NO. 1210-001 | AUGUST 11, 2005

# Financial Accounting Series

EXPOSURE DRAFT

## Proposed Statement of Financial Accounting Standards

### Accounting for Certain Hybrid Financial Instruments

### an amendment of FASB Statements No. 133 and 140

This Exposure Draft of a proposed Statement of Financial Accounting Standards is issued by the Board for public comment. Written comments should be addressed to:

Technical Director
File Reference No. 1210-001

Comment Deadline: October 10, 2005

Financial Accounting Standards Board
of the Financial Accounting Foundation

Responses from interested parties wishing to comment on the Exposure Draft must be *received* in writing by October 10, 2005. Interested parties should submit their comments by email to director@fasb.org, File Reference 1210-001. Those without email may send their comments to the "Technical Director—File Reference 1210-001" at the address at the bottom of this page. Responses should *not* be sent by fax.

All comments received by the FASB are considered public information. Those comments will be posted to the FASB's website and will be included in the project's public record.

Any individual or organization may obtain one copy of this Exposure Draft without charge until October 10, 2005, on written request only. *Please ask for our Product Code No. E184.* For information on applicable prices for additional copies and copies requested after October 10, 2005, contact:

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PO Box 5116
Norwalk, CT 06856-5116

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Financial Accounting Standards Board
of the Financial Accounting Foundation
401 Merritt 7, PO Box 5116, Norwalk, Connecticut 06856-5116

## Notice for Recipients of This Exposure Draft

This proposed Statement would amend FASB Statements No. 133, *Accounting for Derivative Instruments and Hedging Activities,* and No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. This proposed Statement would:

a. Permit fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation
b. Clarify which interest-only strips and principal-only strips are not subject to the requirements of Statement 133
c. Establish a requirement to evaluate beneficial 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
d. Clarify that concentrations of credit risk in the form of subordination are not embedded derivatives
e. Eliminate restrictions on a qualifying special-purpose entity's ability to hold passive derivative financial instruments that pertain to beneficial interests that are or contain a derivative financial instrument.

Two other proposed Statements are being exposed concurrently that would also amend Statement 140. One of the proposed Statements relates to the accounting for servicing of financial assets. The other proposed Statement would revise or clarify the derecognition requirements for financial assets and the initial measurement of interests related to transferred financial assets that are held by a transferor.

To understand the overall effect on Statement 140 of these proposed Statements, it is important to consider all three documents. An appendix (Appendix C) attached to all three documents marks the combined effect on any paragraphs that would be amended by two or more of the proposed Statements. Copies of all three proposed Statements are available at the FASB website: **www.fasb.org**.

The Board invites individuals and organizations to send written comments on all matters in this proposed Statement. Comments are requested from those who agree with the provisions of this proposed Statement as well as from those who do not.

Comments are most helpful if they identify the specific paragraph or group of paragraphs to which they relate and clearly explain the problem or question. Those who disagree with the provisions of this proposed Statement are asked to describe their suggested alternatives, supported by specific reasoning.

### Fair Value Election

**Issue 1:** Do you support the Board's decision to permit fair value remeasurement for hybrid financial instruments that contain an embedded derivative that otherwise would require bifurcation?

## Evaluation to Determine If Embedded Derivatives Exist

**Issue 2:** Should this proposed Statement provide implementation guidance on how to evaluate whether an instrument contains an embedded derivative that would require bifurcation? If so, what type of guidance do you believe the Board should consider?

## Interaction with Statement 140

**Issue 3:** This proposed Statement requires evaluation of instruments for identification of embedded derivatives and permits but does not require fair value measurement for instruments that contain embedded derivatives that otherwise would require bifurcation. Are the requirements for evaluating and accounting for interests issued by qualifying SPEs clear and understandable? Is the guidance for evaluating how the existence of embedded derivatives would affect whether an entity is a qualifying SPE clear and understandable? If not, what additional clarifying guidance should the Board consider?

## Effective Date

**Issue 4:** This proposed Statement would be applicable to all instruments obtained or issued after the earlier of fiscal years beginning after December 15, 2005, or fiscal years that begin during the fiscal quarter in which the Statement is issued, if applicable. Do you believe that the effective date provides sufficient time for implementation by calendar-year reporting enterprises?

## Summary

This proposed Statement would amend FASB Statements No. 133, *Accounting for Derivative Instruments and Hedging Activities,* and No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. This proposed Statement would resolve issues addressed in Statement 133 Implementation Issue No. D1, "Application of Statement 133 to Beneficial Interests in Securitized Financial Assets."

This proposed Statement would:

a. Permit fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation
b. Clarify which interest-only strips and principal-only strips are not subject to the requirements of Statement 133
c. Establish a requirement to evaluate beneficial 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
d. Clarify that concentrations of credit risk in the form of subordination are not embedded derivatives
e. Eliminate restrictions on a qualifying special-purpose entity's ability to hold passive derivative financial instruments that pertain to beneficial interests that are or contain a derivative financial instrument.


### Reasons for Issuing This Proposed Statement

In January 2004, the Board added this project to its agenda to address what was characterized as a temporary exemption relating to the application of the bifurcation requirements of Statement 133 to beneficial interests in securitized financial assets.

Prior to the effective date of Statement 133, the FASB received inquiries on the application of the exception in paragraph 14 of Statement 133 to beneficial interests in securitized financial assets. In response to the inquiries, Implementation Issue D1 indicated that the staff believes that 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. Pending issuance of further guidance, Implementation Issue D1 indicated that entities may continue to apply the guidance related to accounting for beneficial interests in paragraphs 14 and 362 of Statement 140. Those paragraphs 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 should 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,* and may not be classified as held-to-maturity. Further, Implementation Issue D1 indicated that holders of beneficial interests in securitized financial assets that are not subject to paragraphs 14 and 362 of Statement 140 are not required to apply Statement 133 to those beneficial interests until further guidance is issued.

## How This Proposed Statement Would Improve Financial Reporting

This proposed Statement would improve financial reporting by eliminating the exemption from applying Statement 133 to beneficial interests in securitized financial assets so that similar instruments would be accounted for similarly regardless of the form of the instruments. This proposed Statement also would improve financial reporting by allowing a preparer to elect fair value measurement, at inception for subsequent measurement, on an instrument-by-instrument basis, in cases in which a derivative would otherwise have had to be bifurcated. Election of fair value measurement would also result in more financial instruments being measured at what the Board regards as the most relevant attribute, fair value.

## The Effective Date of This Proposed Statement

This proposed Statement would be effective for all instruments obtained or issued after the beginning of the earlier of an entity's first fiscal year beginning after December 15, 2005, or the entity's fiscal year that begins during the fiscal quarter in which the Statement is issued, if applicable.

**Proposed Statement of Financial Accounting Standards**

**Accounting for Certain Hybrid Financial Instruments**

**an amendment of FASB Statements No. 133 and 140**

**August 11, 2005**

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**Proposed Statement of Financial Accounting Standards**

**Accounting for Certain Hybrid Financial Instruments**

**an amendment of FASB Statements No. 133 and 140**

**August 11, 2005**

## INTRODUCTION

1. FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* establishes, among other things, the accounting for certain derivatives embedded in other financial instruments. (This combination is referred to as a hybrid financial instrument.)

2. This Statement modifies the existing accounting for certain hybrid financial instruments by:

a. Permitting fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation
b. Clarifying which interest-only strips and principal-only strips are not subject to the requirements of Statement 133
c. Establishing a requirement to evaluate beneficial 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
d. Clarifying that concentrations of credit risk in the form of subordination are not embedded derivatives
e. Amending FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,* to eliminate restrictions on the ability of a qualifying special-purpose entity (SPE) to hold passive derivative financial instruments that pertain to beneficial interests that are or contain a derivative financial instrument.

## STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

### Amendments to Statement 133

3. Statement 133 is amended as follows: [Added text is underlined and deleted text is ~~struck out~~.]

a. Paragraph 14:

> However, interest-only strips and principal-only strips are not subject to the requirements of this Statement provided the strips~~they~~ (a) ~~initially~~ result~~ed~~ from separating the ~~rights to receive~~portions of the 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~~labeled interest and principal and (b) do not incorporate any terms not present in the original financial instrument described above.

b. Paragraphs 14A and 14B are added as follows:

> The holder of a beneficial interest in securitized financial assets (other than those identified in paragraph 14) should determine whether the interest is a freestanding derivative or contains an embedded derivative that under paragraphs 12 and 13 would be required to be separated into a host contract and a derivative instrument. The determination should be based on the contractual terms of the beneficial interest. A holder of a beneficial interest or an issuer of an instrument is required to obtain sufficient information about the payoff structure and the payment priority of the instrument to determine whether an embedded derivative exists.
>
> Credit risk in a beneficial interest resulting from financial instruments or other assets and liabilities (including derivative contracts) that are held by the issuing entity, shall not be considered an embedded derivative under this Statement. The concentration of credit risk in the form of subordination of one interest to another shall not be considered an embedded derivative under this Statement.

c. Paragraph 16:

> In subsequent provisions of this Statement, both (a) a derivative instrument included within the scope of this Statement by paragraphs 6–11 and (b) an embedded derivative instrument that has been separated from a host contract as required by paragraph 12 are collectively referred to as derivative instruments. If an embedded derivative instrument is separated from its host contract, the host contract shall be accounted for based on generally accepted accounting principles applicable to instruments of that type that do not contain embedded derivative instruments. ~~If an entity cannot reliably identify and measure the embedded derivative instrument that paragraph 12 requires be separated from the host~~

~~contract, the entire contract shall be measured at fair value with gain or loss recognized in earnings, but it may not be designated as a hedging instrument pursuant to this Statement.~~Upon identifying a hybrid financial instrument that under paragraph 12 would be required to be separated into a host contract and a derivative instrument, an entity may, at inception, irrevocably elect to remeasure that hybrid financial instrument in its entirety at fair value (with changes in fair value recognized in earnings). However, that hybrid instrument may not be designated as a hedging instrument pursuant to this Statement. This election shall be made on an instrument-by-instrument basis. Both hybrid financial instruments that are assets and those that are liabilities are eligible for the fair value measurement election.

**Amendments to Statement 140**

4. Statement 140 is amended as follows:

a. Paragraph 35(c)(2):

Passive **derivative financial instruments** that pertain to beneficial interests ~~(other than another derivative financial instrument)~~ issued or sold to parties other than the transferor, its affiliates, or its agents (paragraphs 39 and 40)

b. Paragraph 40:

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

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

**Effective Date and Transition**

5. This Statement shall be effective for all instruments obtained or issued after the beginning of the earlier of an entity's first fiscal year beginning after December 15, 2005, or the entity's fiscal year that begins during the fiscal quarter in which the Statement is

issued, if applicable. Provisions of this Statement shall not be applied to instruments that an entity holds at the effective date.

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

## Appendix A

## BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

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## Appendix A

# BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

## Introduction

A1. This appendix summarizes considerations that Board members deemed significant in reaching the conclusions in this Statement. It includes reasons for accepting certain views and rejecting others. Individual Board members gave greater weight to some factors than to others.

## Background Information

A2. Prior to the implementation of Statement 133, constituents questioned the application of that Statement's definition of a derivative and bifurcation requirements to beneficial interests in securitized financial assets. In response to those questions, the Board issued Statement 133 Implementation Issue No. D1, "Application of Statement 133 to Beneficial Interests in Securitized Financial Assets," in June 2000. That Issue provides that entities need not evaluate such interests for embedded derivatives. Rather, entities may continue to apply the measurement guidance related to accounting for beneficial interests in paragraphs 14 and 362 of Statement 140, until further guidance is issued. The scope of Implementation Issue D1 covers transactions involving both qualifying and nonqualifying SPEs.

A3. The Board attempted to address issues relating to Implementation Issue D1 as part of the Exposure Drafts that led to the issuance of Statement 140 and FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*. In both instances, the Board was unable to reach a decision that would have resolved the issues underlying the Implementation Issue D1 exemption.

A4. In January 2004, the Board decided to add a project to its agenda to reconsider the accounting for beneficial interests in securitized financial assets with the objective of replacing the interim guidance in Implementation Issue D1.

A5. The scope of the project was expanded to encompass all hybrid financial instruments (including beneficial interests in securitized financial assets) in October 2004.

## Amendments to Statement 133

### Amendments Related to Interest-Only Strips and Principal-Only Strips

A6. This Statement clarifies the scope exception for interest-only strips and principal-only strips provided in paragraph 14 of Statement 133.

A7. The Board considered deleting paragraph 14 of Statement 133 in its entirety, which would have resulted in all interest-only strips and principal-only strips being subject to the requirements of Statement 133, including the embedded derivative provisions. The Board

acknowledges that there is no conceptual basis for the exemption provided to interest-only strips and principal-only strips. Some Board members supported deleting paragraph 14 because although there are interests whose economic characteristics are similar to those that qualify for the paragraph 14 exemption, they are ineligible for the exemption because of the form of those interests.

A8. Rather than deleting paragraph 14 of Statement 133, the Board decided to amend that paragraph to limit its application to a narrow set of instruments. The Board acknowledged that paragraph 14 was intended to simplify the application of Statement 133 by exempting instruments created by merely separating principal and interest from the provisions of that Statement. The Board concluded that amending paragraph 14 to apply to a narrow set of instruments would retain this simplification.

A9. In deciding on a narrow application of the exemption provided in paragraph 14 of Statement 133, the Board also decided that beneficial interests in securitized financial assets should not qualify for the exemption from the bifurcation requirements of Statement 133.

**Amendments Related to Beneficial Interests in Securitized Financial Assets**

A10. In reconsidering the accounting for beneficial interests in securitized financial assets and the application of Statement 133 to those interests, the Board considered several alternatives. The Board considered and rejected the alternative of making the temporary exemption provided by Implementation Issue D1 permanent, because that exemption would have resulted in permanent differences in the accounting for a wide range of similar instruments merely based on the form of the instrument.

A11. The Board considered requiring that all beneficial interests in securitized financial assets be accounted for at fair value with changes in fair value recognized in earnings. This alternative would have reduced complexity and would have resulted in more financial instruments being reported at fair value, the most relevant measurement attribute for financial instruments. However, this alternative also would have perpetuated dissimilar accounting for similar instruments merely based on the form of the instrument.

A12. The Board also considered requiring that all beneficial interests in securitized financial assets be accounted for at fair value with changes in fair value recognized in other comprehensive income until realized. Board members acknowledged that this alternative would have also perpetuated dissimilar accounting for similar instruments based on the form of the instrument. In addition, some Board members believe that allowing the changes in fair value of embedded derivatives to be recognized in other comprehensive income rather than in earnings does not improve financial reporting.

A13. The Board decided to eliminate the exemption from Statement 133 for beneficial interests in securitized financial assets provided temporarily by Implementation Issue D1 and to require that those interests be evaluated to determine whether they are freestanding derivatives or whether they contain embedded derivatives. Eliminating this exemption addressed one of the Board's concerns, as expressed in paragraph A10. The Board also

decided to permit beneficial interests in securitized financial assets that contain embedded derivatives that would otherwise require bifurcation to be accounted for as a single instrument at fair value with changes in fair value recognized in earnings. The Board reasoned that this approach results in instruments being subject to the requirements of Statement 133, regardless of the form of the transaction. This approach also simplifies the accounting for instruments for which fair value measurement is elected. Of the alternatives considered by the Board, this approach results in the greatest degree of convergence with International Accounting Standards.

A14. The Board acknowledged that comparability among entities and consistency within an entity will be impaired as a result of permitting either of two divergent accounting treatments for similar or identical instruments. The Board also noted that instruments for which fair value measurement is elected will not be eligible to be used as hedging instruments that receive special hedge accounting. However an embedded derivative may still be separately recognized and be eligible as a hedging instrument under Statement 133.

A15. The Board considered whether the accounting for beneficial interests in securitized financial assets should distinguish between interests purchased and interests received by the transferor in a securitization transaction. The Board decided that there should be no distinction in the application of the requirements of Statement 133 based on whether the holder of a beneficial interest in a securitized financial asset is a purchaser of the interest or a transferor that receives the interest in transferred assets in the securitization transaction.

A16. The Board considered how a beneficial interest in securitized financial assets should be evaluated for embedded derivatives. The Board decided to require that an evaluation of the terms of interests be performed and that sufficient evidence be obtained to determine whether there is an embedded derivative that requires bifurcation in the interest. The Board believes sufficient evidence can generally be obtained by analyzing the arrangements that govern the payoff structure and the subordination status of the instrument. The Board believes understanding the payoff structure and subordination status of the instrument will require an understanding of the nature and amount of assets and the nature and amount of liabilities and other beneficial interests comprising a transaction. The Board further believes that, in many cases, information available to purchasers of interests will provide sufficient information to perform the analyses required by paragraphs 12 and 13 of Statement 133 to determine whether instruments contain embedded derivatives that would require bifurcation. Summarized information may be sufficient in some cases for that determination. However, if only summarized information is available, and that information is insufficient for that determination, a purchaser of a beneficial interest would be obligated to obtain sufficient detailed information to determine the existence of derivatives or embedded derivatives.

A17. The evaluation of instruments for embedded derivatives will vary in complexity depending on the nature of the instrument. For example, a senior interest with a market rate of return may require little further investigation, whereas a residual interest that absorbs risk disproportionate to other interests may require significant investigation.

A18. The Board noted that the creditworthiness of an issuer is determined by the assets it holds. The Board considered whether the form of those assets (whether cash instruments or derivatives) should result in different accounting conclusions for the beneficial interests issued by the entity. For example, a single class of beneficial interests that receives the credit risk and market return of an instrument such as a corporate bond that is held by the issuing entity is not considered to include an embedded credit default swap. The same economic profile could be created if the entity issuing the beneficial interest sold a credit default swap referenced to the corporate bond and purchased high-quality collateral. The Board decided that the accounting for beneficial interests with similar credit risks should be similar and should not be based on whether a cash instrument or a derivative contract created the credit risk. The Board also concluded that no embedded credit derivative is present in the beneficial interests in either of the above examples.

A19. The Board also considered whether concentrations of credit risk in subordinated beneficial interests in securitized financial assets should be considered embedded derivatives. Some Board members believe that concentrations of credit risk that are created by subordinating one interest to another interest represent, in effect, credit default swaps embedded in the subordinated interest and that such credit default swaps should be identified as embedded derivatives requiring bifurcation. However, the Board decided not to define concentrations of credit risk as embedded derivatives, regardless of how they arise.

A20. The Board decided not to extend the requirements of paragraph 13(b) of Statement 133 for interest rate leverage factors to credit concentrations. Some Board members reasoned that credit concentrations should not be recognized as embedded derivatives because there is no obligation on the part of the subordinated interest holder to transfer cash or assets. That is, the subordination functions through a cash allocation mechanism in which cash flows that otherwise would have been allocated to the subordinated interest holder instead are allocated to the senior interest holder, to effectively allocate credit losses from the senior interest holder to the subordinated interest holder. Other Board members reasoned that the purchase price of a subordinated interest reflects the investor's assessment of the cash flows it expects to receive, including the likelihood of default and, therefore, concentrations of credit risk are reflected in the fair value of the subordinated interest. As the credit risk of the subordinated interest is reflected in its fair value, there is no need for separate recognition of credit concentrations.

A21. The Board noted, however, that other aspects of Statement 133 regarding credit risk and the identification of credit risk as an embedded derivative are not affected by the Board's decision on concentrations of credit risk. For example, Example 2 in Statement 133 Implementation Issue No. B36, "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," would continue to represent credit risk that is not clearly and closely related to the host contract.

**Amendments Related to the Fair Value Election**

A22. Having decided to permit fair value measurement for beneficial interests in securitized financial assets that contain embedded derivatives that otherwise would be required to be bifurcated, the Board considered how to establish the scope of instruments eligible for this election. Interests obtained by a transferor in a securitization transaction would be readily identifiable as beneficial interests in securitized financial assets. However, the Board concluded that the accounting for an interest should not be limited to interests created in a transaction accounted for by the transferor as a sale in accordance with Statement 140. Furthermore, the Board believes there should be no accounting distinction for a purchaser of a beneficial interest, depending on whether the transaction creating that interest was accounted for as a sale or as a financing under Statement 140. The Board considered and rejected definitions that might have clarified what interests would be considered beneficial interests in securitized financial assets. Likewise, the Board considered and rejected an approach that would have defined beneficial interests in securitized financial assets based on the presence of a defined securitization vehicle.

A23. Although the scope of Implementation Issue D1, and the original scope of instruments that would be eligible for the fair value measurement election, is limited to beneficial interests in securitized financial assets, the Board decided to extend that election to any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation. The Board believes that this decision eliminates the need to distinguish between beneficial interests in securitized financial assets and other hybrid instruments. Moreover, this decision eliminates the need for the practicability exception previously provided in paragraph 16 of Statement 133. This expansion will permit many interests other than beneficial interests in securitized financial assets to be measured in their entirety at fair value.

A24. The Board decided to limit the election to measure at fair value to hybrid *financial* instruments because it has not yet identified the most relevant measurement attribute for nonfinancial host contracts.

A25. The Board considered requiring that the election to adopt fair value as the measurement attribute for certain hybrid financial instruments be made as an entity-wide policy decision. The Board noted that requirement would increase comparability for instruments held by a given entity. However, the Board rejected this approach because it seemed likely to limit the number of entities that elect fair value measurement. The Board also considered requiring that the election be applied on a type-of-instrument basis. The Board rejected this approach because it would require definitions of types of instruments, thereby introducing additional complexity and because it would limit the use of fair value. The Board decided to require application of the fair value election on an instrument-by-instrument basis. The Board reasoned that the hedge accounting elections of Statement 133 are applied on an item-by-item basis and that an instrument-by-instrument application of the fair value election is most consistent with other requirements of Statement 133. In addition, the Board reasoned that an instrument-by-instrument election is the best way to encourage fair value measurement. The Board was also willing to sacrifice comparability

to achieve increased relevance through expanded use of fair value measurement and to simplify accounting.

A26. The Board decided that the fair value election should be applied irrevocably at initial recognition to impose discipline on an elective accounting method. Otherwise preparers would be able to elect fair value measurement to obtain desired reporting results with the benefit of hindsight.

A27. The Board decided not to require any additional disclosures for entities electing to measure hybrid financial instruments at fair value pursuant to this Statement. The Board reasoned that added disclosures might reduce the effects of noncomparability resulting from the election to measure hybrid financial instruments at fair value. The Board, however, is sympathetic to constituents' concerns that financial instrument disclosures be developed in a comprehensive rather than a piecemeal manner. The Board concluded that adding disclosures as part of this Statement would not be appropriate. The Board notes that qualitative disclosures about the methods used to measure instruments at fair value under this Statement will be required by FASB Statement No. XXX, *Fair Value Measurements.* The Board also notes that other applicable disclosure requirements (such as those in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* and Statement 140, among others) continue to apply to hybrid financial instruments under this Statement.

**Amendment to Statement 140**

A28. The Board considered the impact on the requirements for qualifying SPEs of eliminating the Implementation Issue D1 exemption from the bifurcation requirements of Statement 133 and the requirement to evaluate beneficial interests in securitized financial assets to obtain sufficient evidence to determine if an embedded derivative exists. The Board decided to eliminate the prohibition on a qualifying SPE from holding a derivative financial instrument that pertains to a beneficial interest *other than another derivative financial instrument*. That prohibition was included in Statement 140 to preclude a qualifying SPE from holding a derivative that, because of the Implementation Issue D1 exemption, might not be accounted for as a derivative by the qualifying SPE's beneficial interest holders. Because this Statement will eliminate the Implementation Issue D1 exemption, the prohibition is no longer necessary.

**Effective Date and Transition**

A29. The Board decided that the effective date for the amendment to Statement 133 on the accounting for hybrid financial instruments that otherwise would require separation into a host contract and a derivative instrument should be consistent with the amendments to Statement 140 on the accounting for servicing rights and the requirements of a qualifying SPE. The Board notes that many financial institutions requested the election to subsequently measure hybrid financial instruments and servicing rights at fair value and that the application of the election would not be burdensome. Based on these two factors, the Board believes that the measurement provisions in the three related projects that amend Statement 133 and 140 should be effective close to the expected issuance dates of

the final Statements. The Board decided that the application of the measurement guidance in all three projects would be effective at the earlier of fiscal years beginning after December 15, 2005, or fiscal years that begin during the fiscal quarter in which the final Statement is issued, if applicable. If the final Statement is issued between December 1, 2005, and February 28, 2006, calendar-year reporting entities would apply the Statement as of January 1, 2006, and entities with fiscal years ending on November 30, 2005, would apply the Statement as of December 1, 2005. If a reporting entity's fiscal year ends on June 30, the final Statement would be effective for fiscal years beginning July 1, 2006.

A30. The Board considered whether the election to measure hybrid financial instruments that otherwise would require separation into a host contract and a derivative instrument at fair value should be applied on a prospective basis for new instruments or on a prospective basis for new instruments *and* for existing instruments with a cumulative effect adjustment recorded to reflect existing hybrid financial instruments at fair value. Some Board members suggested that an entity be allowed to apply the fair value election to existing hybrid financial instruments that are currently being bifurcated to ease implementation of Statement 133. The Board decided that if the fair value election were made applicable to existing hybrid financial instruments, the fair value election should be applied to *all* hybrid financial instruments, rather than to only certain bifurcated hybrid financial instruments selected by the reporting entity. However, the Board concluded that application on an all-or-none basis would not be practical as some derivatives from bifurcated hybrid financial instruments could be hedging instruments under Statement 133, and combining the derivative with the host into a hybrid financial instrument measured at fair value would eliminate the opportunity to use the embedded derivative as a hedging instrument. The Board also rejected that alternative because of complexities associated with recognition of gains or losses on host contracts. The Board also considered requiring application of the requirements of this Statement to all existing instruments. The Board rejected that alternative because it would require preparers to perform a bifurcation evaluation on interests that previously had not been subject to Statement 133 because of the Implementation Issue D1 exemption. Instead, the Board decided that the election should be applied on a prospective basis for new instruments and that existing instruments would not be eligible for this election.

**Benefits and Costs**

A31. The mission of the FASB is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including preparers, auditors, and users of financial information. In fulfilling that mission, the Board endeavors to determine that a proposed standard will fill a significant need and that the costs imposed to meet that standard, as compared with other alternatives, are justified in relation to the overall benefits of the resulting information. Although the costs to implement a new standard may not be borne evenly, investors and creditors—both present and potential—and other users of financial information benefit from improvements in financial reporting, thereby facilitating the functioning of markets for capital and credit and the efficient allocation of resources in the economy.

A32. The Board's assessment of the benefits and costs of amending Statements 133 and 140 with respect to the accounting for hybrid financial instruments was based on discussions with preparers and users of financial statements.

A33. The Board concluded that a fair value measurement election should be provided for certain hybrid financial instruments that otherwise would require bifurcation. The Board reasoned that providing this election would decrease the burden associated with applying Statement 133 to hybrid financial instruments. The Board concluded that the expected benefits of both improved financial reporting resulting from consistent application of Statement 133 to different instruments with similar economic characteristics and simplification in financial reporting achieved through permitting fair value measurement for certain hybrid instruments would outweigh the decreased comparability in financial statements and the costs associated with implementing this Statement.

A34. The Board concluded that eliminating the Implementation Issue D1 exemption would improve financial reporting by requiring all instruments to be subject to the Statement 133 bifurcation requirements rather than exempting instruments in the form of beneficial interests in securitized financial assets. As a result of eliminating the Implementation Issue D1 exemption, the Board was able to simplify the qualifying SPE criteria by deleting the parenthetical phrase *other than another derivative financial instrument*. Removing this restriction on qualifying SPEs and eliminating the Implementation Issue D1 exemption will result in increased consistency in the application of the bifurcation requirements of Statement 133 and will result in either the identification of more derivatives in beneficial interests in securitized financial assets or accounting for such interests in their entirety at fair value.

## Appendix B

## IMPACT ON EITF ISSUES

B1. This portion of this appendix addresses the impact of this Statement on the consensuses reached on EITF Issues relating to hybrid financial instruments, beneficial interests in securitized financial assets, and interest-only strips and principal-only strips. The following table lists each issue discussed by the EITF and indicates (a) the status of the EITF consensus or topic after issuance of this Statement and (b) the effect of this Statement on that consensus or topic (if any) or the reasons that specific issues are beyond the scope of this Statement. This appendix does not address the impact of this Statement on other authoritative accounting literature included in categories (b), (c), and (d) in the GAAP hierarchy as discussed in AICPA Statement on Auditing Standards (SAS) No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles.

| **Status Legend** | |
|---|---|
| **Nullified/Partially Nullified** | Consensus is either nullified or partially nullified by this Statement. |
| **Resolved** | Issue is resolved by this Statement. |
| **Affirmed with Modification** | Issue was affirmed by this Statement with some change to the consensus. |
| **Other** | Analysis of the impact of this Statement on the EITF guidance has not been completed. |

| EITF Issue No. | Title | Effect of Statement on Consensus | Addition to Abstracts |
|---|---|---|---|
| 85-9 | Revenue Recognition on Options to Purchase Stock of Another Entity | Affirmed with Modification | Statement XXX amended Statement 133 in December 2005. Statement XXX provides a fair value measurement election for certain hybrid financial instruments with embedded derivatives that otherwise would require bifurcation. |
| 85-29 | Convertible Bonds with a "Premium Put" | Affirmed with Modification | Statement XXX amended Statement 133 in December 2005. Statement XXX provides a fair value measurement election for certain hybrid financial instruments with embedded derivatives that otherwise would require bifurcation. |
| 86-15 | Increasing-Rate Debt | Affirmed with Modification | Statement XXX amended Statement 133 in December 2005. Statement XXX provides a fair value measurement election for certain hybrid financial instruments with embedded derivatives that otherwise would require bifurcation. |
| 86-28 | Accounting Implications of Indexed Debt Instruments | Affirmed with Modification | Statement XXX amended Statement 133 in December 2005. Statement XXX provides a fair value measurement election for certain hybrid financial instruments with embedded derivatives that otherwise would require bifurcation. |
| 88-11 | Allocation of Recorded Investment When a Loan or Part of a Loan Is Sold | Affirmed with Modification | Statement XXX amended Statement 133 in December 2005. Statement XXX indicates that interest-only strips and principal-only strips exempt from the bifurcation requirements of Statement 133 are limited to a narrowly defined set of such instruments. |

| EITF Issue No. | Title | Effect of Statement on Consensus | Addition to Abstracts |
|---|---|---|---|
| 90-19 | Convertible Bonds with Issuer Option to Settle for Cash upon Conversion | Affirmed with Modification | Statement XXX amended Statement 133 in December 2005. Statement XXX provides a fair value measurement election for certain hybrid financial instruments with embedded derivatives that otherwise would require bifurcation. |
| 96-12 | Recognition of Interest Income and Balance Sheet Classification of Structured Notes | Affirmed with Modification | Statement XXX amended Statement 133 in December 2005. Statement XXX provides a fair value measurement election for certain hybrid financial instruments with embedded derivatives that otherwise would require bifurcation. |
| 97-15 | Accounting for Contingency Arrangements Based on Security Prices in a Purchase Business Combination | Affirmed with Modification | Statement XXX amended Statement 133 in December 2005. Statement XXX provides a fair value measurement election for certain hybrid financial instruments with embedded derivatives that otherwise would require bifurcation. |
| 98-5 | Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios | Affirmed with Modification | Statement XXX amended Statement 133 in December 2005. Statement XXX provides a fair value measurement election for certain hybrid financial instruments with embedded derivatives that otherwise would require bifurcation. |
| 99-20 | Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets | Affirmed with Modification | Statement XXX amended Statement 133 in December 2005. Statement XXX provides a fair value measurement election for certain hybrid financial instruments with embedded derivatives that otherwise would require bifurcation. |

| EITF Issue No. | Title | Effect of Statement on Consensus | Addition to Abstracts |
|---|---|---|---|
| 00-19 | Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock | Affirmed with Modification | Statement XXX amended Statement 133 in December 2005. Statement XXX provides a fair value measurement election for certain hybrid financial instruments with embedded derivatives that otherwise would require bifurcation. |
| 03-7 | Accounting for the Settlement of the Equity-Settled Portion of a Convertible Debt Instrument That Permits or Requires the Conversion Spread to Be Settled in Stock (Instrument C of Issue No. 90-19) | Affirmed with Modification | Statement XXX amended Statement 133 in December 2005. Statement XXX provides a fair value measurement election for certain hybrid financial instruments with embedded derivatives that otherwise would require bifurcation. |
| D-63 | Call Options "Embedded" in Beneficial Interests Issued by a Qualifying Special-Purpose Entity | Affirmed with Modification | Statement XXX amended Statement 133 in December 2005. Statement XXX provides a fair value measurement election for certain hybrid financial instruments with embedded derivatives that otherwise would require bifurcation. |

## IMPACT ON DERIVATIVE IMPLEMENTATION ISSUES

B2. This portion of this appendix addresses the impact of this Statement on the responses to Derivative Implementation Issues relating to hybrid financial instruments and interest-only strips and principal-only strips. This appendix does not address the impact of this Statement on other authoritative accounting literature included in categories (b), (c), and (d) in the GAAP hierarchy discussed in SAS 69.

| Issue No. | Title | Effect of Statement on Issue | Addition to Implementation Issue |
|---|---|---|---|
| B1 | Separating the Embedded Derivative from the Host Contract | Affected | FASB Statement No. XXX, *Accounting for Certain Hybrid Financial Instruments* |
| B2 | Leveraged Embedded Terms | Affected | FASB Statement No. XXX, *Accounting for Certain Hybrid Financial Instruments* |
| B4 | Foreign Currency Derivatives | Affected | FASB Statement No. XXX, *Accounting for Certain Hybrid Financial Instruments* |
| B6 | Allocating the Basis of a Hybrid Instrument to the Host Contract and the Embedded Derivative | Affected | FASB Statement No. XXX, *Accounting for Certain Hybrid Financial Instruments* |
| B10 | Equity-Indexed Life Insurance Contracts | Affected | FASB Statement No. XXX, *Accounting for Certain Hybrid Financial Instruments* |
| B11 | Volumetric Production Payments | Affected | FASB Statement No. XXX, *Accounting for Certain Hybrid Financial Instruments* |
| B13 | Accounting for Remarketable Put Bonds | Affected | FASB Statement No. XXX, *Accounting for Certain Hybrid Financial Instruments* |
| B15 | Separate Accounting for Multiple Derivative Features Embedded in a Single Hybrid Instrument | Affected | FASB Statement No. XXX, *Accounting for Certain Hybrid Financial Instruments* |

| Issue No. | Title | Effect of Statement on Issue | Addition to Implementation Issue |
|---|---|---|---|
| B17 | Term-Extending Options in Contracts Other Than Debt Hosts | Affected | FASB Statement No. XXX, *Accounting for Certain Hybrid Financial Instruments* |
| B20 | Must the Terms of a Separated Non-Option Embedded Derivative Produce a Zero Fair Value at Inception? | Affected | FASB Statement No. XXX, *Accounting for Certain Hybrid Financial Instruments* |
| B23 | Terms of a Separated Non-Option Embedded Derivative When the Holder Has Acquired the Hybrid Instrument Subsequent to Its Inception | Affected | FASB Statement No. XXX, *Accounting for Certain Hybrid Financial Instruments* |
| B24 | Interaction of the Requirements of EITF Issue No. 86-28 and Statement 133 Related to Structured Notes Containing Embedded Derivatives | Affected | FASB Statement No. XXX, *Accounting for Certain Hybrid Financial Instruments* |

| Issue No. | Title | Effect of Statement on Issue | Addition to Implementation Issue |
|---|---|---|---|
| B36 | 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 | Affected | FASB Statement No. XXX, *Accounting for Certain Hybrid Financial Instruments* |
| B37 | Mandatorily Redeemable Preferred Stock Denominated in either a Precious Metal or a Foreign Currency | Affected | FASB Statement No. XXX, *Accounting for Certain Hybrid Financial Instruments* |
| C4 | Interest-Only and Principal-Only Strips | Superseded | FASB Statement No. XXX, *Accounting for Certain Hybrid Financial Instruments* |
| D1 | Application of Statement 133 to Beneficial Interests in Securitized Financial Assets | Affected | FASB Statement No. XXX, *Accounting for Certain Hybrid Financial Instruments*<br>Note deleted and replaced by: **Note:** FASB Statement No. XXX, *Accounting for Certain Hybrid Financial Instruments,* addresses issues on the evaluation of beneficial interests issued in securitization transactions under Statement 133. The FASB staff interim guidance in this Implementation Issue remains effective for instruments recognized prior to the effective date of Statement XXX. |

## Appendix C

## STATEMENT 140 MARKED TO SHOW CHANGES THAT WOULD BE MADE BY THE COMBINATION OF THE PROPOSED STATEMENTS ON THE ACCOUNTING FOR TRANSFERS OF FINANCIAL ASSETS, SERVICING OF FINANCIAL ASSETS, AND CERTAIN HYBRID FINANCIAL INSTRUMENTS

C1. The proposed Statements on transfers of financial assets, the accounting for servicing of financial assets, and the accounting for certain hybrid financial instruments would amend FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.* Each proposed Statement reflects only those Board decisions made in conjunction with that proposed Statement and does not reflect Board decisions made in connection with the other proposed Statements.

C2. In some cases, paragraphs in Statement 140 would be amended by only one proposed Statement and appear in this appendix exactly as written in one of the three proposed Statements. In other cases, certain paragraphs would be affected by a combination of Board decisions made in relation to more than one proposed Statement and those paragraphs have been edited in this appendix to show the combined effect of those decisions. This appendix contains the following sections of Statement 140 as originally issued, marked to integrate changes from the three proposed Statements that would affect Statement 140: standards, implementation guidance, Appendix C, and Appendix E. This appendix does not contain a separate summary or the appendixes for Background Information and Basis for Conclusions or Amendments to Existing Pronouncements. The following paragraphs of Statement 140 are affected by more than one proposed Statement and contain significant changes:

a. Paragraphs 10, 11, and 62, which address initial measurement of interests retained and received by a transferor in connection with a transfer of financial assets, have been amended in different ways by the proposed Statement on transfers of financial assets and the proposed Statement on servicing. The proposed Statement on transfers of financial assets changes the terminology and measurement provisions for beneficial interests received by a transferor as proceeds from the sale of financial assets, and the proposed Statement on servicing changes the measurement provisions for servicing assets.
b. Paragraphs 17, 343, and 345 reflect the combined effect of the proposed Statements on transfers of financial assets and servicing on the disclosure requirements of Statement 140.
c. Paragraphs 62, 65, 66, and 67 reflect the combined effect of the proposed Statements on transfers of financial assets and servicing on the examples in Statement 140.
d. Paragraphs 35 and 40 address the permitted assets and activities of a qualifying SPE. The proposed Statement on transfers of financial assets would allow a qualifying SPE to hold passive derivative financial instruments that pertain to all beneficial interests issued by a qualifying SPE, including beneficial interests held by the transferor that were previously prohibited. The proposed Statement on certain hybrid financial instruments would eliminate restrictions on a qualifying SPE's

ability to hold passive derivative financial instruments that pertain to beneficial interests that are or contain a derivative financial instrument. Both of those proposed changes are reflected in the amended paragraphs 35 and 40 in this combined appendix.

C3. If the three proposed Statements were adopted as exposed, Statement 140 (the standard, implementation guidance, Appendix C, and Appendix E) would read as follows: [Added text is underlined and deleted text is ~~struck out~~.]

## STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

### Accounting for Transfers and Servicing of Financial Assets

8A. The requirements of this Statement apply to transfers of individual financial assets in their entirety, transfers of groups of financial assets in their entirety, and transfers of participating interests in individual financial assets (which are referred to collectively in this Statement as *transferred financial assets*). A participating interest has the following characteristics:

a. It represents an ownership interest in an individual financial asset other than an equity instrument, a derivative financial instrument, or a hybrid financial instrument with an embedded derivative that is not clearly and closely related as described in Statement 133.
b. All cash flows received from the asset are divided among the participating interests (including any interest retained by the transferor, its consolidated affiliates, or its agents) in proportion to the share of ownership represented by each, except for servicing fees representing adequate compensation and, if applicable, a share of the contractual interest representing all or a portion of the transferor's gain on sale received by the transferor as consideration related to the sale of the participating interest. The ownership shares remain constant over the life of the original financial asset.
c. Participating interest holders have no recourse to the transferor (or its consolidated affiliates or agents) or to each other, and no participating interest is subordinated to another. That is, no participating interest holder is entitled to receive cash before any other participating interest holder. The rights of each participating interest holder (including the transferor if it retains a participating interest) have the same priority, and that priority does not change in the event of bankruptcy or other receivership of the transferor, the original debtor, or any participating interest holder.
d Neither the transferor (or its consolidated affiliates, its agents, or a bankruptcy trustee or other receiver for the transferor, its consolidated affiliates, or its agents) nor any participating interest holder has the right to pledge or exchange the entire financial asset in which they own a participating interest.

9. A transfer of a financial asset~~s~~, a group of financial assets, or a participating interest in an individual financial asset (which are referred to collectively in this Statement as *transferred financial assets*) ~~(or all or a portion of a financial asset) in which~~ shall be

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

a. The transferred financial assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership ~~(paragraphs 27 and 28)~~. Transferred financial assets are isolated in bankruptcy or other receivership only if the available evidence provides reasonable assurance that the transferred financial assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any **consolidated affiliate of the transferor** that is not a special-purpose corporation or other entity designed to make remote the possibility that it would enter bankruptcy or other receivership (bankruptcy-remote entity) (paragraphs 9(d), 9(e), 27, 27A, 27B, 28, and 83(c)).

b. ~~Each transferee (or, if~~Unless the transferee is a qualifying SPE (paragraph 35), ~~each holder of its beneficial interests)~~ the transferee has the right to pledge or exchange the transferred financial 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). If the transferee is a qualifying SPE, each holder of **beneficial interests** issued by that qualifying SPE (including the transferor itself if it holds a beneficial interest) has the right to pledge or exchange its beneficial interests, and no condition both constrains the holder from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor. If a transaction involves a series of steps designed to isolate the transferred financial assets (as described in paragraph 83), each entity that receives the transferred financial assets is a transferee, and each transfer must meet this condition.

c. Neither t~~T~~he transferor or its consolidated affiliates or agents~~does not~~ maintains effective control over the transferred financial assets through either (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (paragraphs 47–49) or (2) the ability to unilaterally cause the holder to return specific assets, other than through a **cleanup call** (paragraphs 50–54).

d. The isolation analysis must consider any arrangement or agreement made in connection with a transfer even if it was not entered into at the time of the transfer.

e. If the transferee is a qualifying SPE, no arrangement or agreement is made between any holder of beneficial interests issued by that qualifying SPE and the transferor, or its consolidated affiliates or agents that would have caused the assets not to be isolated as required by paragraphs 9(a) and 9(d) if the same arrangement or agreement had involved the qualifying SPE instead of its beneficial interest holders.

## Accounting for Transfers of Participating Interests and Servicing of Financial Assets

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

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

Upon completion[2a] of a transfer of participating interests that satisfies the conditions to be accounted for as a sale (paragraph 9), the transferor shall:

a. Allocate the previous carrying amount between the participating interests sold and the transferor's participating interests retained, if any, based on their relative fair values at the date of the transfer.
b. Derecognize participating interests sold.
c. Initially measure any participating interest retained at the allocated carrying amount as calculated in (a) (paragraphs 61–67).
d. Recognize and initially measure at fair value servicing assets, servicing liabilities, and other assets obtained including rights to contractual interest from the participating interests sold that represent the transferor's gain on the sale, if any. If it is not practicable to estimate the fair value of an asset or a liability, the transferor shall apply alternative measures (paragraphs 71 and 72) and adjust the recognition of gain or loss accordingly.
e. Recognize in earnings any gain or loss on the sale.

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

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[2a]Although a transfer of securities may not be considered to be completed until the settlement date, this Statement does not modify other generally accepted accounting principles, including FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans,* and AICPA Statements of Position and audit and accounting Guides for certain industries, that require accounting at the trade date for certain contracts to purchase or sell securities.

**Accounting for Transfers and Servicing of Entire Financial Assets**

11. Upon completion[3] of a transfer of an individual financial asset in its entirety or a group of financial assets in their entirety that satisfies the conditions to be accounted for as a sale (paragraph 9), the transferor (**seller**) shall:

a. Derecognize ~~all~~the transferred assets in their entirety~~sold~~.

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

b. Recognize and i~~I~~nitially measure at fair value servicing assets and any other assets obtained, including the transferor's beneficial interests and any other interests in the transferred financial assets and liabilities incurred in the~~a~~ sale, including servicing liabilities (paragraphs 68–70),[3a] or, if it is not practicable to estimate the fair value of an asset or a liability, the transferor shall apply alternative measures (paragraphs 71 and 72).

c~~d~~. Recognize in earnings any gain or loss on the sale.

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

12. If a transfer of financial assets ~~in exchange~~ ~~for cash or other consideration (other than beneficial interests in the transferred assets)~~ does not meet the criteria for a sale in paragraph 9, the transferor and transferee shall account for the transfer as a secured borrowing with pledge of collateral (paragraph 15). The transferor shall continue to report the transferred financial assets in its statement of financial position with no change in the measurement methodology.

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[3]Refer to footnote 2a.~~Although a transfer of securities may not be considered to have reached completion until the settlement date, this Statement does not modify other generally accepted accounting principles, including FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans,* and AICPA Statements of Position and audit and accounting Guides for certain industries, that require accounting at the trade date for certain contracts to purchase or sell securities.~~

[3a]A partial list of assets that might be obtained and liabilities that might be assumed includes cash, put or call options held or written (for example, guarantee or recourse obligations), forward commitments (for example, commitments to deliver additional receivables during the revolving periods of some securitizations), swaps (for example, provisions that convert interest rates from fixed to variable), transferors beneficial interests, and servicing liabilities.

**Recognition and Measurement of Servicing Assets and Liabilities**

13. Each time an entity undertakes an obligation to service financial assets it shall recognize either a servicing asset or a servicing liability for that servicing contract, unless it transfers the assets to a qualifying SPE in a **guaranteed mortgage securitization,** receives~~retains~~ all of the resulting securities, and classifies them as debt securities held-to-maturity in accordance with FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. ~~If the servicing asset or liability was purchased or assumed rather than undertaken in a sale or securitization of the financial assets being serviced, it shall be measured initially at its fair value, presumptively the price paid. A servicing asset or liability shall be amortized in proportion to and over the period of estimated net servicing income (if servicing revenues exceed servicing costs) or net servicing loss (if servicing costs exceed servicing revenues). A servicing asset or liability shall be assessed for impairment or increased obligation based on its fair value (paragraphs 61–64).~~ Each servicing asset or liability shall be measured initially at its fair value, if practicable, which is, presumptively, the price paid or received if the asset was purchased or the liability was assumed. For subsequent measurement of each class of servicing assets and liabilities, an entity shall apply one of the following methods:

a. *Amortization Method:* Amortize servicing assets or liabilities in proportion to and over the period of estimated net servicing income or net servicing loss. This method requires the assessment of servicing assets or liabilities for impairment or increased obligation based on fair value at each reporting date.

b. *Fair Value Measurement Method:* Report servicing assets or liabilities at fair value at each reporting date and report changes in fair value of servicing assets and liabilities in earnings in the period in which the changes occur.

The election described in this paragraph shall be made separately for each class of servicing assets and liabilities. An entity shall apply the same subsequent measurement method to each servicing asset or liability in a class. The class of servicing assets and liabilities shall be determined based on the major asset type being serviced as described in paragraph 17(h) (for example, mortgage loans, credit card receivables, and automobile loans). The fair value measurement method is preferable to the amortization method for purposes of justifying a subsequent change in accounting principle under FASB Statement No. 154, *Accounting Changes and Error Corrections*. An entity may elect to adopt the fair value measurement method at the beginning of a fiscal year that begins after the effective date of this Statement for an existing class of servicing assets and liabilities or upon initial recognition of a new class of servicing assets and liabilities. However, once an entity elects to adopt the fair value measurement method for a class of servicing assets and liabilities, that election shall not be reversed.

**Financial Assets Subject to Prepayment**

14. Interest-only strips, ~~retained~~participating interests, ~~in securitizations,~~beneficial interests, loans, other receivables, or other financial assets that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially

all of its recorded investment, except for instruments that are within the scope of Statement 133, shall be subsequently measured like investments in debt securities classified as available-for-sale or trading under Statement 115, as amended (paragraph 362).

### Secured Borrowings and Collateral

15. A debtor may grant a **security interest** in certain assets to a lender (the secured party) to serve as collateral for its obligation under a borrowing, with or without recourse to other assets of the debtor. An obligor under other kinds of current or potential obligations, for example, interest rate swaps, also may grant a security interest in certain assets to a secured party. If collateral is transferred to the secured party, the custodial arrangement is commonly referred to as a pledge. Secured parties sometimes are permitted to sell or repledge (or otherwise transfer) collateral held under a pledge. The same relationships occur, under different names, in transfers documented as sales that are accounted for as secured borrowings (paragraph 12). The accounting for noncash[4] collateral by the debtor (or obligor) and the secured party depends on whether the secured party has the right to sell or repledge the collateral and on whether the debtor has defaulted.

a. If the secured party (transferee) has the right by contract or custom to sell or repledge the collateral, then the debtor (transferor) shall reclassify that asset and report that asset in its statement of financial position separately (for example, as security pledged to creditors) from other assets not so encumbered.
b. If the secured party (transferee) sells collateral pledged to it, it shall recognize the **proceeds** from the sale and its obligation to return the collateral. The sale of the collateral is a transfer subject to the provisions of this Statement.
c. If the debtor (transferor) defaults under the terms of the secured contract and is no longer entitled to redeem the pledged asset, it shall derecognize the pledged asset, and the secured party (transferee) shall recognize the collateral as its asset initially measured at fair value or, if it has already sold the collateral, derecognize its obligation to return the collateral.
d. Except as provided in paragraph 15(c), the debtor (transferor) shall continue to carry the collateral as its asset, and the secured party (transferee) shall not recognize the pledged asset.

## Extinguishments of Liabilities

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

a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes delivery of cash, other financial assets, goods, or services or

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

reacquisition by the debtor of its outstanding debt securities whether the securities are canceled or held as so-called treasury bonds.

b. The debtor is legally released[5] from being the primary obligor under the liability, either judicially or by the creditor.

**Disclosures**

17. An entity shall disclose the following:

a. For collateral:
   (1) If the entity has entered into repurchase agreements or securities lending transactions, its policy for requiring collateral or other security.
   (2) If the entity has pledged any of its assets as collateral that are not reclassified and separately reported in the statement of financial position pursuant to paragraph 15(a), the carrying amount and classification of those assets as of the date of the latest statement of financial position presented.
   (3) If the entity has accepted collateral that it is permitted by contract or custom to sell or repledge, the fair value as of the date of each statement of financial position presented of that collateral and of the portion of that collateral that it has sold or repledged, and information about the sources and uses of that collateral.

b. If debt was considered to be extinguished by in-substance defeasance under the provisions of FASB Statement No. 76, *Extinguishment of Debt,* prior to the effective date of Statement 125,[6] a general description of the transaction and the amount of debt that is considered extinguished at the end of the period so long as that debt remains outstanding.

c. If assets are set aside after the effective date of Statement 125 solely for satisfying scheduled payments of a specific obligation, a description of the nature of restrictions placed on those assets.

d. If it is not practicable to estimate the fair value of certain assets obtained or liabilities incurred in transfers of financial assets during the period, a description of those items and the reasons why it is not practicable to estimate their fair value.

~~e. For all servicing assets and servicing liabilities:~~
   ~~(1) The amounts of servicing assets or liabilities recognized and amortized during the period~~
   ~~(2) The fair value of recognized servicing assets and liabilities for which it is practicable to estimate that value and the method and significant assumptions used to estimate the fair value~~
   ~~(3) The risk characteristics of the underlying financial assets used to stratify recognized servicing assets for purposes of measuring impairment in accordance with paragraph 63~~

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

[6]Refer to footnote 11 to paragraph 19.

~~(4) The activity in any valuation allowance for impairment of recognized servicing assets—including beginning and ending balances, aggregate additions charged and reductions credited to operations, and aggregate direct write-downs charged against the allowances for each period for which results of operations are presented.~~

e. For servicing assets and liabilities subsequently measured at fair value:

(1) The classes of servicing assets and liabilities subsequently measured at fair value and management's basis for its decision to subsequently measure those classes of servicing assets and liabilities at fair value.

(2) A description of the risks inherent in the servicing activities and, if applicable, the instruments used to mitigate the income statement effect of a change in fair value of the servicing assets and liabilities. Disclosure of quantitative information about the instruments used to manage the risks inherent in the servicing activities, including the fair value of those instruments at the beginning and end of the period, is encouraged but not required.

(3) The activity in the balance of each class of servicing assets and each class of servicing liabilities (including a description of where changes in fair value are reported in the statement of income for each period for which results of operations are presented), including:

(a) The beginning and ending balances

(b) Additions (through purchase, assumption, or asset transfer)

(c) Disposals

(d) Changes in fair value during the period from payment on the underlying assets, and changes in valuation inputs or assumptions used in the valuation model

(e) The amount of contractual servicing fees earned for each period for which results of operations are presented, including a description of where each source of activity is reported in the statement of income.

(4) A description of the valuation techniques or other methods used to estimate the fair value of each class of servicing assets and liabilities. If a valuation model is used, the description should include the methodology and model validation procedures, as well as quantitative and qualitative information about the assumptions used in the valuation model (for example, discount rates and prepayments). An entity that provides quantitative information about the instruments used to manage the risks inherent in the servicing activities, as encouraged by (2) above, is encouraged, but not required, to disclose a description of the valuation techniques, as well as quantitative and qualitative information about the assumptions used to estimate the fair value of those instruments.

(5) A sensitivity analysis or stress test showing the hypothetical effect on the fair value of each class of the servicing assets and liabilities of two or more unfavorable variations from the expected levels for each key assumption that is reported under (4) above independently from any change in another key assumption, and a description of the objectives, methodology, and limitations of the sensitivity analysis or stress test. An entity that discloses quantitative information about the instruments used to manage the risks inherent in the

servicing activities, as encouraged by (2) above, is encouraged, but not required, to disclose a separate sensitivity analysis for those instruments.

f. For servicing assets and liabilities subsequently amortized in proportion to and over the period of estimated net servicing income or loss and assessed for impairment or increased obligation:

(1) The classes of servicing assets and liabilities amortized and management's basis for its decision not to subsequently measure those classes of servicing assets and liabilities at fair value.

(2) A description of the risks inherent in the servicing activities and, if applicable, the instruments used to mitigate the income statement effect of a change in fair value of the servicing assets and servicing liabilities. Disclosure of quantitative information about the instruments used to manage the risks inherent in the servicing activities, including the fair value of those instruments at the beginning and end of the period, is encouraged but not required.

(3) The activity in the balance of each class of servicing assets and each class of servicing liabilities (including a description of where changes in fair value are reported in the statement of income for each period for which results of operations are presented), including:

(a) The beginning and ending balances

(b) Additions (through purchase, assumption, or asset transfer)

(c) Amortization

(d) Disposals

(e) Impairment (recoveries)

(f) The amount of contractual servicing fees earned for each period for which results of operations are presented, including a description of where each source of activity is reported in the statement of income.

(4) For each class of servicing assets and liabilities, the fair value of recognized servicing assets and liabilities at the beginning and end of the period if it is practicable to estimate the value.

(5) A description of the valuation techniques or other methods used to estimate fair value of the servicing assets and liabilities. If a valuation model is used, the description should include the methodology and model validation procedures, as well as quantitative and qualitative information about the assumptions used in the valuation model (for example, discount rates or prepayment speeds). An entity that provides quantitative information about the instruments used to manage the risks inherent in the servicing activities, as encouraged by (2) above, is encouraged, but not required, to disclose a description of the valuation techniques as well as quantitative and qualitative information about the assumptions used to estimate the fair value of those instruments.

(6) The risk characteristics of the underlying financial assets used to stratify recognized servicing assets for purposes of measuring impairment in accordance with paragraph 63.

(7) The activity in any valuation allowance for impairment of recognized servicing assets—including beginning and ending balances, aggregate additions charged and recoveries credited to operations, and aggregate write-downs charged

against the allowance—for each period for which results of operations are presented.

(8) A sensitivity analysis or stress test showing the hypothetical effect on the fair value of each class of servicing assets and servicing liabilities of two or more unfavorable variations from the expected levels for each key assumption that is reported under (5) above independently from any change in another key assumption, and a description of the objectives, methodology, and limitations of the sensitivity analysis or stress test. An entity that provides quantitative information about the instruments used to manage the risks inherent in the servicing activities, as encouraged by (2) above, is encouraged, but not required, to disclose a separate sensitivity analysis for those instruments.

gf. If the entity has securitized financial assets during any period presented and accounts for that transfer as a sale, for each major asset type (for example, mortgage loans, credit card receivables, and automobile loans):

(1) Its accounting policies for initially measuring the retainedtransferor's beneficial interests, if any, including the methodology (whether quoted market price, prices based on sales of similar assets and liabilities, or prices based on valuation techniques) used in determining their fair value (paragraphs 68–70).

(2) The characteristics of securitizations (a description of the transferor's continuing involvement with the transferred assets, including, but not limited to, servicing, recourse, and restrictions on retainedthe transferor's beneficial interests) and the gain or loss from sale of financial assets in securitizations.

(3) The key assumptions[7] used in measuring the fair value of the transferor's beneficialretained interests at the time of securitization (including, at a minimum, quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable financial assets,[8] and anticipated credit losses, if applicable).

(4) Cash flows between the securitization SPE and the transferor, unless reported separately elsewhere in the financial statements or notes (including proceeds from new securitizations, proceeds from collections reinvested in revolving-period securitizations, purchases of delinquent or foreclosed loans, servicing fees, and cash flows received on the transferor's beneficial interests retained).

hg. If the entity has a transferor's beneficialretained interests in securitized financial assets at the date of the latest statement of financial position presented, for each major asset type (for example, mortgage loans, credit card receivables, and automobile loans):

(1) Its accounting policies for subsequently measuring the transferor's beneficialthose retained interests, including the methodology (whether quoted market price, prices based on sales of similar assets and liabilities, or prices based on valuation techniques) used in determining their fair value (paragraphs 68–70).

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

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

(2) The key assumptions used in subsequently measuring the fair value of those interests (including, at a minimum, quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable financial assets, and anticipated credit losses, including expected static pool losses,[9] if applicable).

(3) A sensitivity analysis or stress test showing the hypothetical effect on the fair value of those interests of two or more unfavorable variations from the expected levels for each key assumption that is reported under (2) above independently from any change in another key assumption, and a description of the objectives, methodology, and limitations of the sensitivity analysis or stress test.

(4) For the securitized assets and any other financial assets that it manages together with them:[10]

   (a) The total principal amount outstanding, the principal amount related to the beneficial interests sold to parties other than the transferor~~portion that has been derecognized~~, and the principal amount related to the transferor's beneficial interests~~portion~~ that continues to be recognized in each category reported in the statement of financial position, at the end of the period

   (b) Delinquencies at the end of the period

   (c) Credit losses, net of recoveries, during the period

   Disclosure of average balances during the period is encouraged, but not required.

**Implementation Guidance**

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

**Effective Date and Transition**

**[Paragraphs 19–25 have been omitted because the effective dates of those provisions in Statement 140 have passed. However, in July 2001, 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,* was issued to provide certain financial institutions with an additional transition period to apply Statement 140. That transition period will end June 30, 2006. For the transition and effective date provisions of this amendment refer to paragraphs C4–C14 of this appendix.]**

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

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

## Appendix A

## IMPLEMENTATION GUIDANCE

### Introduction

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

### Isolation beyond the Reach of the Transferor and Its Creditors

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

27A. A transfer of a financial asset, a group of financial assets, or a participating interest in an individual financial asset (which are referred to collectively in this Statement as *transferred financial assets*) is considered to have isolated the transferred financial assets only if a legal analysis would support the following conclusions under the laws in the applicable jurisdiction:

a. The transfer is legally a sale.
b. In the event of bankruptcy, receivership, or other insolvency of the transferor or any consolidated affiliate of the transferor that is not a bankruptcy-remote entity, the transferred asset would not be deemed to be part of the estate of the transferor or its consolidated affiliate.

27B. A true sale opinion from an attorney is often required to support a conclusion that transferred financial assets have been isolated. A nonconsolidation opinion is often also required if the transfer is to an affiliated entity, a qualifying SPE, or another SPE.

a. Under U.S. law, a true sale opinion is an attorney's conclusion that the transferred financial assets have been sold and are beyond the reach of the transferor's creditors and that a court would conclude that the transferred assets would not be included in the transferor's bankruptcy estate. That opinion should relate to the transferor and transferee and should also consider the provisions of paragraphs 9(d) and 9(e).
b. Under U.S. law, a nonconsolidation opinion is an attorney's conclusion that a court would recognize that an entity holding the transferred financial assets exists separately from the transferor and that the court would not order the substantive consolidation of the assets and liabilities of the entity holding the transferred financial assets with the assets and liabilities of the transferor in the event of the transferor's bankruptcy or receivership.

A legal opinion is not required if a transferor has a reasonable basis to conclude that the appropriate legal opinion or opinions would be given if requested. For example, the transferor might reach a conclusion without consulting an attorney if it had experience with other transfers with the same facts and circumstances, including under similar applicable laws and regulations.

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

**Conditions That Constrain a Transferee**

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

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

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

**Transferor's Rights or Obligations to Reacquire Transferred Assets**

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

exchanging or pledging them and thus do not preclude sale accounting under paragraph 9(b).

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

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

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

## Qualifying SPE

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

a. It is demonstrably distinct from the transferor (paragraph 36).
b. Its permitted activities (1) are significantly limited, (2) were entirely specified in the legal documents that established the SPE or created the beneficial interests in the transferred financial assets that it holds, and (3) may be significantly changed only with the approval of the holders of at least a majority of the beneficial interests held by entities other than any transferor, its consolidated affiliates, and its agents (paragraphs 37 and 38).
c. It may hold only:
   (1) Financial assets transferred to it that are passive in nature (paragraph 39) and are not equity instruments (other than those noted in paragraph 35(c)(5))
   (2) Passive **derivative financial instruments** that pertain to beneficial interests ~~(other than another derivative financial instrument)~~ issued ~~or sold to parties other than the transferor, its affiliates, or its agents~~ (paragraphs 39 and 40)

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

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

(3) Financial assets (for example, guarantees or rights to collateral) that would reimburse it if others were to fail to adequately service financial assets transferred to it or to timely pay obligations due to it and that it entered into when it was established, when assets were transferred to it, or when beneficial interests (other than derivative financial instruments) were issued by the SPE
(4) Servicing rights related to financial assets that it holds
(5) Temporarily, nonfinancial assets or equity instruments obtained in connection with the collection of financial assets that it holds (paragraph 41)
(6) Cash collected from assets that it holds and investments purchased with that cash pending distribution to holders of beneficial interests that are appropriate for that purpose (that is, money-market or other relatively risk-free instruments without options and with maturities no later than the expected distribution date).

d. If it can sell or otherwise dispose of noncash financial assets, it can do so only in automatic response to one of the following conditions:
(1) Occurrence of an event or circumstance that (a) is specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds; (b) is outside the control of the transferor, its affiliates, or its agents; and (c) causes, or is expected at the date of transfer to cause, the fair value of those financial assets to decline by a specified degree below the fair value of those assets when the SPE obtained them (paragraphs 42 and 43)
(2) Exercise by a BIH (other than the transferor, its affiliates, or its agents) of a right to put that holder's beneficial interest back to the SPE (paragraph 44)
(3) Exercise by the transferor of a call or ROAP specified in the legal documents that established the SPE, transferred assets to the SPE, or created the beneficial interests in the transferred assets that it holds (paragraphs 51–54 and 85–88)
(4) Termination of the SPE or maturity of the beneficial interests in those financial assets on a fixed or determinable date that is specified at inception (paragraph 45).

e. If its governing documents permit **rollovers of beneficial interests,** no party (including its consolidated affiliates or agents) has the opportunity to obtain a more-than-trivial incremental benefit by virtue of having more than one type of involvement with the entity (paragraph 45A).

**Need to Be Demonstrably Distinct from the Transferor**

36. A qualifying SPE is demonstrably distinct from the transferor only if it cannot be unilaterally dissolved by any transferor, its affiliates, or its agents and either (a) at least 10 percent of the fair value of its beneficial interests is held by parties other than any transferor, its affiliates, or its agents or (b) the transfer is a guaranteed mortgage securitization.[17] An ability to unilaterally dissolve an SPE can take many forms, including

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

but not limited to holding sufficient beneficial interests to demand that the trustee dissolve the SPE, the right to call all the assets transferred to the SPE, and a right to call or a prepayment privilege on the beneficial interests held by other parties.

**Limits on Permitted Activities**

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

38. The BIHs other than any transferor, its affiliates, or its agents may have the ability to change the powers of a qualifying SPE. If the powers of a previously qualifying SPE are changed so that the SPE is no longer qualifying, unless the conditions in paragraph 9(b) are then met by the SPE itself and the conditions in paragraphs 9(a) and 9(c) continue to be met, that change would bring the transferred assets held in the SPE back under the control of the transferor (paragraph 55).

**Limits on What a Qualifying SPE May Hold**

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

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

a. Is entered into (1) when the beneficial interests are issued by the qualifying SPE ~~to parties other than the transferor, its affiliates, or its agents or sold to such other parties after being issued by the qualifying SPE to the transferor, its affiliates, or its agents~~ or (2) when a passive derivative financial instrument needs to be replaced upon occurrence of an event or circumstance (specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds) outside the control of the transferor, its affiliates, or its agents, for example, when the counterparty to the derivative defaults or is downgraded below a specified threshold

b. Has a notional amount that does not initially exceed the amount of those beneficial interests issued and is not expected to exceed them subsequently
c. Has characteristics that relate to, and partly or fully but not excessively counteract, some risk associated with those beneficial interests issued or the related transferred financial assets.

41. A qualifying SPE may hold equity instruments or nonfinancial assets other than servicing rights only temporarily and only if those equity instruments or nonfinancial assets result from collecting the transferred financial assets. For example, a qualifying SPE could be permitted to temporarily hold foreclosed nonfinancial collateral. In contrast, an entity cannot be a qualifying SPE if, for example, it receives from a transferor significant secured financial assets likely to default with the expectation that it will foreclose on and profitably manage the securing nonfinancial assets. A qualifying SPE also may hold the residual value of a sales-type or a direct financing lease only to the extent that it is guaranteed at the inception of the lease either by the lessee or by a third party financially capable of discharging the obligations that may arise from the guarantee (paragraph 89). The term *equity instruments* includes equity securities as defined in Statement 115 as well as other forms of ownership interest in entities, such as partnership interests and investments in operating joint ventures.

**Limits on Sales or Other Dispositions of Assets**

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

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

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

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

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

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

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

45A. If its governing documents permit rollovers of beneficial interests, no party (including its consolidated affiliates or agents) has the opportunity to obtain a more-than-trivial incremental benefit by virtue of having more than one type of involvement with the entity. *Opportunity to obtain a more-than-trivial incremental benefit* refers to a party's opportunity, as a result of holding a combination of rights or obligations, to enhance its rights or to minimize its obligations related to the qualifying SPE in comparison to the opportunities associated with the same rights or obligations if each right and each obligation were held by separate, unrelated parties. *Involvement with the entity* refers to conditional or unconditional rights to receive assets from the entity or obligations to deliver assets to the entity as well as decision-making authority or obligations to provide services to the entity. The types of involvement include:

a. An obligation to provide liquidity to support the issuance by a qualifying SPE of beneficial interests that will be rolled over, regardless of the form of the obligation. Some examples include a line of credit, letter of credit, and an obligation to purchase assets or beneficial interests. Obligations of servicers of financial assets are not

subject to these requirements if the servicing contract includes only the terms and conditions customarily included in arm's-length contracts to service the same types of assets.

b. Enhancement of the credit quality of the beneficial interests issued by a qualifying SPE regardless of the form in which that enhancement is provided. Some examples include a subordinated right to cash flows from the assets of a qualifying SPE, a guarantee of either the collectibility of the qualifying SPE's assets or payment of its liabilities, and options to put impaired assets.

c. A right or obligation to specify the terms and conditions of the beneficial interests that the qualifying SPE issues, to decide which investors to sell them to, to decide when to issue beneficial interests, or any combination thereof (to direct the financing activities of the SPE). Those rights and obligations are constrained by paragraph 35(b), which states that the qualifying SPE's permitted activities must be entirely specified in the legal documents that established the qualifying SPE or created the beneficial interests in the transferred financial assets it holds and must be significantly limited.

Whether that party has an opportunity to obtain a more-than-trivial incremental benefit from combinations of involvements requires consideration of the specific facts and circumstances. Beneficial interests issued by a revolving-period master trust are not considered rollovers if the proceeds are applied to reduce the transferor's interest.

#### Qualifying SPEs and Consolidated Financial Statements

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

### Maintaining Effective Control over Transferred Assets

#### Agreement to Repurchase or Redeem Transferred Assets

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

a. The assets to be repurchased or redeemed are the same or substantially the same as those transferred (paragraph 48).
b. The transferor is able to repurchase or redeem them on substantially the agreed terms, even in the event of default by the transferee (paragraph 49).
c. The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price.
d. The agreement is entered into concurrently with the transfer.

48. To be substantially the same,[18] the asset that was transferred and the asset that is to be repurchased or redeemed need to have all of the following characteristics:

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

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

**Ability to Unilaterally Cause the Return of Specific Transferred Assets**

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

51. If the transferee is a qualifying SPE, it has met the conditions in paragraph 35(d) and therefore must be constrained from choosing to exchange or pledge the transferred assets. In that circumstance, any call held by the transferor is effectively attached to the assets and could—depending on the price and other terms of the call—maintain the transferor's effective control over transferred assets through the ability to unilaterally cause the transferee to return specific assets. For example, a transferor's unilateral ability to cause a

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[18]In this Statement, the term substantially the same is used consistently with the usage of that term in the AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position.

qualifying SPE to return to the transferor or otherwise dispose of specific transferred assets at will or, for example, in response to its decision to exit a market or a particular activity, could provide the transferor with effective control over the transferred assets.

52. A call that is attached to transferred assets maintains the transferor's effective control over those assets if, under its price and other terms, the call conveys more than a trivial benefit to the transferor. Similarly, any unilateral right to reclaim specific assets transferred to a qualifying SPE maintains the transferor's effective control over those assets if the right conveys more than a trivial benefit to the transferor. A call or other right conveys more than a trivial benefit if the price to be paid is fixed, determinable, or otherwise potentially advantageous, unless because that price is so far out of the money or for other reasons it is probable when the option is written that the transferor will not exercise it. Thus, for example, a call on specific assets transferred to a qualifying SPE at a price fixed at their principal amount maintains the transferor's effective control over the assets subject to that call. Effective control over transferred assets can be present even if the right to reclaim is indirect. For example, if an embedded call allows a transferor to buy back the beneficial interests of a qualifying SPE at a fixed price, then the transferor remains in effective control of the assets underlying those beneficial interests. A cleanup call, however, is permitted as an exception to that general principle.

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

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

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

55. A change in law, status of the transferee as a qualifying SPE, or other circumstance may result in the transferor's regaining control of assets previously accounted for appropriately as having been sold, because one or more of the conditions in paragraph 9

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

## Measurement of Interests Held after a Transfer of Financial Assets

### Assets Obtained and Liabilities Incurred as Proceeds

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

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

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

Company A agrees to provide the transferee a return at a floating rate of interest even though the contractual terms of the loan are fixed rate in nature (that provision is effectively an interest rate swap).[18a]

| **Fair Values** | |
|---|---|
| Cash proceeds | $1,050 |
| Interest rate swap | 40 |
| Call option | 70 |
| Recourse obligation | 60 |

[18a]For purposes of this illustration, the transaction described in this paragraph is assumed to meet the conditions for a sale in paragraph 9 of this Statement. There is no assurance or presumption that this transaction or any other transaction in the examples in this Statement would actually be judged to meet the isolation condition or other conditions in paragraph 9.

**Net Proceeds**

| | |
|---|---|
| Cash received | $1,050 |
| Plus: Call option | 70 |
| Interest rate swap | 40 |
| Less: Recourse obligation | (60) |
| Net proceeds | $1,100 |

**Gain on Sale**

| | |
|---|---|
| Net proceeds | $1,100 |
| Carrying amount of loans sold | 1,000 |
| Gain on sale | $ 100 |

**Journal Entry**

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

~~**Retained Interests**~~

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

59. If the transferor's beneficial~~retained~~ interest~~s~~ is~~are~~ subordinated to more senior interests held by others, that subordination may concentrate into the transferor's beneficial ~~retained~~ interest~~s~~ most of the risks inherent in the transferred assets and shall be taken into consideration in estimating the fair value of the transferor's beneficial~~retained~~ interest~~s~~. For example, if the amount of the gain recognized~~, after allocation~~, on a securitization with a subordinated transferor's beneficial~~retained~~ interest is greater than the gain would have been if the transferor held no beneficial interest in the transferred financial assets~~had the entire asset been sold~~, the transferor needs to be able to identify why that can occur. Otherwise, it is likely that the impact of the transferor's beneficial~~retained~~ interest being

subordinate to a senior interest has not been adequately considered in the determination of the fair value of the transferor's subordinated beneficial~~retained~~ interest.

**Illustration—Recording Transfers of Participating~~Partial~~ Interests**

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

**Fair Values**

| | |
|---|---|
| Cash proceeds for nine-tenths participating interest sold | $990 |
| One-tenth participating interest retained [($990 ÷ 9/10) × 1/10] | 110 |

**Allocated Carrying Amount Based on Relative Fair Values**

| | Fair Value | Percentage of Total Fair Value | Allocated Carrying Amount |
|---|---|---|---|
| Nine-tenths participating interest sold | $ 990 | 90 | $ 900 |
| One-tenth participating interest retained | 110 | 10 | 100 |
| Total | $1,100 | 100 | $1,000 |

**Gain on Sale**

| | |
|---|---|
| Net proceeds | $990 |
| Carrying amount of loans sold | 900 |
| Gain on sale | $ 90 |

**Journal Entry**

| | | |
|---|---|---|
| Cash | 990 | |
| Participating interest | 100 | |
| Loans | | ~~900~~1,000 |
| Gain on sale of participating interest | | 90 |

To record transfer and reclassify the transferor's participating interest

**Servicing Assets and Liabilities**

61. Servicing of mortgage loans, credit card receivables, or other financial assets commonly includes, but is not limited to, collecting principal, interest, and escrow payments from borrowers; paying taxes and insurance from escrowed funds; monitoring

delinquencies; executing foreclosure if necessary; temporarily investing funds pending distribution; remitting fees to guarantors, trustees, and others providing services; and accounting for and remitting principal and interest payments to the holders of beneficial interests ~~in the financial assets~~or participating interests. Servicing is inherent in all financial assets; it becomes a distinct asset or liability only when contractually separated from the underlying assets by sale or securitization of the assets with servicing retained or separate purchase or assumption of the servicing. If an entity sells a participating interest in a financial asset, it recognizes the servicing asset or liability, if any, related to the participating interest sold, but it does not recognize a separate servicing asset or liability related to the participating interest retained.

62. An entity that undertakes a contract to service transferred financial assets shall recognize either a servicing asset or a servicing liability, with only one exception. (That exception is if the transferor transfers the assets in a guaranteed mortgage securitization, retains all of the resulting securities, and classifies them as debt securities held-to-maturity in accordance with Statement 115, in which case the servicing asset or liability may be reported together with the asset being serviced.) Each sale or securitization in which~~with~~ servicing is obtained~~retained~~ or each separate purchase or assumption of servicing results in a servicing contract. A servicer of financial assets commonly receives the benefits of servicing—revenues from contractually specified servicing fees, late charges, and other ancillary sources, including "float," all of which it is entitled to receive only if it performs the servicing—and incurs the costs of servicing the assets. Each servicing contract results in a servicing asset or servicing liability. Typically, the benefits of servicing are expected to be more than **adequate compensation** to a servicer for performing the servicing, and the contract results in a servicing asset. However, if the benefits of servicing are not expected to adequately compensate a servicer for performing the servicing, the contract results in a servicing liability. (A servicing asset may become a servicing liability, or vice versa, if circumstances change, and the initial measure for servicing may be zero if the benefits of servicing are just adequate to compensate the servicer for its servicing responsibilities.)

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

a. Report servicing assets separately from servicing liabilities in the statement of financial position (paragraph 13).
b. Initially measure servicing assets ~~retained in~~arising from a sale or securitization of the assets being serviced at fair value~~their allocated previous carrying amount based on relative fair values~~, if practicable~~, at the date of the sale or securitization~~ (paragraphs 10, 58–60, and 68–72).
c. Initially measure servicing assets purchased or servicing liabilities assumed at fair value, presumptively the price paid or received (paragraph 13).
d. Initially measure servicing liabilities undertaken in a sale or securitization at fair value, if practicable (paragraphs 11(b), 11(c), and 68–72).
e. Account separately for rights to future interest income from the serviced assets that exceeds contractually specified servicing fees. Those rights are not servicing assets;

they are financial assets, effectively interest-only strips to be accounted for in accordance with paragraph 14 of this Statement.

f. Subsequently measure separately recognized servicing assets or liabilities at either fair value or by amortizing the amount recognized in proportion to and over the period of estimated net servicing income for assets (the excess of servicing revenues over servicing costs) or the period of estimated net servicing loss for liabilities (the excess of servicing costs over servicing revenues). An entity may make an irrevocable decision to subsequently measure servicing assets or liabilities at fair value at the beginning of any fiscal year. The election to subsequently measure servicing assets or liabilities at fair value shall be made for each class (as described in paragraph 13(b)) of servicing assets or liabilities. Different elections can be made for different classes of servicing assets or liabilities. Changes in fair value should be reported in earnings for servicing assets or liabilities subsequently measured at fair value (paragraph 13).

g. Subsequently evaluate and measure impairment of servicing assets that are subsequently measured using the amortization method described in paragraph 13(a) as follows:
   (1) Stratify servicing assets based on one or more of the predominant risk characteristics of the underlying financial assets. Those characteristics may include financial asset type,[19] size, interest rate, date of origination, term, and geographic location.
   (2) Recognize impairment through a valuation allowance for an individual stratum. The amount of impairment recognized shall be the amount by which the carrying amount of servicing assets for a stratum exceeds their fair value. The fair value of servicing assets that have not been recognized shall not be used in the evaluation of impairment.
   (3) Adjust the valuation allowance to reflect changes in the measurement of impairment subsequent to the initial measurement of impairment. Fair value in excess of the carrying amount of servicing assets for that stratum, however, shall not be recognized. This Statement does not address when an entity should record a direct write-down of recognized servicing assets (paragraph 13).

h. ~~Subsequently measure servicing liabilities by amortizing the amount recognized in proportion to and over the period of estimated net servicing loss—the excess of servicing costs over servicing revenues. However,~~For servicing liabilities subsequently measured under the amortization method, if subsequent events have increased the fair value of the liability above the carrying amount, for example, because of significant changes in the amount or timing of actual or expected future cash flows relative to the cash flows previously projected, the servicer shall revise its earlier estimates and recognize the increased obligation as a loss in earnings (paragraph 13).

64. As indicated above, transferors sometimes agree to take on servicing responsibilities when the future benefits of servicing are not expected to adequately compensate them for

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

performing that servicing. In that circumstance, the result is a servicing liability rather than a servicing asset. For example, if in the transaction illustrated in paragraph 57 the transferor had agreed to service the loans without explicit compensation and it estimated the fair value of that servicing obligation at $50, net proceeds would be reduced to $1,050, gain on sale would be reduced to $50, and the transferor would report a servicing liability of $50.

**Illustration—Sale of Receivables with Servicing and Other Assets Obtained~~Retained~~**

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

**Fair Values**

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

**~~Carrying Amount Based on Relative Fair Values~~**

| | ~~Fair Value~~ | ~~Percentage of Total Fair Value~~ | ~~Allocated Carrying Amount~~ |
|---|---|---|---|
| ~~Loans sold~~ | ~~1,000~~ | ~~91.0~~ | ~~$ 910~~ |
| ~~Servicing asset~~ | ~~40~~ | ~~3.6~~ | ~~36~~ |
| ~~Interest-only strip receivable~~ | ~~60~~ | ~~5.4~~ | ~~54~~ |
| ~~Total~~ | ~~1,100~~ | ~~100.0~~ | ~~$1,000~~ |

**Gain on Sale**

| | |
|---|---|
| ~~Net~~Cash proceeds | $1,000 |
| Servicing asset | 40 |
| Interest-only strip receivable | 60 |
| Total assets received | 1,100 |
| Carrying amount of loans sold | 1,000~~910~~ |
| Gain on sale | $ 100~~90~~ |

**Journal Entries**

| | | |
|---|---|---|
| Cash | 1,000 | |
| Servicing asset | 40 | |
| Interest-only strip receivable | 60 | |
| Loans | | 1,000~~910~~ |
| Gain on sale | | 100~~90~~ |
| To record transfer and recognition of the servicing asset and interest-only strip receivable obtained | | |

| | | |
|---|---|---|
| ~~Servicing asset~~ | ~~36~~ | |
| ~~Interest-only strip receivable~~ | ~~54~~ | |
| ~~Loans~~ | | ~~90~~ |
| ~~To record servicing asset and interest-only strip receivable~~ | | |

| | | |
|---|---|---|
| ~~Interest-only strip receivable~~ | ~~6~~ | |
| ~~Equity~~ | | ~~6~~ |
| ~~To begin to subsequently measure interest-only strip receivable like an available-for-sale security (paragraph 14)~~ | | |

66. The previous illustration demonstrates how a transferor would account for a simple sale ~~or securitization~~ in which a servicing right is separately recognized~~retained~~. Company C might instead transfer the financial assets to a corporation or a trust that is a qualifying SPE. The qualifying SPE then securitizes the loans by selling beneficial interests to the public. The qualifying SPE pays the cash proceeds to the original transferor, which accounts for the transfer as a sale and derecognizes the financial assets assuming that the criteria in paragraph 9 are met. Securitizations often combine the elements shown in paragraphs 57, 60, and 65, as illustrated below.

**Illustration—Recording Transfers of ~~Partial Interests~~Entire Financial Assets to a Qualifying SPE with Proceeds of Cash and Beneficial Interests, ~~Derivatives,~~ Other Liabilities Incurred, and Servicing Obtained**

67. Company D originates $1,000 of prepayable loans that yield 10 percent interest income for their 9-year expected lives. Company D transfers the loans in their entirety to a qualifying SPE and in return receives $900 cash and a beneficial interest issued by the qualifying SPE with a fair value of $100.~~Company D sells nine-tenths of the principal plus interest of 8 percent to another entity.~~ Company D will continue to service the loans, and the contract stipulates that its compensation for performing the servicing is ~~the~~ 2 percent of the contractual interest on the loans.~~interest income not sold.~~ Company D ~~obtains an~~

~~option to purchase from the transferee loans similar to the loans sold (which are readily obtainable in the marketplace) and~~ incurs a limited recourse obligation to repurchase delinquent loans.[19a]

**Fair Values**

| | |
|---|---|
| ~~Cash proceeds~~Loans sold | $1,000~~900~~ |
| ~~Call option~~ | ~~70~~ |
| Recourse obligation | 60 |
| Servicing asset | 90 |
| Beneficial interest received~~One-tenth interest retained~~ | 100 |

**~~Net Proceeds~~**

| | |
|---|---|
| ~~Cash received~~ | ~~$900~~ |
| ~~Plus: Call option~~ | ~~70~~ |
| ~~Less: Recourse obligation~~ | ~~(60)~~ |
| ~~Net proceeds~~ | ~~$910~~ |

**~~Carrying Amount Based on Relative Fair Values~~**

| | ~~Fair Value~~ | ~~Percentage of Total Fair Value~~ | ~~Allocated Carrying Amount~~ |
|---|---|---|---|
| ~~Interest sold~~ | ~~$910~~ | ~~83~~ | ~~830~~ |
| ~~Servicing asset~~ | ~~90~~ | ~~8~~ | ~~80~~ |
| ~~One-tenth interest retained~~ | ~~100~~ | ~~9~~ | ~~90~~ |
| ~~Total~~ | ~~$1,000~~ | ~~100~~ | ~~$1,000~~ |

**Gain on Sale**

| | |
|---|---|
| ~~Net~~Cash proceeds | $900~~910~~ |
| Servicing asset | 90 |
| Beneficial interest received | 100 |
| Total assets received | 1,090 |
| Carrying amount of loans sold | 1,000~~830~~ |
| Recourse obligation | 60 |
| Gain on sale | $30~~80~~ |

---

[19a]For purposes of this illustration, the transaction described in this paragraph is assumed to meet the conditions for a sale in paragraph 9 of this Statement. There is no assurance or presumption that this transaction or any other transaction in the examples in this Statement would actually be judged to meet the isolation condition or other conditions. For example, a two-step transfer as described in paragraph 83 may be required to meet the isolation condition in paragraph 9(a).

**Journal Entries**

| | | |
|---|---|---|
| Cash | 900 | |
| Beneficial interest | 100 | |
| ~~Call option~~ | ~~70~~ | |
| Servicing asset | 90 | |
| Loans | | 1,000~~830~~ |
| Recourse obligation | | 60 |
| Gain on sale | | 30~~80~~ |
| To record transfer of loans, receipt of beneficial interest and servicing asset and incurrence of the recourse obligation | | |

| | | |
|---|---|---|
| ~~Servicing asset~~ | ~~80~~ | |
| ~~Loans~~ | | ~~80~~ |
| ~~To record servicing asset~~ | | |

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

**Fair Value**

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

69. If quoted market prices are not available, the estimate of fair value shall be based on the best information available in the circumstances. The estimate of fair value shall consider prices for similar assets and liabilities and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated future cash flows,[20] option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. Valuation techniques for measuring financial assets and liabilities and servicing assets and liabilities shall be consistent with the objective of measuring fair value. Those techniques shall incorporate assumptions that market participants would use in their estimates of values, future

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

revenues, and future expenses, including assumptions about interest rates, default, prepayment, and volatility.[21] In measuring **financial liabilities** and servicing liabilities at fair value, the objective is to estimate the value of the assets required currently to (a) settle the liability with the holder or (b) transfer a liability to an entity of comparable credit standing.

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

## If It Is Not Practicable to Estimate Fair Values

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

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

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

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

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

| **Fair Values** | **Case 1** | **Case 2** |
| --- | --- | --- |
| Cash proceeds | $1,050 | $1,050 |
| Servicing asset | XX* | 40 |
| Call option | 70 | 70 |
| Recourse obligation | 60 | XX* |
| Fair value of loans transferred | 1,100 | 1,100 |

*Not practicable to estimate fair value.

| **Net Proceeds** | **Case 1** | **Case 2** |
| --- | --- | --- |
| Cash received | $1,050 | $1,050 |
| Plus: Call option | 70 | 70 |
| Less: Recourse obligation | (60) | XX |
| Net proceeds | $1,060 | $1,120 |

**~~Carrying Amount Based on Relative Fair Values (Case 1)~~**

| | ~~Fair Value~~ | ~~Percentage of Total Fair Value~~ | ~~Allocated Carrying Amount~~ |
| --- | --- | --- | --- |
| ~~Loans sold~~ | ~~$1,060~~ | ~~100~~ | ~~$1,000~~ |
| ~~Servicing asset~~ | ~~0~~ | ~~0~~ | ~~0~~ |
| ~~Total~~ | ~~$1,060~~ | ~~100~~ | ~~$1,000~~ |

**~~Carrying Amount Based on Relative Fair Values (Case 2)~~**

| | ~~Fair Value~~ | ~~Percentage of Total Fair Value~~ | ~~Allocated Carrying Amount~~ |
| --- | --- | --- | --- |
| ~~Loans sold~~ | ~~$1,120~~ | ~~97~~ | ~~$ 970~~ |
| ~~Servicing asset~~ | ~~40~~ | ~~3~~ | ~~30~~ |
| ~~Total~~ | ~~$1,160~~ | ~~100~~ | ~~$1,000~~ |

| Journal Entries | Case 1 | | Case 2 | |
|---|---|---|---|---|
| Cash | 1,050 | | 1,050 | |
| Servicing asset | 0* | | ~~3~~40 | |
| Call option | 70 | | 70 | |
| Loans | | 1,000 | | 1,000 |
| Recourse obligation | | 60 | | 16~~5~~0† |
| Gain on sale | | 60 | | 0 |
| To record transfer | | | | |

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

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

### Securitizations

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

74. An originator of a typical securitization (the transferor) transfers a portfolio of financial assets to an SPE, commonly a trust. In "pass-through" and "pay-through" securitizations, receivables are transferred to the SPE at the inception of the securitization, and no further transfers are made; all cash collections are paid to the holders of beneficial interests in the SPE. In "revolving-period" securitizations, receivables are transferred at the inception and also periodically (daily or monthly) thereafter for a defined period (commonly three to eight years), referred to as the revolving period. During the revolving period, the SPE uses most of the cash collections to purchase additional receivables from the transferor on prearranged terms.

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

76. Pass-through, pay-through, and revolving-period securitizations that meet the criteria in paragraph 9 qualify for sale accounting under this Statement. All financial

assets obtained ~~or retained~~ and liabilities incurred by the originator of a securitization that qualifies as a sale shall be recognized and measured as provided in paragraph 11; that includes the implicit forward contract to sell new receivables during a revolving period, which may become valuable or onerous to the transferor as interest rates and other market conditions change.

**Revolving-Period Securitizations**

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

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

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

**Isolation of Transferred Financial Assets ~~in Securitizations~~**

80. A transaction~~securitization~~ carried out in one transfer or a series of transfers may or may not isolate the transferred financial assets beyond the reach of the transferor and its creditors. Whether it does depends on the structure of the ~~securitization~~ transaction taken as a whole, considering such factors as the type and extent of further involvement in arrangements to protect investors from credit and interest rate risks, the availability of other assets, and the powers of bankruptcy courts or other receivers. The discussion in paragraphs 81–83 relates only to the isolation condition in paragraph 9(a). The conditions in paragraphs 9(b)–9(e) must also be considered to determine whether a transferor has surrendered control over the transferred financial assets.

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

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

83. Still other transactions~~securitizations~~ use two or more transfers intended to isolate transferred financial assets beyond the reach of the transferor and its creditors, even in bankruptcy. In those "two-step" structures:

a. First, the corporation transfers financial assets to a consolidated special-purpose corporation that, although wholly owned, is so designed that the possibility that the transferor or its creditors could reclaim the assets is remote (a bankruptcy-remote entity). This first transfer is designed to be judged to be a true sale at law, in part because the transferor does not provide "excessive" credit or yield protection to the special-purpose corporation, and the Board understands that transferred assets are likely to be judged beyond the reach of the transferor or the transferor's creditors even in bankruptcy.

b. Second, the bankruptcy-remote entity~~special-purpose corporation~~ transfers the assets to a trust or other legal vehicle (including a variable interest entity as defined in FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities,* or a qualifying SPE as defined in paragraph 35 of this Statement) with a sufficient increase in the credit or yield protection on the second transfer (provided by a junior transferor's~~retained~~ beneficial interest or other means) to merit the high credit rating sought by third-party investors who buy senior beneficial interests in the trust. Because of that aspect of its design, that second transfer might not be judged to be a true sale at law and, thus, the transferred assets could at least in theory be reached by a bankruptcy trustee for the bankruptcy-remote entity~~special-purpose corporation~~.

c. However, the bankruptcy-remote entity~~special-purpose corporation~~ is designed to make remote the possibility that it would enter bankruptcy, either by itself or by substantive consolidation into a bankruptcy of its parent should that occur. For example, its charter forbids it from undertaking any other business or incurring any liabilities, so that there can be no creditors to petition to place it in bankruptcy. Furthermore, its dedication to a single purpose is intended to make it extremely unlikely, even if it somehow entered bankruptcy, that a receiver under the U.S. Bankruptcy Code could reclaim the transferred financial assets because it has no other assets to substitute for the transferred financial assets.

The Board understands that "two-step" transactions~~securitizations~~ described above, taken as a whole, generally would be judged under present U.S. law as having isolated the assets beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership. However, if the second transfer is to an entity that is not a qualifying SPE, the transferor must determine whether the entity should be consolidated with the transferor.

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

**Removal-of-Accounts Provisions**

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

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

a. An unconditional ROAP or repurchase agreement that allows the transferor to specify the assets that may be removed, because such a provision allows the transferor unilaterally to remove specific assets
b. A ROAP conditioned on a transferor's decision to exit some portion of its business, because whether it can be triggered by canceling an affinity relationship, spinning off a business segment, or accepting a third party's bid to purchase a specified (for example, geographic) portion of the transferor's business, such a provision allows the transferor unilaterally to remove specific assets.

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

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

88. A ROAP that can be exercised only in response to a third party's action that has not yet occurred does not maintain the transferor's effective control over assets potentially subject to that ROAP. However, when a third party's action (such as default or cancellation) or decision not to act (expiration) occurs that allows removal of assets to be initiated solely by the transferor, the transferor must recognize any assets subject to the ROAP, whether the ROAP is exercised or not. If the ROAP is exercised, the assets are recognized because the transferor has reclaimed the assets. If the ROAP is not exercised, the assets are recognized because the transferor now can unilaterally cause the qualifying SPE to return those specific assets and, therefore, the transferor once again has effective control over those transferred assets (paragraph 55).

## Sales-Type and Direct Financing Lease Receivables

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

### Illustration—Recording Transfers of Lease Financing Receivables with Residual Values

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

**Carrying Amounts**

| | | |
|---|---|---|
| Minimum lease payments | | $540 |
| Unearned income related to minimum lease payments | | 370 |
| Gross investment in minimum lease payments | | 910 |
| Unguaranteed residual value | $ 30 | |
| Unearned income related to residual value | 60 | |
| Gross investment in residual value | | 90 |
| Total gross investment in financing lease receivable | | $1,000 |

**Gain on Sale**

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

**Journal Entry**

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

To record sale of nine-tenths ~~of~~ participating interest in the minimum lease payments at the beginning of year 2

### Securities Lending Transactions

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

92. In some securities lending transactions, the criteria in paragraph 9 are met, including the effective control criterion in paragraph 9(c), and consideration other than beneficial interests in the transferred assets is received. Those transactions shall be accounted for (a) by the transferor as a sale of the "loaned" securities for proceeds consisting of the cash

"collateral"[22] and a forward repurchase commitment and (b) by the transferee as a purchase of the "borrowed" securities in exchange for the "collateral" and a forward resale commitment. During the term of that agreement, the transferor has surrendered control over the securities transferred and the transferee has obtained control over those securities with the ability to sell or transfer them at will. In that case, creditors of the transferor have a claim only to the "collateral" and the forward repurchase commitment.

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

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

**Illustration—Securities Lending Transaction Treated as a Secured Borrowing**

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

[22]If the "collateral" in a transaction that meets the criteria in paragraph 9 is a financial asset that the holder is permitted by contract or custom to sell or repledge, that financial asset is proceeds of the sale of the "loaned" securities. To the extent that the "collateral" consists of letters of credit or other financial instruments that the holder is not permitted by contract or custom to sell or repledge, a securities lending transaction does not satisfy the sale criteria and is accounted for as a loan of securities by the transferor to the transferee.

**Facts**

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

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

**Journal Entries for the Transferor**

*At inception:*

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

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

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

*At conclusion:*

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

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

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

**Journal Entries for the Transferee**

*At inception:*

| | | |
|---|---|---|
| Receivable under securities loan agreements | 1,020 | |
| Cash | | 1,020 |
| To record transfer of cash collateral | | |
| | | |
| Cash | 1,000 | |
| Obligation to return borrowed securities | | 1,000 |
| To record sale of borrowed securities to a third party and the resulting obligation to return securities that it no longer holds | | |

*At conclusion:*

| | | |
|---|---|---|
| Obligation to return borrowed securities | 1,000 | |
| Cash | | 1,000 |
| To record the repurchase of securities borrowed | | |
| | | |
| Cash | 1,024 | |
| Receivable under securities loan agreements | | 1,020 |
| Interest revenue ("rebate") | | 4 |
| To record the receipt of cash collateral and rebate interest | | |

**Repurchase Agreements and "Wash Sales"**

96. Government securities dealers, banks, other financial institutions, and corporate investors commonly use repurchase agreements to obtain or use short-term funds. Under those agreements, the transferor ("repo party") transfers a security to a transferee ("repo counterparty" or "reverse party") in exchange for cash[23] and concurrently agrees to reacquire that security at a future date for an amount equal to the cash exchanged plus a stipulated "interest" factor.

97. Repurchase agreements can be effected in a variety of ways. Some repurchase agreements are similar to securities lending transactions in that the transferee has the right to sell or repledge the securities to a third party during the term of the repurchase agreement. In other repurchase agreements, the transferee does not have the right to sell or repledge the securities during the term of the repurchase agreement. For example, in a tri-party repurchase agreement, the transferor transfers securities to an independent third-party custodian that holds the securities during the term of the repurchase agreement.

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

Also, many repurchase agreements are for short terms, often overnight, or have indefinite terms that allow either party to terminate the arrangement on short notice. However, other repurchase agreements are for longer terms, sometimes until the maturity of the transferred asset. Some repurchase agreements call for repurchase of securities that need not be identical to the securities transferred.

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

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

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

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

**Loan Syndications**

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

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

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

## Loan Participations

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

~~105. Transfers by the originating lender may take the legal form of either assignments or participations. The transfers are usually on a nonrecourse basis, and the transferor ("originating lender") continues to service the loan. The transferee ("participating entity") may or may not have the right to sell or transfer its participation during the term of the loan, depending upon the terms of the participation agreement.~~

106. If a~~the~~ ~~loan~~ participation agreement transfers a participating interest in a financial asset (as described in paragraph 8A of Statement 140 as amended) and gives the transferee the right to pledge or exchange its participating~~those participations~~ interest and the other criteria in paragraph 9 are met, the transfer~~s to the transferee~~ shall be accounted for by the transferor as a sale~~s~~ of a ~~financial assets~~participating interest. A transferor's right of first refusal on a bona fide offer from a third party, a requirement to obtain the transferor's permission that shall not be unreasonably withheld, or a prohibition on sale to the transferor's competitor if other potential willing buyers exist is a limitation on the transferee's rights but presumptively does not constrain a transferee from exercising its right to pledge or exchange. However, if the ~~loan~~ participation agreement constrains the transferee~~s~~ from pledging or exchanging its participating~~their participations~~ interest, the transferor presumptively receives a more than trivial benefit, has not relinquished control over the participating~~loan~~ interest, and shall account for the transfer~~s~~ as a secured borrowing~~s~~.

## Banker's Acceptances and Risk Participations in Them

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

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

109. A risk participation is a contract between the accepting bank and a participating bank in which the participating bank agrees, in exchange for a fee, to reimburse the

accepting bank in the event that the accepting bank's customer fails to honor its liability to the accepting bank in connection with the banker's acceptance. The participating bank becomes a guarantor of the credit of the accepting bank's customer.

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

**Illustration—Banker's Acceptance with a Risk Participation**

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

**Facts**

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

**Journal Entries for Accepting Bank**

*At issuance of acceptance:*

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

*At purchase of risk participation from a participating bank:*

| | | |
|---|---|---|
| Guarantee purchased | 10 | |
| Cash | | 10 |

*Upon presentation of the accepted time draft:*

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

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

| Account | Debit | Credit |
|---|---|---|
| Cash | 1,000 | |
| Guarantee expense | 10 | |
| Receivable from customer | | 1,000 |
| Guarantee purchased | | 10 |

**Journal Entries for Participating Bank**

*Upon issuing the risk participation:*

| Account | Debit | Credit |
|---|---|---|
| Cash | 10 | |
| Guarantee liability | | 10 |

*Upon payment by the customer to the accepting bank:*

| Account | Debit | Credit |
|---|---|---|
| Guarantee liability | 10 | |
| Guarantee revenue | | 10 |

*OR:*

*In the event of total default by the customer:*

| Account | Debit | Credit |
|---|---|---|
| Guarantee loss | 990 | |
| Guarantee liability | 10 | |
| Cash (paid to accepting bank) | | 1,000 |

### Factoring Arrangements

112. Factoring arrangements are a means of discounting accounts receivable on a nonrecourse, notification basis. Accounts receivable are sold outright, usually to a transferee (the factor) that assumes the full risk of collection, without recourse to the transferor in the event of a loss. Debtors are directed to send payments to the transferee. Factoring arrangements that meet the criteria in paragraph 9 shall be accounted for as sales of financial assets because the transferor surrenders control over the receivables to the factor.

### Transfers of Receivables with Recourse

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

Otherwise, a transfer of receivables with recourse shall be accounted for as a secured borrowing.

**Extinguishments of Liabilities**

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

## Appendix C

## ILLUSTRATIVE GUIDANCE

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

343. The first example illustrates the disclosure of accounting policies for a transferor's beneficial~~retained~~ interest~~s~~ and servicing rights. In particular, it describes the accounting policies for (a) initial measurement (paragraph 17(g~~f~~)(1)) and (b) subsequent measurement (paragraph 17(h~~g~~)(1)), including determination of fair value.

### NOTE X—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

**Receivable Sales**

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

speeds, forward yield curves, and discount rates commensurate with the risks involved.

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

**NOTE Y—SALES OF RECEIVABLES**

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

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

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

345. The following is an illustration of the quantitative information about key assumptions used in measuring the~~retained~~ servicing rights and the transferor's beneficial interests at the date of sale or securitization for each financial period presented (paragraph 17(g~~f~~)(3)).

Key economic assumptions used in measuring the ~~retained~~servicing rights and transferor's beneficial interests at the date of securitization resulting from securitizations completed during the year were as follows (rates* per annum):

**Note: The chart in this illustration and related footnotes are not reproduced here because there are no changes to that portion of this paragraph.**

346. The following is an illustration that combines disclosure of the key assumptions used in valuing ~~retained~~the servicing rights and the transferor's beneficial interests at the end of the latest period (paragraph 17(h~~g~~)(2)) and the hypothetical effect on current fair

value of two or more pessimistic variations from the expected levels for each of the key assumptions (paragraph 17(h~~g~~)(3)).

**Note: The chart in this illustration and related footnotes are not reproduced here because there are no changes to that portion of this paragraph.**

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

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

| | **Automobile Loans Securitized in** | | |
|---|---|---|---|
| **Actual and Projected Credit Losses (%) as of:** | **20X0** | **20X1** | **20X2** |
| December 31, 20X2 | 5.0 | 5.9 | 5.1 |
| December 31, 20X1 | 5.1 | 5.0 | |
| December 31, 20X0 | 4.5 | | |

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

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

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

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

**Note:**

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

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

| | **Total Principal Amount of Loans** | | **Principal Amount of Loans 60 Days or More Past Due*** | | **Average Balances[35]** | | **Net Credit Losses†** | |
|---|---|---|---|---|---|---|---|---|
| | **At December 31** | | | | **During the Year** | | | |
| **Type of Loan** | **20X2** | **20X1** | **20X2** | **20X1** | **20X2** | **20X1** | **20X2** | **20X1** |
| Automobile loans | $830 | $488 | $42.3 | $26.8 | $720 | $370 | $21.6 | $12.6 |
| Residential mortgage loans (fixed-rate) | 482 | 302 | 5.8 | 3.6 | 470 | 270 | 5.6 | 3.2 |
| Residential mortgage loans (adjustable) | 544 | 341 | 7.1 | 6.8 | 520 | 300 | 6.2 | 6.0 |
| Credit card loans | 300 | 250 | 15 | 12.5 | 350 | 300 | 16 | 15 |
| **Total loans managed or securitized‡** | 2,156 | 1,381 | $70.2 | $49.7 | 2,060 | 1,240 | $49.4 | $36.8 |
| Less: | | | | | | | | |
| Loans securitized§ | 1,485 | 905 | | | 1,368 | 752 | | |
| Loans held for sale or securitization | 19 | 11 | | | 17 | 9 | | |
| **Loans held in portfolio[36]** | $652 | $465 | | | $675 | $479 | | |

**Notes:**

*Loans 60 days or more past due are based on end of period total loans.

†Net credit losses are charge-offs and are based on total loans outstanding.

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

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

[35]This disclosure is optional.

[36]Loans held in portfolio are reported separately from loans held for securitization because they are measured differently.

## Appendix E

## GLOSSARY

364. This appendix defines terms used in this Statement.

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

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

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

**Beneficial interest~~s~~**
A ~~R~~right~~s~~ to receive all or portions of specified cash inflows to a qualifying SPE~~trust or other entity~~, including senior and subordinated shares of interest, principal, or other cash inflows to be "passed-through" or "paid-through," premiums due to guarantors, commercial paper obligations, and residual interests, whether in the form of debt or equity.

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

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

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

**Consolidated affiliate of the transferor**

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

**Contractually specified servicing fees**

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

**Derecognize**

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

**Derivative financial instrument**

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

**Embedded call**

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

**Fair value**

Refer to paragraphs 68–70.

**Financial asset**

Cash, evidence of an ownership interest in an entity, or a contract that conveys to a second entity a contractual right (a) to receive cash or another financial instrument from a first entity or (b) to exchange other financial instruments on potentially favorable terms with the first entity (Statement 107, paragraph 3(b)).

**Financial liability**

A contract that imposes on one entity a contractual obligation (a) to deliver cash or another financial instrument to a second entity or (b) to exchange other financial instruments on potentially unfavorable terms with the second entity (Statement 107, paragraph 3(a)).

**Freestanding call**

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

**Guaranteed mortgage securitization**

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

**Interest-only strip**

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

**Proceeds**

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

**Recourse**

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

**Rollovers of beneficial interests**

Reissuances of beneficial interests to obtain cash or other assets to retire or otherwise settle existing beneficial interests held by parties other than the transferor. Beneficial interests issued by revolving-period master trusts (as described in paragraph 79) are not considered rollovers if the proceeds are applied to reduce the transferor's beneficial interest.

**Securitization**

The process by which financial assets are transformed into securities.

**Security interest**

A form of interest in property that provides that upon default of the obligation for which the security interest is given, the property may be sold in order to satisfy that obligation.

**Seller**

A transferor that relinquishes control over financial assets by transferring them to a transferee in exchange for consideration.

**Servicing asset**

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

**Servicing liability**

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

**Transfer**

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

**Transferee**

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

**Transferor**

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

~~**Undivided interest**~~

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

**Unilateral ability**

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

## Combined Effective Date and Transition

### Effective Date

C4. The provisions of paragraph 9(a) of Statement 140 (as amended) shall be applied by both public and nonpublic entities upon issuance of this Statement. If the transferor, its consolidated affiliates, or its agents have any remaining commitments related to the transferred financial assets to deliver additional cash or other assets, the provisions also would be applicable to transfers occurring prior to the effective date of this Statement.

C5. A public entity shall apply all other derecognition provisions, including those reflected in paragraphs 8A, 9(b), 9(d), 9(e), 27, 27A, 27B, 35(c), 35(e), 39, 40, 41, 43, 45A, and 80–83 of Statement 140 (as amended), to transfers of financial assets occurring after the end of the first fiscal quarter beginning after the issuance of this Statement. For a public entity with a calendar year-end, if the final Statement is issued in February 2006, the guidance shall apply to transfers occurring as of July 1, 2006. A nonpublic entity shall apply those provisions to transfers of financial assets occurring in the first fiscal year beginning after the issuance of this Statement. For both public and nonpublic entities, the

measurement provisions described in paragraphs 10 and 11 of Statement 140, as amended, relating to transfers of financial assets and paragraphs 4 and 5 of the proposed Statement relating to servicing would apply at the earlier of fiscal years beginning after December 15, 2005, or fiscal years beginning during the quarter in which the final Statement is issued. For a public or nonpublic entity with a calendar year-end, if the final Statement is issued in February 2006, those provisions would apply to transfers beginning as of January 1, 2006.

**Accounting for Certain Hybrid Financial Instruments**

C6. These provisions shall be effective for all instruments obtained or issued after the beginning of the earlier of an entity's first fiscal year beginning after December 15, 2005, or the entity's fiscal year that begins during the fiscal quarter in which the Statement is issued, if applicable. Provisions of this Statement shall not be applied to instruments that an entity holds at the effective date.

**Transition**

***Servicing Rights***

**Subsequent measurement at fair value upon adoption of this Statement**

C7. An entity may apply an irrevocable decision to subsequently measure a class of separately recognized servicing rights at fair value as of the earlier of the beginning of the first fiscal year that begins after December 15, 2005, or the beginning of fiscal years beginning during the fiscal quarter in which the Statement is issued. The subsequent measurement of servicing rights at fair value shall be applied prospectively with a cumulative-effect adjustment to beginning retained earnings to reflect the difference between the fair value and the carrying amount of the servicing rights that exist at the date of the entity's election.

**Subsequent measurement at fair value after adoption of this Statement**

C8. An entity may apply an irrevocable decision to subsequently measure an existing class of separately recognized servicing rights at fair value as of the beginning of any fiscal year that begins subsequent to the adoption of this Statement. The subsequent measurement of servicing rights at fair value shall be applied prospectively with a cumulative-effect adjustment to beginning retained earnings to reflect the difference between the fair value and the carrying amount of the servicing rights that exist at the date of the entity's election.

**Subsequent measurement at fair value for a new class of servicing rights**

C9. If after the date of initial adoption of this Statement an entity recognizes servicing rights of a class of assets for which no such servicing rights had previously been recognized by the entity, that entity may elect to subsequently measure that new class of servicing rights at fair value at the date of initial recognition of that class of servicing rights.

*Transfers of Financial Assets*

**Amendment related to the effect of indirect agreements on the transferor's ability to meet the isolation requirement**

C10. If a formerly qualifying SPE that fails to meet the condition in paragraph 9(d) of Statement 140 (as amended) maintains its qualifying status under previous accounting standards, it shall continue to be considered a qualifying SPE unless it receives additional assets or issues additional beneficial interests other than those it was previously committed to receive or issue as a result of commitments to parties other than the transferor.

**Amendments related to permitted assets of qualifying SPEs**

C11. If a formerly qualifying SPE affected by paragraphs 35 and 41 of Statement 140 (as amended) maintains its qualifying status under previous accounting standards, it shall continue to be considered a qualifying SPE unless it receives additional assets or issues additional beneficial interests other than those it was previously committed to receive or issue as a result of commitments to parties other than the transferor. Existing qualifying SPEs that hold equity securities *and* roll over (retire or reissue) beneficial interests would apply the transition provisions related to rollovers of beneficial interests.

**Amendments related to rollovers of beneficial interests**

C12. If a formerly qualifying SPE[*] that fails to meet the conditions in paragraphs 35(e), 45A, and 364 of Statement 140 (as amended) maintains its qualifying status under previous accounting standards, it shall continue to be considered a qualifying SPE until six months after the effective date of this Statement, or until it has rolled over a majority of the beneficial interests that were outstanding at the effective date of this Statement as set forth in paragraph C5 of this Statement, whichever is later. If the formerly qualifying SPE fails to meet the conditions in this Statement (as described in the previous sentence), it shall be considered disqualified and shall not be eligible for the exceptions in paragraph 46 of Statement 140 and paragraphs 4(c) and 4(d) of FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*.

**Amendments related to isolation of assets**

C13. If a formerly qualifying SPE that fails to meet the condition in paragraph 9(e) of Statement 140 (as amended) maintains its qualifying status under previous accounting standards, it shall continue to be considered a qualifying SPE unless it receives additional assets or issues additional beneficial interests other than those it was previously committed to receive or issue as a result of commitments to parties other than the transferor. That means that a formerly qualifying SPE that is a revolving-period master trust may receive additional assets during revolving periods associated with beneficial interests previously issued, but if it issues new beneficial interests, it must meet the

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[*]Formerly qualifying SPEs include those that met the conditions in paragraphs 35–46 before amendment as well as those that did not meet those conditions but maintained qualifying status under paragraph 25 of Statement 140.

condition in paragraph 9(e) (as amended) with respect to those new beneficial interests. If the formerly qualifying SPE that fails to meet the condition in paragraph 9(e) violates any of the conditions in this paragraph, it shall be considered disqualified and shall not be eligible for the exceptions in paragraph 46 of Statement 140 and paragraphs 4(c) and 4(d) of Interpretation 46(R).

**Reporting the effects of changes**

C14. Any changes in accounting for transactions reported in previously issued financial statements shall be reported as the cumulative effect of an accounting change and shall be reflected in the carrying amounts of assets and liabilities as of the beginning of the period presented and an offsetting adjustment, if any, shall be made to the opening balance of retained earnings for that period as of (a) the date this Statement becomes effective, (b) the date when the qualifying SPE becomes disqualified as described in paragraphs C10–C13 of this Statement, or (c) the date the entity issues additional interests as described in paragraph C9 of this Statement.