced credit enhancement has not been considered in this example in determining the fair value of the residual interest. In addition, Transferor should periodically (including at the time paragraph 55 is applied) evaluate beneficial interests for other-than-temporary impairment.

Although the consensuses reached in this Issue do not address the recognition of other-than-temporary impairment losses on available-for-sale ~~retained~~ interests that continue to be held by Transferor in a securitization transaction, for purposes of Scenarios A–C, assume that the loan going into default (which occurs on December 1, 20X1) indicates an other-than-temporary impairment of the interest that continues to be held by T~~t~~ransferor~~'s retained interest~~.

Scenario A

Value remains stable at $85, ROAP becomes exercisable

December 1, 20X1

Loan	$82	
Due to qualifying SPE		$82

To record loan subject to the default ROAP and obligation to the qualifying SPE, both at fair value at the time the ROAP is no longer contingent, pursuant to paragraph 55 of Statement 140.[5]

Loss	$15	
Accumulated other comprehensive income		$15

To recognize in earnings an other-than-temporary impairment of the ~~retained~~ interest that continues to be held by Transferor because of the default on the underlying loan.

ROAP exercised by Transferor

December 31, 20X1

Due to qualifying SPE	$82	
Beneficial interest in qualifying SPE	18	
Cash		$100

To record exercise of the default ROAP and the resulting beneficial interest in the qualifying SPE to the extent of the additional investment.[6]

[5] The fair value of the portion of loan "re-purchased" is equal to the fair value of the obligation to the qualifying SPE to deliver 100 percent of the cash flows associated with that portion of the loan ""re-purchased."

[6] That additional investment would be subject to periodic evaluation for impairment under separate guidance.

Loans	$3	
~~Retained i~~Interest in qualifying SPE that continues to be held by Transferor		$3

To reclassify ~~Transferor's retained~~ the interest that continues to be held by Transferor in the loan—which has been entirely reclaimed by Transferor through exercise of the ROAP—by combining that ~~retained~~ interest with the portion of the loan previously sold ($82), so that the entire loan is combined.

Scenario B

Value declines further (from $85 to $70), ROAP becomes exercisable on December 1, 20X1

July 1, 20X1–November 30, 20X1

Other comprehensive income	$3	
~~Retained i~~Interest in qualifying SPE that continues to be held by Transferor		$3

To record decrease in fair value of the ~~retained~~ interest that continues to be held by Transferor to zero. (Additional decline in value of $12 is borne by the senior beneficial interest holders.)[1]

December 1, 20X1

Loan	$70	
Due to qualifying SPE		$70

To record loan subject to the default ROAP and obligation to the qualifying SPE at fair value at the time the ROAP is no longer contingent.[2]

Loss	$18	
Accumulated other comprehensive income		$18

To recognize in earnings an other-than-temporary impairment of the ~~retained~~ interest that continues to be held by Transferor because of the default on the underlying loan.

[1]Under Scenario B, because of the further decline in the fair value of the loan, an additional loss of $15 is anticipated. However, Transferor's loss is limited to the value of the ~~Transferor's retained~~ interest that it continues to hold ($3). At that point, the value of ~~the~~that ~~retained~~ interest is adjusted to zero. If Transferor chooses to exercise that out-of-the-money ROAP, it incurs an additional loss ($12) to be recognized upon exercise.

[2]The fair value of the portion of the loan "re-purchased" is equal to the fair value of the obligation to the qualifying SPE to deliver 100 percent of the cash flows associated with the portion of the loan "re-purchased."

ROAP exercised by Transferor

December 31, 20X1

Due to qualifying SPE	$70	
Loss	12	
Beneficial interest in qualifying SPE	18	
Cash		$100

To record exercise of the default ROAP, the resulting loss on the reacquisition of the loan to which Transferor now bears all risk and rewards, and the resulting beneficial interest in the qualifying SPE to the extent of the additional investment.[3]

Scenario C

Value recovers (from $85 to $90), ROAP becomes exercisable on December 1, 20X1

July 1, 20X1–November 30, 20X1

~~Retained i~~Interest in qualifying SPE that continues to be held by Transferor	$5	
Other comprehensive income		$5

To record increase in fair value of the ~~*retained*~~ *interest that continues to be held by Transferor to $8 ($18 – [100 – 90]).*

December 1, 20X1

Loan	$82	
Due to qualifying SPE		$82

To record loan subject to the default ROAP and obligation to the qualifying SPE at fair value at the time the ROAP is no longer contingent.[4]

Loss	$10	
Accumulated other comprehensive income		$10

To recognize in earnings an other-than-temporary impairment of the ~~*retained*~~ *interest that continues to be held by Transferor because of the default on the underlying loan.*

[3]That additional investment would be subject to periodic evaluation for impairment under applicable guidance.

[4]The fair value of the portion of the loan "re-purchased" is equal to the fair value of the obligation to the qualifying SPE to deliver 100 percent of the cash flows associated with that portion of the loan "re-purchased."

ROAP exercised by Transferor

December 31, 20X1

Due to qualifying SPE	$82	
Beneficial interest in qualifying SPE	18	
Cash		$100

To record exercise of the default ROAP and the resulting beneficial interest in the qualifying SPE to the extent of the additional investment.[5]

Loan	$8	
~~Retained i~~Interest in qualifying SPE that continues to be held by Transferor		$8

To reclassify the ~~Transferor's retained~~ interest that continues to be held by Transferor in the loan—which has been entirely reclaimed by Transferor through exercise of the ROAP—by combining that ~~retained~~ interest with the portion of the loan previously sold ($82) such that the entire loan is combined.

Issue 2—Accounting for a Paragraph 55 Event—Disqualification of the Special-Purpose Entity

Example 2~~—Retained~~ Interest That Continues to Be Held by Transferor Accounted for as Available-for-Sale Security (Pre- and Post-Transfer)

On January 1, 20X1, Transferor transfers to a qualifying SPE a debt security that has a fair value of $110 and an amortized cost basis of $100 (unrealized gains of $10 in accumulated other comprehensive income at January 1, 20X1). Assume that Transferor receives cash of $55 from the qualifying SPE and a *pari passu* beneficial interest representing 50 percent of the debt security's cash flows with an initial fair value of $55. No servicing asset or liability is created as a result of the transfer. A third party also holds a *pari passu* beneficial interest representing 50 percent of the debt security's cash flows (initial fair value of $55). Prior to the transfer, Transferor accounted for the debt security as available-for-sale under the requirements of Statement 115.

Transferor initially classifies the ~~its retained~~ interest that it continues to hold as available-for-sale and will subsequently account for it under the guidance in Issue 99-20. Transferor has no other contingent or other rights with respect to the transferred debt security. The following journal entry would be made:

[5]That additional investment would be subject to periodic evaluation for impairment under applicable guidance.

January 1, 20X1

Cash	$55	
~~Retained i~~Interest in qualifying SPE that continues to be held by Transferor	55	
Accumulated other comprehensive income	5	
Available-for-sale security		$110
Realized gain		5

To record transfer accounted for as a sale.

Six months after the transfer, the fair value of the transferred debt security has increased to $120. However, at that date an event occurs that results in the qualifying SPE being disqualified. The following journal entries would be made:

January 1, 20X1–June 30, 20X1

~~Retained i~~Interest in qualifying SPE that continues to be held by Transferor	$5	
Other comprehensive income		$5

To record increase in fair value of the ~~retained~~ interest that continues to be held by Transferor.

July 1, 20X1

Available-for-sale security	$60	
Due to SPE		$60

To record "re-purchase" of transferred financial asset and obligation to SPE at fair value.[6]

Example 3—Derivative Entered into by a Qualifying SPE

On January 1, 20X1, Transferor transfers to a qualifying SPE a fixed-rate debt security that has a fair value and an amortized cost basis of $100. Assume that Transferor receives cash of $50 from the qualifying SPE and a beneficial interest representing 50 percent of the debt security's cash flows with an initial fair value of $50. No servicing asset or liability is created as a result of the transfer. On January 1, 20X1, the qualifying SPE enters into a pay-fixed receive-LIBOR interest rate swap with a third party that has a notional amount of $50. The interest rate on the fixed leg of the swap equals the fixed interest rate on the debt security. The qualifying SPE issues a beneficial interest to a third party representing 50 percent of the debt security's principal

[6]The fair value of the portion of the available-for-sale security "re-purchased" is equal to the fair value of the obligation to the SPE to deliver 100 percent of the cash flows associated with that portion of the available-for-sale security "re-purchased." The fair value of the available-for-sale security "re-purchased" is equal to 50 percent of the total fair value of the available-for-sale security of $120.

cash flows bearing interest that varies with LIBOR (sale proceeds and initial fair value of $50). Prior to the transfer, Transferor accounted for the debt security as available-for-sale under the requirements of Statement 115. The debt security is not pre-payable.

Transferor initially classifies the ~~its retained~~ interest that it continues to hold as available-for-sale and will subsequently account for it under the guidance in Issue 99-20. Transferor has no other contingent or other rights with respect to the transferred debt security. The following journal entry would be made:

January 1, 20X1

Cash	$50	
~~Retained i~~Interest in qualifying SPE that continues to be held by Transferor	50	
Available-for-sale security		$100

To record transfer accounted for as a sale.

Six months after the transfer, the fair value of the transferred debt security has increased to $110. The fair value of the variable-rate third-party beneficial interest is $50. The fair value of the swap is a $5 liability of the qualifying SPE. At that date an event occurs that results in the qualifying SPE being disqualified. The following journal entries are applicable:

January 1, 20X1–June 30, 20X1

~~Retained i~~Interest in qualifying SPE that continues to be held by Transferor	$5	
Other comprehensive income		$5

To record increase in fair value of the ~~retained~~ interest that continues to be held by Transferor.

July 1, 20X1

Available-for-sale security	$55	
Due to SPE		$55

To record "re-purchase" of transferred financial asset and obligation to SPE at fair value.[7]

[7]The fair value of the portion of the available-for-sale security "re-purchased" and the obligation to the SPE are equal. In this example, the fair value of the portion of the available-for-sale security "re-purchased" is equal to 50 percent of the total fair value of that available-for-sale security of $110.

Issues 4 and 5—Accounting for Servicing Asset and Subsequent Accounting for ~~Retained~~ Interest That Continues to Be Held by Transferor

Example 4~~—Retained~~ Interest T~~t~~hat Continues to Be Held by Transferor Accounted for as an Available-for-Sale Security with a Servicing Asset

This example assumes the following facts:

On January 2, 20X1, Company A originates $1,000 of loans, yielding 10.5 percent interest income for their estimated life of 9 years. Company A later sells, through a "two-step" transfer using a qualifying SPE, the $1,000 principal plus the right to receive interest income of 8 percent to investors for $1,000. Company A will continue to service the loans for a fee of 100 basis points. Company A retains a 100 basis point interest-only (IO) strip receivable. The guarantor, a third party, receives 50 basis points as a guarantee fee.

At the date of transfer:

- The fair value of the servicing asset is $40 ~~(allocated cost is $36)~~.
- The total fair value of the loans including servicing is $1,~~0~~400 (allocated cost is $945.50~~10~~).
- The fair value of the interest-income strip receivable is $60 (allocated cost is $54.50).

On December 1, 20X1, an event occurs that results in the qualifying SPE being disqualified. The fair value of the portion of the originally transferred financial assets that were previously accounted for as sold that remain outstanding in the SPE on that date is $929. The fair value of the ~~retained~~ interest~~s~~ that continues to be held by Transferor (in the form of an IO strip) on that date is $58. The fair value of the servicing asset on that date is $38. The guarantee that was entered into by the SPE does not trade with the underlying assets. The fees on this guarantee will be paid as part of the cash waterfall.[8]

[8]All cash flows from the assets transferred to the trust are initially sent directly to the trust and then distributed in order of priority. The priority of payments in the cash waterfall is as follows: servicing fees, guarantees, amounts due to outside beneficial interest holders, and amounts due to the ~~residual~~ beneficial interest that continues to be held by Transferor ~~holders~~.

Issue 4—Accounting for Servicing Asset before and after a Paragraph 55 Event

Once a servicing asset is recognized it should not be added back to the underlying asset. Even when the transferor has regained control over the underlying assets via a paragraph 55 event, the related servicing asset should continue to be separately recognized~~, amortized, and evaluated for impairment under Statement 140~~.

Issue 5—Subsequent Accounting for ~~Retained~~ Interests that Continue to Be Held Transferor

Example 5—Accounting for the Sale of Loans When the ~~Retained~~ Interest That Continues to Be Held by Transferor Is an IO Strip That Is Accounted for at Fair Value in the Same Manner as an Available-for-Sale Security (per Paragraph 14 of Statement 140)

This example is based on the same facts as those assumed under Example 4. The accounting for the servicing asset after a paragraph 55 event has occurred is discussed in Issue 4.

Carrying Amount Based on Relative Fair Values

	Fair Value	Percentage of Total Fair Value	Allocated Carrying Amount
Loans	$1,040 ~~1,000~~	94.55~~90.91~~	$ 945.50~~910~~
~~Servicing asset~~	~~40~~	~~3.64~~	~~36~~
~~Retained~~~~i~~Interest that continues to be held by Transferor	60	5.45	54.50~~54~~
Total	$1,100	100.00	$1,000.00

January 2, 20X1

Cash	$1,000.00	
Interest that continues to be held by Transferor	54.50	
Servicing asset	40.00	
Loans		$1,000.00 ~~910~~
Gain on sale		94.50~~90~~

To record the sale of the assets and to recognize interest that continues to be held by Transferor and a servicing asset.

~~Servicing asset~~	~~$36~~	
~~Retained interests (available-for-sale)~~	~~54~~	
~~Loans~~		~~$90~~

~~*To reclassify loans as a servicing asset and a retained interest.*~~

December 1, 20X1

~~Retained i~~Interest that continues to be held by Transferor	$3.50~~4~~	

(available-for-sale)
    Other comprehensive income $3.50~~4~~

To subsequently measure the ~~retained~~ interest that continues to be held by Transferor in the same manner as an available-for-sale security.

After the Paragraph 55 Event

December 1, 20X1

Loans	$929	
Due to SPE		$929

To recognize the previously sold loans on Transferor's books along with the obligation to pass the cash flows associated with those loans to SPE.

Accounting for the Re-Recognized Assets and Interests That Continue to Be Held~~Retained~~ by ~~the~~ Transferor

- Transferor would continue to account for the ~~retained~~ interests that continues to be held by Transferor (in accordance with paragraph 13 of Statement 115) at fair value with changes in fair value recognized in other comprehensive income.
- Transferor would account for the loans at cost plus accrued interest in accordance with Statement 91.

Issue No. 02-12

Title: Permitted Activities of a Qualifying Special-Purpose Entity in Issuing Beneficial Interests under FASB Statement No. 140

Dates Discussed: June 19–20, 2002; September 11–12, 2002; November 21, 2002

References: FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
FASB Statement No. 156, *Accounting for Servicing of Financial Assets*
FASB Technical Bulletin No. 01-1, *Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 Related to the Isolation of Transferred Financial Assets*
FASB Special Report, *A Guide to Implementation of Statement 140 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities: Questions and Answers*

ISSUE

1. Guidance provided by Statement 140 for distinguishing between transfers of financial assets that are sales and those that are secured borrowings focuses on whether control over the transferred assets has been surrendered by the transferor and obtained by the transferee. A transferor has surrendered control over transferred financial assets if the three conditions in paragraph 9 of Statement 140 are met. Paragraph 9(b) of Statement 140 (the second condition) states:

> Each transferee (or, if the transferee is a qualifying SPE (paragraph 35), each holder of its beneficial interests) has the right to pledge or exchange the assets (or beneficial interests) it received, and no condition both constrains the transferee (or holder) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor (paragraphs 29–34).

2. In a securitization, financial assets are transferred to a securitization vehicle or special-purpose entity (SPE) that issues beneficial interests in those assets to investors and, perhaps, the transferor. The beneficial interests provide the holders with the right to receive specified cash inflows from the assets held by the SPE. In most securitizations, the SPE is constrained from pledging or exchanging the transferred financial assets. However, the holders of the beneficial interests usually are free to exchange or pledge their interests. Thus, for the transfer to be accounted for as a sale, the SPE must be a qualifying SPE (as defined in Statement 140) to meet

all of the conditions in paragraph 9 of Statement 140. If it is a qualifying SPE, then the transferor does not consolidate the SPE. If certain other criteria are met, the assets are derecognized and no liability is recognized in the consolidated financial statements of the transferor and its subsidiaries.

3. Statement 140 specifies restrictive conditions that must be met for an SPE to be considered qualifying. To be considered a qualifying SPE, paragraph 35 of Statement 140 requires that:

a. It is demonstrably distinct from the transferor (paragraph 36).
b. Its permitted activities be (1) significantly limited, (2) entirely specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds, and (3) significantly changed only with the approval of the holders of at least a majority of the beneficial interests held by entities other than any transferor, its affiliates, and its agents (paragraphs 37 and 38).
c. It may hold only: [specified assets as described in paragraph 35(c)(1)−(6)].
d. . . . it can sell or otherwise dispose of noncash financial assets . . . only in automatic response to [certain specified] conditions. . . .

4. While Statement 140 is very specific about the activities of a qualifying SPE with regard to the assets it holds and the derivatives it enters into, that Statement contains little discussion about the issuance of beneficial interests. Statement 140 does not specify whether either (a) the conditions for a qualifying SPE require that the terms of beneficial interests to be issued be specified at inception of the entity or (b) the qualifying SPE (or its designee or agent) may establish the terms of replacement beneficial interests. Issues arise in two common securitization situations that are described below.

Example 1—Initial Issuances after Inception

In typical revolving-period securitizations (like credit card securitizations), the transferor continuously transfers receivables into the securitization vehicle. The transferor receives either (a) cash proceeds or (b) an increased beneficial interest in the securitization vehicle. When the transferor receives only increased beneficial interests in the securitization vehicle, a sale is not recorded for accounting purposes (discussed more completely in paragraph 79 of Statement 140). It is common for a transferor to "build up" those~~is~~ ~~retained~~ interests that continue to be held by a transferor for a period of time. At some point, often selected by the SPE or its designee or agent (which may be the transferor or its affiliate), the qualifying SPE will issue beneficial interests in those receivables to third parties, resulting in the recognition of a sale by the transferor. The beneficial interests issued have longer terms than the short-term assets in the securitization vehicle.

Example 2—Refinancings

In some securitizations, longer-term assets are financed with short-term beneficial interests. For example, an SPE initially issues beneficial interests in the form of commercial paper with an average term of 90 days. The securitization vehicle holds receivables due in five years, which is also the intended life of the vehicle. Thus, when the 90-day commercial paper becomes due, the SPE must issue replacement beneficial interests (expressed another way, it must refinance) often on terms selected by the SPE or its designee or agent. If for any reason the SPE is unable to issue replacement beneficial interests to investors, commonly the existing beneficial interests are to be repaid by a loan to be drawn down under a prearranged backup line of credit. Such "liquidity backup lines" are sometimes provided by the transferor or its affiliate; in other cases, the liquidity backup lines are provided by third parties. The transferor typically recognizes a sale of the receivables at the time of the initial transfer and issuance of beneficial interests.

5. The issues are:

Issue 1(a)—The extent to which a qualifying SPE (or its affiliate or agent) is permitted to determine the terms of beneficial interests issued after the inception of the qualifying SPE (i) prior to the derecognition by the transferor of the assets that the beneficial interests represent (Example 1) or (ii) after derecognition by the transferor of the assets that the beneficial interests represent (Example 2)

Issue 1(b)—If an existing SPE (or its designee or agent) determines the terms of new beneficial interests, whether the conditions requiring that a qualifying SPE's activities be "significantly limited" and "entirely specified" have a different effect on a structure that contains long-term assets and issues short-term beneficial interests (LT/ST structure, Example 2) than on a structure that contains short-term assets and issues long-term beneficial interests (ST/LT structure, Example 1)

Issue 2—If a qualifying SPE (or its designee or agent) is permitted to determine the terms of newly issued beneficial interests as described in Issue 1, whether it would be permissible for the transferor to have the ability to direct the qualifying SPE to prepay previously issued beneficial interests with proceeds of newly issued beneficial interests.

EITF DISCUSSION

6. At the June 19–20, 2002 meeting, the Task Force discussed the meaning of the phrases *significantly limited* and *entirely specified* in paragraph 35(b) of Statement 140 in relation to issuances of beneficial interests after the inception of a qualifying SPE. The Task Force discussed whether a qualifying SPE can have the power to exercise judgment in determining the terms of beneficial interests within a range specified in the legal documents that established the SPE or that created its earlier beneficial interests and, if so, whether the range should be based on time to maturity, on markets (types of instruments), or on both.

7. A Task Force member noted that an additional issue relates to transfers to qualifying SPEs under a master trust arrangement. The Task Force did not reach agreement on that additional issue and did not discuss Issue 2.

8. The Task Force reached a tentative conclusion on one aspect of Issue 1 that a limitation to beneficial interests with terms of 270 days or less would establish a range that could be considered significantly limited. The Task Force discussed other ranges that might be considered significantly limited and other ways of providing guidance to interpret *significantly limited* and *entirely specified* but was not asked to reach a consensus. The Task Force requested that the FASB staff conduct further research on this Issue to better understand the characteristics of market instruments.

9. At the September 11–12, 2002 meeting, the Task Force discussed Issues 1(a) and 1(b) and considered four approaches, including an expanded version of the approach discussed at the June 19–20, 2002 meeting. Those approaches attempt to clarify the meaning of *significantly limited* and *entirely specified* in the context of the ability of a qualifying SPE to issue beneficial interests after the inception of a qualifying SPE. The Task Force was not asked to reach a consensus. However, the Task Force expressed an initial preference for an approach that focuses on whether the maturities of the beneficial interests are *well supported* by the underlying assets of the qualifying SPE. The Task Force asked the FASB staff to provide further clarification with respect to the concept of *well supported* and to consider the types of guarantees or liquidity arrangements that may be provided by the transferor, its affiliates, and its agents, and whether

those arrangements affect the determination of whether the beneficial interests are *well supported*.

10. At the November 21, 2002 meeting, the Task Force discussed Issues 1(a) and 1(b) but was not asked to reach a consensus on either Issue. The Task Force asked the staff to further develop and clarify both the approach focusing on whether maturities of beneficial interests are *well supported* and the approach focusing on restrictions on the maturities and other aspects of beneficial interests that replace other beneficial interests. Issue 2 is to be included within the Task Force discussions of Issue 1(b).

STATUS

11. An FASB staff representative announced that the FASB had decided, at its January 22, 2003 Board meeting, to address the issues in Issue 02-12 as part of a Board project on the interpretation of Statement 140. As a result, the Task Force has agreed to discontinue further discussion of this Issue.

12. Statement 156, issued in March 2006, amends Statement 140 with respect to the accounting for separately recognized servicing assets and servicing liabilities. Statement 156 does not modify this Issue; however this Issue reflects the Board's decision in Statement 156 to replace the term *retained interests* with *interests that continue to be held by a transferor*.

13. No further EITF discussion is planned.

Title: Gain Recognition on Transfers of Financial Assets under FASB Statement No. 140~~125~~ [a]

Date Discussed: March 18-19, 1998

The SEC Observer announced that the SEC staff is becoming increasingly concerned over the application of generally accepted accounting principles to a sale or securitization of financial assets and to assets that are retained or received or liabilities that are incurred. This announcement reminds financial statement preparers of the requirements for recognition, measurement, and disclosure.

1. Recognition of gains or losses on the sale of financial assets is not elective.

   Paragraph 11 of FASB Statement No. 140~~25~~, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,* as amended by FASB Statement No. 156, *Accounting for Servicing of Financial Assets*, requires that upon completion of a transfer of financial assets that satisfies the conditions for a sale, the transferor shall (a) derecognize all assets sold, (b) recognize and initially measure at their fair value all assets obtained and liabilities incurred,[9] and (c) recognize in earnings any gain or loss on the sale. The transferor should not defer in the balance sheet a gain or loss resulting from the sale of financial assets.

2. In estimating the fair value of ~~retained~~ interests that continue to be held by transferor and new interests, including separately recognized servicing assets and servicing liabilities, the assumptions used in those valuations must be consistent with market conditions.

   In accounting for a sale of financial assets, fair value is used in allocating the carrying amount of the financial assets between the assets sold and the interests ~~retained~~ that continue to be held by the transferor. Fair value also is used in the initial measurement of assets obtained and liabilities incurred in a sale. Fair value is the amount at which an item could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Paragraph ~~43~~69 of Statement 1~~25~~40, as amended by Statement 156, prescribes that if quoted market prices are not available, the estimate of fair value shall be based on the best information available, which may include the results of valuation techniques. If fair values are estimated, those valuations should incorporate assumptions that market participants would use in their estimates of values, future revenues, and future expenses, including assumptions about interest rates, default, prepayment, and volatility. Thus, using assumptions that are not consistent with current market conditions in order to

[a] This topic was formerly titled, "Gain Recognition on Transfers of Financial Assets under FASB Statement No. 125."

[9] Paragraphs ~~42–45 of Statement 125~~ 68–72 of Statement 140, as amended by Statement 156, provide guidance on estimating fair value.

ascribe intentionally low or high values to new interests or ~~retained~~ interests that continue to be held by the transferor is not appropriate.

3. Assumptions and methodologies used in estimating the fair value of similar instruments should be consistent.

The discussion of fair value in paragraph ~~43~~69 of Statement 1~~25~~40, as amended by Statement 156, provides useful guidance in the determination of fair value for both initial and subsequent measurements. That guidance indicates that in estimating the fair value of instruments that do not have quoted market prices, the quoted market prices of similar investments or the current market information assumed in valuing similar instruments may be considered. Likewise, it would be inappropriate to use significantly different values or assumptions for new ~~or retained~~ instruments or interests that continue to be held by the transferor that are similar.

4. Significant assumptions used in estimating the fair value of ~~retained~~ interests that continue to be held by the transferor and new interests at the balance sheet date should be disclosed. Significant assumptions generally include quantitative amounts or rates of default, prepayment, and interest.

FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments,* requires the disclosure of fair values of financial instruments at the balance sheet date ~~for retained and new interests that are financial instruments~~. In addition, paragraph 10 of Statement 107 requires the disclosure of significant assumptions used to estimate the fair value of those instruments. Paragraphs 17(f~~e~~)(2) and 17(g)(3) of Statement 140~~125~~, as amended by Statement 156, require~~s~~ similar disclosures of fair value and significant assumptions for recognized servicing assets and servicing liabilities. Assumptions regarding defaults, prepayments, and discount rates generally are significant in estimating the fair values of financial instruments, servicing assets, and servicing liabilities and, therefore, should be disclosed.

Paragraph 17(h) of Statement 140, as amended by Statement 156, requires that an entity that securitizes financial assets during the period disclose, among other things, the key assumptions used in measuring the fair value of interests that continue to be held by the transferor, if any, and servicing assets or servicing liabilities, if any, at the time of securitization (including, at a minimum, quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable financial assets, and anticipated credit losses, if applicable). Paragraph 17(i) of Statement 140, as amended by Statement 156, requires similar information for a transferor’s interests in securitized assets at the date of the latest statement of financial position.

Subsequent Developments

Statement 156, issued in March 2006, amends Statement 140 with respect to the measurement of separately recognized servicing assets and servicing liabilities. Statement 156 does not modify this announcement; however, certain paragraph references have been updated.

~~Statement 125 was replaced by FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, in September 2000. Statement 140 affirms some of this announcement with modification and does not affect other parts of the announcement.~~

1. ~~Statement 140 carries forward the provisions of paragraph 11 of Statement 125 without reconsideration.~~

2. ~~The guidance from paragraphs 43 and 44 of Statement 125 has been carried forward to paragraphs 69 and 70 of Statement 140, which also provide additional guidance about estimating the fair value of retained and new interests.~~

3. ~~Statement 140 does not affect the guidance in paragraph 3 of this announcement that assumptions and methodologies should be consistent.~~

4. ~~Paragraph 17(f) of Statement 140 requires that an entity that securitizes financial assets during the period disclose, among other things, the key assumptions used in measuring the fair value of retained interests at the time of securitization (including, at a minimum, quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable financial assets, and anticipated credit losses, if applicable). Paragraph 17(g) requires similar information for retained interests in securitized assets at the date of the latest statement of financial position.~~

~~While Topic D-69 deals with sales of financial assets, Statement 140's disclosure requirements apply to securitizations of financial assets, and not all sales are securitizations. Therefore, this part of this announcement is affirmed only as it applies to disclosures about retained interests in securitizations of financial assets.~~

Statement 133 Implementation Issues

Title: Embedded Derivatives: Beneficial Interests Issued by Qualifying Special-Purpose Entities
Paragraph references: 12, 60, 61
Date released: October 1999
Date Revision posted to website: March 22, 2006
<u>Affected by:</u> FASB Statement No. 156, *Accounting for Servicing of Financial Assets*

Revised March 17, 2006

Note: This issue was not resolved by the issuance of either FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, (issued in April 2003), or FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments* (issued in February 2006). Resolution of this issue is expected to follow completion of a limited-scope interpretation of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. As a result, the guidance in this issue remains tentative and is subject to change pending the FASB's further consideration of those issues.

QUESTION

How should a beneficial interest issued by a qualifying special-purpose entity (SPE), as defined by FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,* be evaluated under paragraph 12 of Statement 133?

BACKGROUND

Paragraph 12 of Statement 133 requires that an embedded derivative be accounted for separately as a freestanding derivative instrument if all of the following criteria are met: (a) the economic characteristics of the embedded derivative instrument are not clearly and closely related to the economic characteristics and risks of the host contract, (b) the hybrid instrument is not remeasured at fair value with changes in fair value reported in earnings as they occur, and (c) a separate instrument with the same terms as the embedded derivative instrument would meet the definition of a derivative instrument subject to the requirements of Statement 133.

As discussed in tentative Statement 133 Implementation Issue No. D2, "Applying Statement 133 to Beneficial Interests in Securitized Financial Assets (a Resolution of the Issues Raised in Implementation Issue D1)" (which was withdrawn in March 2003), a beneficial interest issued in a securitization transaction that does not meet the definition of a derivative in its entirety must be evaluated under paragraph 12 similar to any other security that may contain terms that affect some or all of the cash flows required by the contract in a manner similar to a derivative instrument. In discussing the application of paragraph 12, tentative Implementation Issue D2 had stated:

> In evaluating whether a beneficial interest that does not meet the definition of a derivative has an embedded derivative requiring bifurcation under paragraph 12, a beneficial interest holder must consider the terms of the beneficial interest itself and the aggregate sources of cash flows that are available to service the interest. That is, beneficial interest holders must consider whether the nature and extent of cash flows generated by the securitized financial instruments are or are not consistent with the stated terms of the interest. Further, the consideration of whether a beneficial interest contains an embedded derivative that must be bifurcated should include the priority of interests (that is, the "cash waterfall"), the relative concentration of risks across various tranches of securities issued by the securitization vehicle, and the nature of any additional credit enhancement or other guarantee available to the interests.

Paragraphs 60 and 61 provide additional guidance for determining when a hybrid instrument contains an embedded derivative that is not clearly and closely related to the host contract.

Questions have been raised regarding the application of the bifurcation guidance in Statement 133 to beneficial interests issued by qualifying SPEs. Specifically, some have questioned whether an investor's beneficial interest in a qualifying SPE is automatically a hybrid instrument that contains an embedded derivative requiring bifurcation if the qualifying SPE holds a combination of debt or equity securities and derivative instruments. In addition, some have questioned how to determine the nature of the host contract in performing the bifurcation analysis.

Four examples of securitization transactions involving qualifying SPEs are outlined below.

Example 1
A qualifying SPE holds fixed-rate corporate bonds (7 percent coupon rate) and a pay-fixed (at 7 percent), receive-variable (LIBOR) interest rate swap. The notional amount of the swap matches the principal amount of the corporate bonds, and the expiration date of the swap matches the maturity date of the bonds. An investor purchases a beneficial interest issued by the qualifying SPE that has an interest rate based on LIBOR and a maturity date that is the same as the securitized instruments.

Example 2
A qualifying SPE holds EURO-denominated variable-rate corporate bonds and a pay-floating-EURO and receive-fixed-U.S. dollar foreign currency interest rate swap. The notional amount of the swap matches the principal amount of the corporate bonds, and the index on which the swap's variable rate is based matches the index on which the bonds' variable rate is based. Also, the swap's repricing dates match the repricing dates of the bonds, and the expiration date of the swap matches the final maturity date of the bonds. An investor purchases a beneficial interest issued by the qualifying SPE that is denominated in U.S. dollars and has a fixed interest rate. The beneficial interest has a maturity date that is the same as the securitized instruments.

Example 3

A qualifying SPE holds 1000 shares of common stock of Company ABC. An investor purchases a beneficial interest issued by the qualifying SPE in the form of private-company equity. The investor receives all distributions and dividends related to the shares of Company ABC common stock held by the qualifying SPE. However, the investor does not have voting rights typical of a Company ABC shareholder. For the purposes of this example, assume that the investment in Company ABC common stock is a passive investment that meets the requirements discussed in paragraph 39 of Statement 140.

Example 4

A qualifying SPE holds 1000 shares of common stock of Company XYZ. An investor purchases a senior beneficial interest issued by the qualifying SPE that has a fixed interest rate. The transferor holds a beneficial interest in the form of private-company equity, which absorbs the first losses related to the securitized shares of common stock. There is no third-party guarantee provided for the senior interest. For the purposes of this example, assume that the investment in Company XYZ common stock is a passive investment that meets the requirements discussed in paragraph 39 of Statement 140.

For purposes of the above examples, assume that the investor does not consolidate the qualifying SPE.

RESPONSE

For the purposes of applying the guidance in paragraphs 12, 60 and 61 of Statement 133, all beneficial interests issued by qualifying SPEs (as defined by Statement 140) that contain embedded derivative features should be considered hybrid instruments with debt host contracts. Accordingly, if a beneficial interest in a qualifying SPE incorporates a return that is based on a risk type other than interest rates (such as an equity-based return), the embedded derivative that incorporates the equity-based return would not be clearly and closely related to the host contract and would require bifurcation. In addition, if a beneficial interest in a qualifying SPE incorporates a return based on interest rates, but the beneficial interest can be contractually settled in such a way that the investor would not recover substantially all of its initial recorded investment due to an embedded interest rate feature, the embedded derivative would not be considered clearly and closely related to the debt host contract and would require bifurcation.

A beneficial interest issued by a qualifying SPE should not automatically be considered a hybrid instrument that contains an embedded derivative requiring bifurcation simply because the qualifying SPE holds a combination of instruments—that is, debt and equity securities and derivative instruments. As previously discussed in tentative Implementation Issue D2, in evaluating whether a beneficial interest has an embedded derivative requiring bifurcation under paragraph 12, a beneficial interest holder must consider both the terms of the beneficial interest it holds and the aggregate sources of cash flows that are available to service the interest.

The examples in the Background section are analyzed as follows.

Example 1
The investor holds a beneficial interest with a payoff equal to a variable-rate bond based on LIBOR. The beneficial interest does not incorporate a return that is based on a risk type other than interest rates. The securitized instruments—the fixed rate bonds with a 7 percent coupon rate and the interest rate swap with fixed payments based on a 7 percent rate and a floating leg based on LIBOR—provide sufficient LIBOR cash flows to satisfy the terms of the beneficial interest. Therefore, the beneficial interest does not contain an embedded derivative that warrants separate accounting under Statement 133.

Example 2
The investor holds a beneficial interest with a payoff equal to a U.S.-dollar denominated fixed-rate bond. The beneficial interest does not incorporate a return that is based on a risk type other than interest rates. The securitized instruments—the EURO-denominated variable-rate corporate bonds and the receive-fixed-U.S. dollar foreign currency interest rate swap—provide sufficient U.S. dollar fixed-rate cash flows to satisfy the terms of the beneficial interest. Therefore, the beneficial interest does not contain an embedded derivative that warrants separate accounting under Statement 133.

Example 3
The investor holds a beneficial interest with a return based on Company ABC common stock. The beneficial interest must be analyzed as a debt host contract. Because the beneficial interest incorporates a return based on equity prices, it contains an embedded feature based on equity prices. That embedded feature permits the investor to participate in fair value changes of Company ABC common stock and incorporates a floor on equity prices that effectively limits the potential loss that would result from a decline in value of Company ABC stock. The embedded equity derivative is not clearly and closely related to the host contract and would require bifurcation.

Example 4
The investor in the senior interest holds a beneficial interest with stated terms that provide for a fixed return. The transferor holds an interest with an equity-based return. Both beneficial interests must be analyzed as debt host contracts. The transferor's interest contains an embedded feature that permits the investor to participate in fair value changes of Company XYZ common stock, after the senior interest is satisfied, plus a purchased floor on equity prices (when the transferor's interest has a fair value of zero) that effectively limits the potential loss that would result from a decline in value of Company XYZ stock. The embedded equity derivative is not clearly and closely related to the host contract and would require bifurcation. With respect to the investor's senior interest, although the stated terms of the interest indicate a fixed return, the securitized shares of Company XYZ stock may not provide sufficient cash flows to satisfy the stated terms of the interest. Therefore, the investor's interest contains an embedded feature that

is a written cap on equity prices equal to the investor's stated fixed return plus a purchased floor on equity prices that effectively limits the potential loss that would result from a decline in value of Company XYZ stock to the amount beyond the loss absorbed by the junior interest. Therefore, the senior interest contains an embedded equity derivative that is not clearly and closely related to the host contract and would require bifurcation.

If a beneficial interest in a qualifying SPE is not a derivative in its entirety and does not contain an embedded derivative that warrants separate accounting under Statement 133, the investor should consider the applicability of paragraphs 14 and 362 of Statement 140 (as amended by Statement 156), which require that ~~retained~~ interests that continue to be held by a transferor in securitizations in which the holder may not recover substantially all of its recorded investment be subsequently measured like investments in debt securities classified as available-for-sale or trading under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.

Effective Date and Transition

The effective date of the revised implementation guidance in this Issue is the first day of the first fiscal quarter beginning after [open]. If an entity had not bifurcated an embedded derivative but is required to do so under the revised guidance, the entity should account for the effects of initially complying with the revised implementation guidance prospectively for all existing beneficial interests whether purchased in a third-party securitization or interests that continue to be held~~retained~~ by transferors as of the effective date of this Issue, except for the existing contracts that qualify for the grandfathering provisions of paragraph 50, which exempts certain hybrid instruments from the embedded derivative provisions of Statement 133 on an all-or-none basis. The effects of initially complying with the revised implementation guidance as of the effective date should be reported as a cumulative-effect-type adjustment of net income.

The above response represents a tentative conclusion. The status of the guidance will remain tentative until it is formally cleared by the FASB and incorporated into an FASB staff implementation guide. The comment period for this Issue ended on July 1, 2002. The FASB plans to consider these issues further in a limited-scope interpretation of FASB Statement 140.

Title:	Embedded Derivatives: Modified Coinsurance Arrangements and Debt Instruments That Incorporate Credit Risk Exposures That Are Unrelated or Only Partially Related to the Creditworthiness of the Obligor under Those Instruments
Paragraph references:	12, 14, 61(c)
Date cleared by Board:	April 2, 2003
Date revision posted to website:	March 22, 2006
Affected by:	FASB Statements No. 155, *Accounting for Certain Hybrid Financial Instruments*, and No. 156, *Accounting for Servicing of Financial Assets*

Revised March 17, 2006

QUESTIONS

Are the embedded features of a debt instrument that incorporates credit risk exposures that are unrelated or only partially related to the creditworthiness of the obligor under that instrument clearly and closely related to the debt host contract? Does a modified coinsurance arrangement, in which funds are withheld by the ceding insurer and a return on those withheld funds is paid based on the ceding company's return on certain of its investments, contain an embedded derivative feature that is not clearly and closely related to the host contract?

BACKGROUND

Questions have been raised regarding the following examples that illustrate instruments that incorporate credit risk exposures that are unrelated or only partially related to the creditworthiness of the obligor under that instrument.

Example 1—Credit-Linked Note Issued by a Corporation

Company A issues a fixed-rate, 10-year, $10 million credit-linked note to an investor that provides for periodic interest payments and the repayment of principal at maturity. However, upon default of a specified reference security (a Company X subordinated debt obligation)[1] the redemption value of the note may be zero or there may be some claim to the recovery value of the reference security (depending on the terms of the specific arrangement). In an event of default of the specified reference security, there is no recourse to the general credit of the obligor

[1] Generally, the term *reference security* refers to the security whose credit rating or default determines the cash flows under a credit derivative. Usually, the terms of credit-linked notes explicitly reference CUSIP numbers of securities in the marketplace.

(Company A). In exchange for accepting the default risk of the reference security, the note entitles the investor to an enhanced yield. The transaction results in the investor "selling credit protection" and Company A "buying credit protection."

Example 2—Reinsurer's Receivable Arising from a Modified Coinsurance Arrangement
Reinsurance Company B enters into a modified coinsurance arrangement (also referred to as a modco arrangement), which is a reinsurance arrangement in which funds are withheld by the ceding insurer, thereby creating an obligation for the ceding company to pay the reinsurer at a later date. Concurrently, the reinsurer (Company B) recognizes a funds-withheld receivable from the ceding insurer as well as a liability representing reserves for the insurance coverage assumed under the modco arrangement. (The amount of Company B's receivable is the ceding company's statutory reserve, whereas the amount of Company B's liability is the reserve under generally accepted accounting principles.) The terms of the ceding company's payable (and Company B's funds-withheld receivable) provide for the future payment of a "principal" amount plus a return (that may be negative) that is based on a specified proportion of the ceding company's return on either its general account assets or a specified block of those assets (such as a specific portfolio of its investment securities). That portfolio is typically composed primarily of fixed-rate debt securities.

Paragraph 61(c) of Statement 133 discusses whether certain embedded credit-sensitive features are clearly and closely related to the host contract. It states:

> *Credit-sensitive payments*. The creditworthiness of the debtor and the interest rate on a debt instrument are considered to be clearly and closely related. Thus, for debt instruments that have the interest rate reset in the event of (1) default (such as violation of a credit-risk-related covenant), (2) a change in the debtor's published credit rating, or (3) a change in the debtor's creditworthiness indicated by a change in its spread over Treasury bonds, the related embedded derivative would *not* be separated from the host contract.

RESPONSE

No. Paragraph 61(c) of Statement 133 indicates that the creditworthiness of an obligor (debtor) of a debt instrument and the interest rate on that instrument are clearly and closely related. Paragraph 190 illustrates a credit-sensitive bond in which the interest rate resets based on changes in the obligor's credit rating. The analysis of that example indicates that the economic characteristics and risks of the embedded credit derivative are clearly and closely related to the economic characteristics and risks of the debt host contract. Conversely, if an instrument incorporates a credit risk exposure that is different from the risk exposure arising from the creditworthiness of the obligor under that instrument, such that the value of the instrument is affected by an event of default or a change in creditworthiness of a third party (that is, an entity that is not the obligor), then the economic characteristics and risks of the embedded credit derivative are not clearly and closely related to the economic characteristics and risks of the host contract, even though the obligor may own securities issued by that third party.

The credit-linked note described in Example 1 includes an embedded credit derivative feature. In that example, the credit risk exposure of the reference security (Company X) and the risk exposure arising from the creditworthiness of the obligor (Company A) are not clearly and closely related. Thus, the economic characteristics and risks of the embedded derivative feature are not clearly and closely related to the economic characteristics and risks of the debt host contract and, accordingly, the criterion in paragraph 12(a) is met. (Note that Statement 155, which was issued in February 2006, ~~and~~ allows for a fair value election for hybrid financial instruments that otherwise would require bifurcation. A ~~H~~hybrid financial instrument~~s~~ that ~~are~~is elected to be accounted for in ~~their~~ its entirety at fair value cannot be used as a hedging instrument in a Statement 133 hedging relationship.)

With respect to the **modco arrangement** in Example 2, the ceding company's funds-withheld payable and Company B's funds-withheld receivable includes an embedded derivative feature that is not clearly and closely related to the host contract. The yield on the payable and receivable in the host contract in this example is based on a specified proportion of the ceding company's return on either its general account assets or a specified block of those assets (such as a specific portfolio of the ceding company's investment securities). The risk exposure of the ceding company's return on its general account assets or its securities portfolio is not clearly and closely related to the risk exposure arising from the overall creditworthiness of the ceding company, which is also affected by other factors. Consequently, the economic characteristics and risks of the embedded derivative feature are not clearly and closely related to the economic characteristics and risks of the host contract and, accordingly, the criterion in paragraph 12(a) is met. This analysis applies whether the host contract is determined to be a debt host or an insurance contract. For example, if the host contract is determined to be the modco arrangement (including the funds-withheld receivable-payable but excluding the embedded derivative), the economic characteristics and risks of the embedded derivative feature are not clearly and closely related to the economic characteristics and risks of the host contract and, accordingly, the criterion in paragraph 12(a) is met.

In both of these examples, the embedded derivative feature generally will require bifurcation unless a fair value election is made pursuant to Statement 155. However, the criteria in paragraphs 12(b) and 12(c) of Statement 133 must be considered prior to concluding that the embedded derivative feature should be bifurcated and accounted for separately. In Example 1, consideration should be given to whether the embedded derivative feature could possibly not be subject to Statement 133 as a financial guarantee under paragraph 10(d) and, in that case, the embedded derivative feature would not warrant bifurcation. In Example 2, the other criteria in paragraph 12 generally would be met, thereby requiring that the embedded derivative feature be bifurcated and accounted for separately unless a fair value election is made pursuant to Statement 155. The nature of the embedded derivative feature and the host contract in both examples should be determined based on the facts and circumstances of the individual contract.

Statement 133 Implementation Issue No. D1, "Application of Statement 133 to Beneficial Interests in Securitized Financial Assets," addresses implementation issues related to the scope exception in paragraph 14 of Statement 133 for interest-only strips and principal-only strips. Implementation Issue D1 indicates that certain assets or liabilities that are beneficial interests or ~~retained~~ interests that continue to be held by a transferor in *securitized* financial assets are not subject to Statement 133. Implementation Issue D1 does not apply to interests in *nonsecuritized* financial assets. Accordingly, the implementation guidance in Implementation Issue B36 does not apply to hybrid instruments that are beneficial interests or ~~retained~~ interests that continue to be held by a transferor in *securitized* financial assets if they are not subject to Statement 133 pursuant to Implementation Issue D1.

This Implementation Issue should be applied to all other arrangements that incorporate credit risk exposures that are unrelated or only partially related to the creditworthiness of the issuer of that instrument. The guidance in this Implementation Issue does not affect the accounting for a nonrecourse debt arrangement (that is, a debt arrangement in which, in the event that the debtor does not make the payments due under the loan, the creditor has recourse solely to the specified property pledged as collateral).

At any time during the fiscal quarter that the guidance in this Implementation Issue is initially applied, companies that have ceded insurance under existing modco arrangements may reclassify securities from the held-to-maturity and available-for-sale categories into the trading category without calling into question the intent of those companies to hold other debt securities to maturity in the future; however, those "taint-free" reclassifications are limited to the amount and type of securities related to the embedded derivatives that are being newly accounted for as derivatives in conjunction with the initial application of that guidance to modco arrangements. The ceding companies should account for those reclassifications as a transfer between categories of investments under paragraph 15 of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities.*

EFFECTIVE DATE AND TRANSITION

The effective date of the implementation guidance in this Issue is the first day of the first fiscal quarter beginning after September 15, 2003. Earlier application as of the beginning of a fiscal quarter is permitted. If an entity had not bifurcated an embedded derivative but is required to do so under the revised guidance, the entity should account for the effects of initially complying with the revised implementation guidance prospectively for all existing financial instruments, except for the existing contracts that qualify for the grandfathering provisions of paragraph 50, which exempts certain hybrid instruments from the embedded derivative provisions of Statement 133 on an all-or-none basis. The effects of initially complying with the revised implementation guidance as of the effective date should be reported as a cumulative-effect-type adjustment of net income.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

FASB Staff Interim Guidance

Title:	Recognition and Measurement of Derivatives: Application of Statement 133 to Beneficial Interests in Securitized Financial Assets
Paragraph references:	12–14, 310, Implementation Issue B36
Date cleared by Board:	June 28, 2000
Date latest revision posted to website:	March 22, 2006
Affected by:	FASB Statements No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities,* No. 155, *Accounting for Certain Hybrid Financial Instruments,* and No. 156, *Accounting for Servicing of Financial Assets*

Revised March 17, 2006

Note: See Effective Date and Transition section for restrictions on the applicability of the interim guidance on this Implementation Issue.

QUESTIONS

The FASB staff has received the following inquiries regarding the application of the exception in paragraph 14 of Statement 133 to certain beneficial interests issued in securitization transactions subject to FASB Statement No. 125 (now FASB Statement No. 140), *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*:

1. What types of instruments qualify for the exception in paragraph 14 of Statement 133? Does that exception apply to only certain interest-only and principal-only strips, or does it apply to other types of beneficial interests in securitized financial assets? Paragraph 14 of Statement 133 states:

> However, interest-only strips and principal-only strips are not subject to the requirements of this Statement provided they (a) initially resulted from separating the rights to receive contractual cash flows of a financial instrument that, in and of itself, did not contain an embedded derivative that otherwise would have been accounted for separately as a derivative pursuant to the provisions of paragraphs 12 and 13 and (b) do not incorporate any terms not present in the original financial instrument described above.

2. If the exception in paragraph 14 does not apply to some types of beneficial interests issued in securitization transactions, do those beneficial interests meet the definition of a derivative in paragraph 6 of Statement 133?

3. If it is determined pursuant to Question 2 that some beneficial interests meet the definition of a derivative in paragraph 6 of Statement 133, how would that conclusion be reconciled to paragraph 3 of FASB Statement No. 134, *Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise*?

RESPONSE

With respect to Question 1, the staff believes that the exception in paragraph 14 of Statement 133 for interest-only and principal-only strips could be interpreted narrowly. That is, the notion in paragraph 14(b) that the interest-only and principal-only strips do not incorporate any terms not present in the original securitized financial asset could be interpreted to relate only to situations where the allocation of interest flows and principal flows is based on *all or a specified proportion* of those respective cash flows of the original instrument. However, the staff recognizes that some may have interpreted paragraph 14(b) more broadly to encompass certain beneficial interests other than interest-only and principal-only strips, because they view securitization transactions generally as a reallocation of the cash flows of the original securitized assets. For example, some may have interpreted the scope exception in paragraph 14 to encompass those beneficial interests that involve prioritization of cash flows due to prepayment risk or credit risk, because those risks are present in the original securitized assets. The staff understands that use of the phrase *any terms not present* in paragraph 14(b) has created some confusion.

The staff further understands that some may have interpreted paragraph 14 as excluding all ~~retained~~ interests that continue to be held by a transferor (previously referred to as *retained interests*) from Statement 133 because of the reference to retained interests in paragraph 310 in the basis for conclusions. Paragraph 310 states, in part, "Accordingly, the Board decided to exclude from the scope of this Statement interest-only and principal-only strips that meet the criteria in paragraph 14 and further consider the accounting for them in conjunction with its consideration of accounting for retained interests in securitizations." The staff observes that the language in paragraph 14 of Statement 133 makes no comments that distinguish between interests that continue to be held~~are retained~~ by a~~the~~ transferor in a securitization transaction and those that are held by third-party investors.

A narrow interpretation of paragraph 14 could require many beneficial interests in securitized financial assets to be assessed to determine whether they meet the definition of a derivative in its entirety pursuant to paragraph 6 of Statement 133. With respect to Question 2, the staff is aware that questions have arisen about how the characteristics of a derivative in paragraph 6 of Statement 133 should be applied to beneficial interests that are subordinated to other interests. [1a]

With respect to Question 3, the staff acknowledges that some perceive a conflict between the scope of Statement 133 and the provisions of paragraph 3 of Statement 134, which permits mortgage-backed securities ~~retained~~ that continue to be held by a transferor after the securitization of mortgage loans held for sale to be classified in accordance with the provisions of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*—guidance that is analogous to the provisions of paragraph 14 of Statement 125 (now Statement 140).[1] Statement 133 amended paragraph 14 of Statement 125 to add the following introductory phrase: "Except for instruments that are within the scope of Statement 133." However, the language in paragraph 3 of Statement 134, which amends FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, omitted that introductory phrase. Thus, a conclusion that some ~~retained~~ mortgage-backed securities that continue to be held by a transferor (beneficial interests from a securitization) meet the definition of a derivative in their entirety would create a conflict with the amending language in paragraph 3 of Statement 134.

Given the issues outlined above, the staff believes the interpretation of the scope exception in paragraph 14 of Statement 133 and the determination of whether beneficial interests in securitized financial assets meet the definition of a derivative are complex issues that warrant further study. Further, if it is determined that some of those beneficial interests do not meet the definition of a derivative in its entirety, the staff believes further study may be required to determine whether the guidance in Statement 133 Implementation Issue No. B12, "Embedded Derivatives in Beneficial Interests Issued by Qualifying Special-Purpose Entities," is adequate to determine whether the beneficial interest has an embedded derivative that must be accounted for separately under paragraph 12 of Statement 133.

The FASB staff plans to discuss at a future Board meeting whether the Board should undertake a project to interpret Statement 133, Statement 125 (now Statement 140), or both. That project would resolve (1) which types of instruments qualify for the exception in paragraph 14 of Statement 133 and (2) whether beneficial interests in securitized financial assets that are subordinated to other interests meet the definition of a derivative in paragraph 6 of Statement 133.

---

[1] As a result of Statement 134, in practice, certain ~~retained~~ mortgage-backed securities that continue to be held by a transferor have been classified as available-for-sale. Paragraph 20 of Statement 134 states that the Board expects that many mortgage-backed securities ~~retained~~ that continue to be held by a transferor would not be classified as held-to-maturity because Statement 125 amended Statement 115 to indicate that a security may not be classified as held-to-maturity if that security can contractually be prepaid or settled in such a way that the holder of the security would not recover substantially all of its recorded investment. In addition, paragraph 3 of Statement 134 indicates that the securitizer must classify as trading any ~~retained~~ mortgage-backed securities that continue to be held by a transferor and that it commits to sell before or during the securitization process.

[1a] The guidance in Statement 133 Implementation Issue No. A9, "Prepaid Interest Rate Swaps," also contributed to those questions, particularly with respect to the application of paragraphs 8 and 9(a). Implementation Issue A9 was superseded by the issuance of Statement 133 Implementation Issue No. A23, "Prepaid Interest Rate Swaps," which does not affect the interim guidance in this Implementation Issue.

Pending further guidance on those questions, entities may continue to apply the guidance related to accounting for beneficial interests in paragraph 14 and paragraph 362~~233~~ of Statement 140~~125~~. Paragraph 14 ~~(as amended)~~ states, "~~Except for instruments that are within the scope of Statement 133, I~~interest-only strips, loans, other receivables, or other ~~retained~~ interests that continue to be held by a transferor in securitizations that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment, except for instruments that are within the scope of Statement 133, shall be subsequently measured like investments in debt securities classified as available-for-sale or trading under Statement 115...." [2] Paragraph 362~~233~~ of Statement 140 amends Statement 115 similarly to indicate that any security that can be contractually prepaid or otherwise settled in such a way that the holder of the security would not recover substantially all of its recorded investment may not be classified as held-to-maturity. The interim guidance is not limited to securitizations involving qualifying special-purpose entities.

Because paragraphs 14 and 362~~233~~ of ~~Statement 125 (now~~ Statement 140~~)~~ require the majority of beneficial interests for which the various differing views on the application of Statement 133 are relevant to be measured like investments in securities classified as either available-for-sale or trading, the staff believes that the primary issue ultimately focuses on whether changes in the fair value of those interests can continue to be recorded in other comprehensive income or must be recorded in earnings. However, holders of beneficial interests in securitized financial assets that are not subject to paragraph 14 or paragraph 362~~233~~ of ~~Statement 125 (now~~ Statement 140~~)~~ are not required to apply Statement 133 to those beneficial interests until further guidance is issued.

For entities that have not yet adopted Statement 133, the interim guidance herein applies to all beneficial interests in securitized financial assets. An entity that has previously adopted Statement 133 and has accounted for a beneficial interest as either a derivative in its entirety or a hybrid instrument with an embedded derivative that is required to be accounted for separately shall not change its accounting for that beneficial interest. However, an entity in that situation is permitted to apply the interim guidance described herein to beneficial interests purchased after June 28, 2000, and to interests ~~retained~~ that continue to be held by a transferor in securitization transactions occurring after June 28, 2000. Alternatively, that entity is permitted to apply an interpretation of Statement 133 that the beneficial interest is either a derivative in its entirety or a hybrid instrument with an embedded derivative that must be accounted for separately.

At its June 28, 2000 meeting, the Board reached the above answer. Absent that, the staff would not have been able to provide interim guidance that would permit beneficial interests in securitized financial assets to be accounted for in accordance with paragraphs 14 and 362~~233~~ of Statement 140~~125~~ until the issues described herein are resolved.

---

[2] As indicated in paragraph 295~~206 in~~of the basis for conclusions, the provisions of paragraph 14 of Statement 140~~125~~ do not apply to situations in which only events that are not the result of contractual provisions, for example, borrower default or changes in the value of an instrument's denominated currency relative to the entity's functional currency, might cause a beneficial interest holder not to recover substantially all of its recorded investment. Pending resolution of the issues described herein, entities are not required to account for those kinds of beneficial interests in securitized financial assets under Statement 133.

EFFECTIVE DATE AND TRANSITION

Statement 155, which was issued in February 2006, addresses issues on the evaluation of beneficial interests issued in securitization transactions under Statement 133. Specifically, Statement 155 amends Statement 133 to establish a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation. The FASB staff interim guidance in this Implementation Issue remains effective for instruments recognized prior to the effective date of Statement 155.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation

Title:	Fair Value Hedges: Stratification of Servicing Assets
Paragraph references:	21(a), footnote 9 (to paragraph 21), 56
Date cleared by Board:	February 17, 1999
Date latest revision posted to website:	March 22, 2006
Affected by:	FASB Statement No. 156, *Accounting for Servicing of Financial Assets*

Revised March 17, 2006

QUESTION

Can an entity use different stratification criteria for the impairment test for servicing assets subsequently measured using the amortization method permitted ~~required~~ by FASB Statement No. ~~125~~140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (as amended by FASB Statement No. 156, *Accounting for Servicing of Financial Assets*), and for the purposes of grouping similar assets to be designated as a hedged portfolio in a fair value hedge under Statement 133?

RESPONSE

Yes. An entity may use different stratification criteria for the purposes of Statement ~~125~~140, as amended by Statement 156, impairment testing and for the purposes of grouping similar assets to be designated as a hedged portfolio in a fair value hedge under Statement 133. An entity is not required to change the stratification criteria used for the purposes of impairment testing under Statement ~~125~~140, as amended, as a result of using different stratification criteria for the purposes of grouping similar assets to be designated as a hedged portfolio in a fair value hedge. However, upon adoption of Statement 133, an entity is permitted to restratify its servicing assets pursuant to paragraph ~~37(g)~~ 63(f) of Statement ~~125~~ 140, as amended, such that the risk strata specified for Statement 133 fair value hedging purposes would also be used for Statement ~~125~~140, as amended, impairment testing purposes.

In order to qualify as a portfolio of similar assets that may be designated as a hedged item in a fair value hedge under Statement 133, servicing assets may be grouped using risk strata that meet the criteria in paragraph 21(a). Specifically, paragraph 21(a) requires that if the hedged item in a fair value hedge is a portfolio of similar assets, such as a portfolio of existing mortgage servicing assets, the individual assets must share the risk exposure for which they are designated as being hedged. Also, the change in fair value attributable to the hedged risk for each individual item in the hedged portfolio must be expected to respond in a generally proportionate manner to the overall change in fair value of the aggregate portfolio attributable to the hedged risk. Footnote 9 to paragraph 21(a)(1) of the Statement states:

> Mortgage bankers and other servicers of financial assets that designate a hedged portfolio by aggregating servicing rights within one or more risk strata used under paragraph ~~37(g)~~63(f) of Statement ~~125~~140, as amended, would not necessarily comply with the requirement in this paragraph for portfolios of similar assets. The risk strata~~um~~ under paragraph ~~37(g)~~ 63(f) of Statement ~~125~~140, as amended, can be based

on any predominant risk characteristic, including date of origination or geographic location.

Because the existing risk strata used for Statement ~~125~~140, as amended, impairment testing may not be sufficient to satisfy the requirements of paragraph 21 of Statement 133, paragraph 56 permits restratification of servicing assets under Statement ~~125~~140, as amended, for fair value hedging purposes upon the adoption of Statement 133. Paragraph 56 states, "...mortgage bankers and other servicers of financial assets may choose to restratify their servicing rights pursuant to paragraph ~~37(g)~~63(f) of Statement ~~125~~140, as amended, in a manner that would enable individual strata to comply with the requirements of this Statement regarding what constitutes 'a portfolio of similar assets.'"

If an entity chooses not to restratify servicing assets for Statement ~~125~~140, as amended, impairment testing consistent with any restratification done for compliance with Statement 133 hedging criteria, the entity would be required to record any adjustments resulting from a fair value hedge to the risk strata used for impairment testing under paragraph ~~37(g)~~63(f) of Statement ~~125~~140, as amended.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Statement 133 Implementation Issue **No. F8**

Title:	Fair Value Hedges: Hedging Mortgage Servicing Right Assets Using Preset Hedge Coverage Ratios
Paragraph references:	20, 21, 369
Date cleared by Board:	March 21, 2001
Date posted to website:	April 10, 2001
Date latest revision posted to website:	March 22, 2006
Affected by:	FASB Statement No. 156, *Accounting for Servicing of Financial Assets*

Revised March 17, 2006

QUESTION

In a fair value hedge of a portion of a recognized servicing right asset subsequently measured using the amortization method, may a company designate the hedged item at the inception of the hedge by initially specifying a series of possible percentages of the servicing right asset (that is, preset hedge coverage ratios) that each correspond to a specified independent variable? Under that approach, at the end of the hedge assessment period, the company would determine the hedged item and measure hedge ineffectiveness by determining retrospectively which hedge coverage ratio would be applied to the servicing right asset to identify the hedged item for that period. (That approach is in contrast to designating the hedged item at the inception of the hedge by specifying a single percentage of that recognized servicing right asset as the hedged item.)

BACKGROUND

Paragraph 21(a)(2) of Statement 133 states, in part, "If the hedged item is a specific portion of an asset or liability (or of a portfolio of similar assets or a portfolio of similar liabilities), the hedged item is one of the following: (a) *A percentage* of the entire asset or liability (or of the entire portfolio)"…(emphasis added). Paragraph 21(a) begins by stating: "The hedged item is specifically identified as either all or a specific portion of a recognized asset or liability…." Paragraph 20(b) states, in part, "An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months."

Servicing rights are contracts to service loans, receivables, or other financial assets under which the servicer is obligated to perform specific administration functions and is compensated with contractually specified servicing fees. ~~Servicing rights are recognized as distinct assets or liabilities only when contractually separated from the underlying assets by sale or securitization of the assets with servicing retained or when separately purchased or acquired~~ Servicing rights are separately recognized as either servicing assets or servicing liabilities when an entity undertakes an obligation to service a financial asset by entering into a servicing contract in any of the following situations as stated in paragraph 13 of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (as amended by FASB Statement No. 156, *Accounting for Servicing of Financial Assets*):

a. A transfer of the servicer's financial assets that meets the requirements for sale accounting
b. A transfer of the servicer's financial assets to a qualifying special-purpose entity (SPE) in a guaranteed mortgage securitization in which the transferor retains all of the resulting securities and classifies them as either available-for-sale securities or trading securities in accordance with FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*
c. An acquisition or assumption of a servicing obligation that does not relate to financial assets of the servicer or its consolidated affiliates.

An entity that transfers its financial assets to a qualifying SPE in a guaranteed mortgage securitization in which the transferor retains all of the resulting securities and classifies them as debt securities held-to-maturity in accordance with Statement 115 may either separately recognize its servicing assets or servicing liabilities or report those servicing assets or servicing liabilities together with the asset being serviced.

Statement 140,as amended by Statement 156, requires that if an entity subsequently measures servicing assets and servicing liabilities using the amortization method, any impairment of servicing assets, which is the amount by which the carrying amount of the servicing assets for an individual stratum exceeds their fair value, must be recognized in current earnings. However, an increase in the fair value ~~over~~above the carrying amount of servicing assets for an individual stratum may not be recognized in current earnings.

Companies that service certain types of financial assets may wish to designate as the hedged item in a fair value hedge a pre-specified percentage of the total change in fair value of those servicing rights (attributable to the hedged risk) that varies based on changes in a specified independent variable. (Because the pre-specified percentage for each specified independent variable can be presented in a rectangular array, that method of determining the hedged item retroactively based on the actual independent variable is sometimes referred to as the matrix method.) For example, mortgage banking companies may wish to use that methodology in designating hedges of mortgage servicing right assets (MSRs) for the following reasons:

- ~~Because~~If servicing assets are subsequently measured using the amortization method and its related impairment analysis ~~at the lower of cost or market~~, companies are not able to achieve substantial offset in earnings of gains and losses of those servicing assets and a forward contract when economically hedging those assets with forward contracts unless special hedge accounting could be applied. Absent the application of special hedge accounting, a decrease in the fair value of the MSR below its carrying amount will be recognized in current earnings as an impairment charge and the increase in the fair value of a derivative functioning as an economic hedge is available to offset some or all of that impairment charge. However, in accordance with Statement 140, as amended, an increase in the fair value of the MSR above its carrying amount is not recorded in earnings, while the corresponding decrease in the fair value of the derivative would be recognized in current earnings.

- The fair values of MSRs do not change in a linear fashion as interest rates increase or decrease. MSR fair values are most significantly impacted by changes in interest rates and the corresponding effect of those changes on prepayment speed estimates and other interest-rate-based assumptions. Decreases in interest rates generally increase prepayment speed estimates on the underlying loans, which reduces the expected cash flows to be received over the life of the MSR and in turn reduces the MSR's fair value. (Increases in interest rates have the opposite effect.) However, when interest rates fall, prepayment speeds increase at a faster pace than they decrease when interest rates rise. When interest rates decrease, prepayment speeds accelerate until they reach a certain threshold, beyond which they accelerate at a slower pace. Therefore, the effect of changes in interest rates on the fair value of MSRs could be significantly different depending upon the extent of the movement in interest rates because of the asymmetrical rate of prepayment and because they lose value at a faster pace when rates fall than they gain when rates rise (that is, they exhibit negative convexity). As a result, if required to establish a single hedge coverage ratio over a time horizon of any length, companies may be unable to establish at the inception of the hedging relationship that the hedging relationship is expected to be highly effective in achieving offsetting changes in fair value attributable to the hedged risk, and, as such, the hedging relationship may not be able to qualify for fair value hedge accounting under Statement 133.

- Because there are no individual derivative products that exactly offset the risk profile of the MSR, mortgage banks generally use combinations of derivatives to hedge MSRs. The negative convexity of MSRs necessitates that the combination of derivatives must have an option-like profile; however, companies typically do not seek to fully replicate the inverse of the MSR risk profile with a combination of derivatives because it is not cost effective.

RESPONSE

No. In a fair value hedge of a portion of a recognized servicing right asset subsequently measured using the amortization method and its related impairment analysis, a company may not designate the hedged item at the inception of the hedge by initially specifying a series of possible percentages of the servicing right asset and then determining at the end of the assessment period what specific percentage of the servicing right asset is the actual hedged item for that period based on the change in a specified independent variable during that period. Thus, the matrix method would *not* be a valid application of the provisions of Statement 133. The reference in paragraph 21(a)(2)(a) of Statement 133 to "a percentage of the entire asset or liability (or of the entire portfolio)" means that only *a single percentage* (that is, "a specific portion") can be designated at the inception of the hedge as the hedged item. Paragraph 21(a)(2)(a) does not permit expressing the hedged item as multiple percentages of a recognized asset or liability and then retroactively determining the hedged item based on an independent matrix of those multiple percentages and the actual scenario that occurred during the period for which hedge effectiveness is being assessed. (However, refer to the limited exception under Statement 133 Implementation Issue No. E18, "Designating a Zero-Cost Collar with Different Notional Amounts As a Hedging Instrument," in which a collar that is comprised of one purchased option and one written option that have different notional amounts is designated as the hedging instrument, and the hedged item is specified as two different proportions of the same asset based on the upper and lower rate or price range of the asset referenced in those two options.)

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Transition Provisions: Transfer of Financial Assets Accounted for Like Available-for-Sale Securities into Trading
Paragraph reference:	55
Date cleared by Board:	November 23, 1999
Date revision posted to website:	March 22, 2006
Affected by:	FASB Statement No. 156, *Accounting for Servicing of Financial Assets*

Revised March 17, 2006

QUESTION

Can the transition provisions in paragraph 55 of Statement 133 be applied to financial assets within the scope of paragraph 14 of FASB Statement No. 140~~125~~, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, thereby enabling those financial assets to be transferred into trading upon the initial adoption of Statement 133?

BACKGROUND

Creditor X enters into a loan agreement with Borrower Y that provides Borrower Y with a prepayment feature such that the loan can be contractually prepaid or otherwise settled in such a manner that Creditor X may not recover substantially all of its recorded investment in the loan to Borrower Y. Paragraph 14 of Statement 140~~125, as amended by Statement 133,~~ states the following:

> ~~Except for instruments that are within the scope of Statement 133,~~ I~~I~~nterest-only strips, loans, other receivables, or other~~retained~~ interests that continue to be held by a transferor in securitizations that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment, except for instruments that are within the scope of Statement 133, shall be subsequently measured *like* investments in debt securities classified as available-for-sale or trading under Statement 115, as amended ~~by this Statement~~…. [Emphasis added.]

In accordance with Statement 140~~125~~, paragraph 14, Creditor X subsequently measures the loan like an available-for-sale security under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, regarding transfers. The loan is still outstanding on the date of the initial adoption of Statement 133 by Creditor X.

The transition provisions in paragraph 55 of Statement 133 allow an entity, upon the initial adoption of that Statement, to transfer any available-for-sale security into the trading category and reclassify the related unrealized gains and losses into earnings consistent with the provisions of Statement 115. Paragraph 55 of Statement 133 does not mention the financial assets accounted for like available-for-sale securities pursuant to paragraph 14 of Statement 140~~125~~.

RESPONSE

Yes. The transition provisions in paragraph 55 of Statement 133 can be applied to financial assets that are within the scope of paragraph 14 of Statement 140~~125~~, thereby enabling those financial assets to be transferred into trading upon the initial adoption of Statement 133. Such a transfer would allow an entity to avoid separate accounting for the embedded derivative and the host contract embodied in the financial asset. Paragraph 12(b) does not permit an embedded derivative to be separated from the host contract and accounted for separately if the hybrid contract that embodies the embedded derivative and the host contract is remeasured at fair value under otherwise applicable generally accepted accounting principles with changes in fair value reported in earnings as they occur.

The loan described within the example falls in the scope of paragraph 14 of Statement 140~~125~~ and will be measured *like* available-for-sale securities under Statement 115. That is, even though the loan is not in the form of a security, it is accounted for *like* a security. Accordingly, all the measurement provisions of Statement 115 would apply to that loan, including those addressing recognition and measurement of impairment (refer to *FASB Staff Implementation Guide*-Statement 140~~125~~, Questions 109~~101~~ and 110~~106~~). Consequently, the transition provisions in paragraph 55 of Statement 133 apply to loans measured *like* available-for-sale securities pursuant to paragraph 14 of Statement 140~~125~~, despite the legal form of the asset.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.