Transfers and servicing of financial assets

September 2020
About the Transfers and servicing of financial assets guide

PwC is pleased to offer our updated Transfers and servicing of financial assets guide. This guide summarizes the applicable accounting literature, including relevant references to and excerpts from the FASB’s Accounting Standards Codification (the Codification). It also provides our insights and perspectives, interpretative and application guidance, illustrative examples, and discussion on emerging practice issues. The PwC guides should be read in conjunction with the applicable authoritative accounting literature.

Chapters 1 – 5 address the process for determining whether transfers of financial assets should be accounted for as a sale or secured borrowing as well as related accounting. Chapter 6 addresses the servicing of financial assets. Each chapter highlights key aspects of the guidance and includes questions and examples to illustrate its application.

References to US GAAP

Definitions, full paragraphs, and excerpts from the FASB’s Accounting Standards Codification are clearly labelled. In some instances, guidance was cited with minor editorial modification to flow in the context of the PwC guide. The remaining text is PwC’s original content.

References to other PwC guidance

This guide provides general and specific references to chapters in other PwC guides to assist users in finding other relevant information. References to other guides are indicated by the applicable guide abbreviation followed by the specific chapter or section number. The other PwC guides referred to in this guide, including their abbreviations are:

- Derivatives and hedging (DH)
- Fair value measurements, global edition (FV)
- Financial statement presentation (FSP)
- Financing transactions (FG)
- Loans and Investments (LI)

Summary of significant changes

Following is a summary of the noteworthy revisions to the guide since it was last updated in July 2018. Additional updates may be made to future versions to keep pace with significant developments.

Revisions made in September 2020

Chapter 1, Introduction and scope of ASC 860

- Figure TS 1-2 and Figure TS 1-3 were updated to clarify the interaction between the guidance in ASC 610-20 and ASC 860.
Chapter 2, Unit of account and participating interest

- Example TS 2-3 was added to illustrate A/B structures where the assigned loan is not considered an entire financial asset.
- Example TS 2-9 and Example TS 2-10 were added to illustrate the application of the guidance regarding multiple advances in specific fact patterns.

Chapter 3, Control criteria for transfers of financial assets

- Question TS 3-2 was updated to clarify what is considered “normal course representations and warranties” and that they do not constitute a form of continuing involvement that precludes sale accounting.
- TS 3.4.3.1 was added to discuss repurchase financing transactions.
- TS 3.5.6.3 was added to discuss set-off rights.
- Figure TS 3-3 was updated to include the applicable guidance in cases where the transferor have no continuing involvement with the transferred asset.
- TS 3.6.2.1 was added to discuss “third party purchaser” arrangements for CMBS.

Chapter 4, Accounting for transfers that qualify as sales

- Former section TS 4.3 was removed. The accounting for beneficial interests under ASU 2016-13, Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments, is included in LI 14.
- TS 4.3 and TS 4.4 were updated to reflect the guidance in ASU 2016-13, Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments.

Chapter 5, Accounting for transfers reported as secured borrowings

- Example TS 5-1 and Example TS 5-3 were updated to reflect the guidance in ASU 2016-13, Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments.

Chapter 6, Servicing of financial assets

- Question TS 6-4 was added to clarify the accounting for a servicer that also enters into a subservicing agreement.

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Chapter 1: Introduction and scope of ASC 860
1.1 Introduction and scope of ASC 860 — overview

A transfer of a financial asset can take many forms; from the sale of a widely-held equity security for cash to sales of trade receivables to a securitization entity in exchange for cash, a subordinated economic interest in the receivables, and servicing rights. A transfer may involve the conveyance of all rights and title in a financial asset to its purchaser or, alternatively, a transferor may sell an ownership interest in only certain of an underlying financial asset’s cash flows. In other instances, the transferor may grant only a security interest in a financial asset pledged with the transferee.

ASC 860, Transfers and Servicing, provides comprehensive guidance to assist a transferor of financial assets to account for transactions that involve a transfer of a recognized financial asset or an interest therein. Perhaps most importantly, ASC 860 prescribes the conditions that a transfer must satisfy to allow the transferor to derecognize the financial asset from its balance sheet. The guidance in ASC 860 addresses not only the transferor’s accounting, but also informs the corresponding accounting by the transferee.

ASC 860’s derecognition model incorporates the so-called financial components approach. The fundamental tenets of that approach include:

- The economic benefits provided by a financial asset (generally, the right to future cash flows) stem from the asset’s underlying contractual provisions, and the entity that controls those benefits should recognize them as its asset.

- A financial asset should be considered sold—and therefore derecognized—if it is transferred and control is surrendered.

- If a transferor has not surrendered control of a financial asset, derecognition is inappropriate; the asset should be considered pledged as collateral to secure an obligation of the transferor.

- The recognition of financial assets (and liabilities) should not be affected by the sequence of transactions that led to their existence; the controlling principle instead is whether a transferor maintains effective control over a transferred asset.

- Transferors and transferees should account for transfers of financial assets similarly (symmetrical reporting).

ASC 860’s derecognition model does not incorporate consideration of an asset’s “risks and rewards” and how a transfer impacts the transacting parties’ assumption or retention of those risks. Instead, it is a control-based framework.

To apply ASC 860’s derecognition template, companies must first identify which party to a transfer controls the financial assets after the exchange. This assessment should consider the transferor’s continuing involvement in the transferred financial asset, including all arrangements or agreements made contemporaneous with, or in contemplation of, the transfer, even if they were not entered into at the time of the transfer. Under the financial components approach, an entity that has surrendered control over a transferred financial asset should derecognize the asset. Conversely, an entity must recognize all financial assets acquired (controlled), and any liabilities incurred, stemming from a transfer.
Figure TS 1-1 illustrates a decision tree to determine whether an exchange represents a transaction subject to the provisions in ASC 860.

**Figure TS 1-1**  
ASC 860: scoping decision tree

Although assets arising from contracts to service financial assets are not financial assets, ASC 860 nonetheless provides guidance on how servicers are to account for these assets (and, if applicable, servicing liabilities). The guidance addresses initial recognition and subsequent measurement, and also specifies how a servicer should account for transfers of servicing rights to third parties. See TS 6 for more information.
1.2 **Financial assets within the scope of ASC 860**

Only recognized financial assets fall within the scope of ASC 860. ASC 860 defines a financial asset.

**Definition from ASC 860-10-20**

Financial Asset: Cash, evidence of an ownership interest in an entity, or a contract that conveys to one entity a right to do either of the following:

a. Receive cash or another financial instrument from a second entity

b. Exchange other financial instruments on potentially favorable terms with the second entity.

A reporting entity should consider this definition when assessing whether the guidance in ASC 860 applies to a transaction. Although a transferred item may constitute an asset, broadly defined, it may not be a financial asset subject to ASC 860.

1.2.1 **Items considered recognized financial assets**

Investments in debt instruments that meet the definition of a financial asset include government and corporate bonds, beneficial interests in securitization entities, commercial loans, residential and commercial mortgages, installment loans, lease payments and certain guaranteed residual values under sales-type and direct finance leases, and credit card and trade receivables. Investments in equity interests, such as shares of common or preferred stock, also are financial assets.

Figure TS 1-2 lists various instruments, contracts, and agreements considered financial assets within the scope of ASC 860.

**Figure TS 1-2**

Examples of recognized financial assets

<table>
<thead>
<tr>
<th>Description</th>
<th>Analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Installment loans, mortgage loans, commercial loans, and credit card and trade receivables</td>
<td>Receivables and loans of all types are considered financial assets because they represent a contract that conveys to their holder a contractual right to receive cash or another financial instrument from another entity.</td>
</tr>
<tr>
<td>Investments in debt securities</td>
<td>A debt security is a financial asset because it conveys to its holder a contractual right to receive cash or another financial instrument from the security’s issuer.</td>
</tr>
<tr>
<td>Description</td>
<td>Analysis</td>
</tr>
<tr>
<td>----------------------------------------------------------------------------</td>
<td>---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Beneficial interests issued by a securitization trust</td>
<td>Beneficial interests are considered financial assets because they convey to the holder a contractual right to receive cash or another financial instrument from the issuing trust. Whether the trust holds financial assets or nonfinancial assets (e.g., title to automobiles) does not alter this conclusion.</td>
</tr>
<tr>
<td>Non-controlling investments in common stock or other forms of ownership interests accounted for at fair value or under the equity-method</td>
<td>Irrespective of how they are measured, investments in common stock or other forms of equity interests are ownership interests, and thus are financial assets. Therefore, transfers of these assets, including equity method investments, are accounted for in accordance with ASC 860. However, if the investments are promised to a counterparty in a contract along with other nonfinancial assets, and substantially all the fair value of the promised assets is concentrated in the nonfinancial assets, the investments are scoped out of ASC 860 and may be within the scope of ASC 610-20.</td>
</tr>
<tr>
<td>Ownership interest in a non-consolidated subsidiary (controlled investee) carried at fair value</td>
<td>Investments in controlled subsidiaries carried at fair value according to industry practice (e.g., an investment company) are considered financial assets, as the holder will realize its investment by disposing of it.</td>
</tr>
<tr>
<td>Derivative assets that are not financial assets, such as a physically settled commodity forward contract</td>
<td>Transfers of assets that are derivative instruments subject to ASC 815, but are not financial assets, are governed by ASC 860. See ASC 815-10-40-2 for further details.</td>
</tr>
<tr>
<td>Forward contract on a financial instrument that must be (or may be) physically settled</td>
<td>Forward contracts on financial instruments in an asset position can be a financial asset because they convey a contractual right (a) to receive cash or another financial instrument from another entity or (b) to exchange other financial instruments on potentially favorable terms with the other entity.</td>
</tr>
<tr>
<td>Receivables arising from sales-type and direct-financing leases</td>
<td>Sales-type and direct-financing lease receivables are considered financial assets because they arise from a contract (the lease) that conveys to the lessor a contractual right to receive cash or another financial instrument from the lessee.</td>
</tr>
<tr>
<td>Lease residual value guaranteed at commencement of a lease</td>
<td>The residual value of a leased asset guaranteed at the lease’s commencement is a financial asset. See ASC 860-10-55-6.</td>
</tr>
</tbody>
</table>
Description | Analysis
--- | ---
Legal settlements-contractual payment plan | The analysis of legal settlements depends on facts and circumstances. If the right to payments has been reduced to a contract enforceable by a government or a court of law, the arrangement is a financial asset.

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1 Under ASC 610-20, entities will no longer “look through” equity method investments to determine if the underlying assets should be accounted for under other guidance, as was previously required under the real estate-specific guidance.

2 Assets that have the potential to be financial assets or financial liabilities, such as forwards and swaps, must meet the criteria of both ASC 860 and ASC 405-20-40-1 in order to be derecognized.

Question TS 1-1 discusses a transaction within the scope of ASC 860.

**Question TS 1-1**

Finance Co originates unsecured consumer loans. Loans written off as uncollectible are periodically pooled and sold to a collection agency. Bank Co receives a cash payment at the transfer date, and is entitled to receive additional consideration if the transferred pool subsequently generates a return above a hurdle rate.

Does ASC 860 apply to these transfers?

**PwC response**

Yes, ASC 860 applies to these transfers. Although the transferred loans have no carrying value at the transfer date, the loans represented recognized financial assets when originated by Finance Co. Despite the subsequent write off, the credit agreement (contract) underlying each origination remains in effect. In our view, the write off stems from Finance Co’s application of a measurement convention and, as such, should not be considered to alter the initial characterization of the loan as a recognized financial asset. The transfer of a written-off loan should be analyzed no differently than the conveyance of loan having a remaining (recognized) cost basis that has been fully reserved in a contra account for loan losses.

**1.2.2 Items not considered recognized financial assets**

Figure TS 1-3 lists various instruments, contracts, and agreements that are not considered recognized financial assets within the scope of ASC 860. The list also includes financial assets that are explicitly scoped out of ASC 860.
**Figure TS 1-3**  
Examples that are not considered recognized financial assets

<table>
<thead>
<tr>
<th>Description</th>
<th>Analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity interest in a consolidated subsidiary</td>
<td>An ownership interest in a consolidated subsidiary is evidence of control of the entity’s individual assets and liabilities, in contrast to an investment in a single financial asset or a group of financial assets. However, ASC 860 does apply to the transfer of an equity interest in a consolidated subsidiary by its parent if that consolidated subsidiary holds only financial assets. See also ASC 810-10-45-22.</td>
</tr>
<tr>
<td>Right to receive future fees under Rule 12b-1 of the Investment Company Act of 1940</td>
<td>Until earned, the right to receive 12b-1 fees is not a recognized asset. Thus, any transfer of the right to receive future fees is an exchange outside the scope of ASC 860. However, once the fee is earned, the receivable recognized by its recipient is a financial asset. See ASC 946-605-25 for further information.</td>
</tr>
<tr>
<td>Insurance contracts</td>
<td>Under an insurance contract, premium payments may be received over time in exchange for writing protection. Those future revenue streams are not currently recognized as financial assets. See ASC 470-10-25 for further information.</td>
</tr>
<tr>
<td>Lease residual value that is guaranteed after lease commencement and unguaranteed lease residuals</td>
<td>Unguaranteed residual values of a leased asset are not financial assets, nor are residual values guaranteed after the lease’s commencement date. Only the residual value of a leased asset guaranteed at the lease’s commencement date qualifies as a financial asset. See ASC 842 for further information.</td>
</tr>
<tr>
<td>Lease payments receivable under an operating lease</td>
<td>Lease payments receivable under an operating lease are unrecognized financial assets. See ASC 842 for further information.</td>
</tr>
<tr>
<td>Legal settlements - no contractual payment plan</td>
<td>The analysis of legal settlements depends on facts and circumstances. Until a judgment from litigation has been reduced to a contract (payment plan) enforceable by a government or a court of law, the arrangement is not a financial asset.</td>
</tr>
<tr>
<td>Taxes receivable (sales and property)</td>
<td>Receivables arising from sales and property taxes are not considered a financial asset, since they arise from an imposition of an obligation by law or regulation. The receivable is considered a financial asset only if the parties agree to payment terms in accordance with a contract.</td>
</tr>
<tr>
<td>Description</td>
<td>Analysis</td>
</tr>
<tr>
<td>-----------------------------------</td>
<td>----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Sale of future revenues</td>
<td>In a sale of future revenues in exchange for cash, the seller agrees to make payments to an investor in an amount related to revenue or income to be earned or received in the future. Those future revenue or income streams are not currently recognized financial assets. See ASC 470-10-25 for further information.</td>
</tr>
<tr>
<td>Servicing rights</td>
<td>Servicing rights arise from a contract that obligates an entity (servicer), in exchange for periodic fees (revenue), to service financial assets. The right to receive future revenue in exchange for services is not considered a financial asset. However, ASC 860-50 prescribes measurement and derecognition standards for contracts to service financial assets (servicing assets and liabilities).</td>
</tr>
<tr>
<td>Shareholder note - classified in equity</td>
<td>A shareholder note classified in equity is not a recognized financial asset. The note is reported as a component of equity—in contrast to a recognized (standalone) financial asset.</td>
</tr>
<tr>
<td>Securitized stranded utility costs</td>
<td>Although stranded costs may represent a utility’s enforceable right to recover such costs from ratepayers, that right stems from an action undertaken by a government authority or utility commission. Since the right does not stem from a contract, the stranded costs are not considered financial assets. However, as noted in the preceding table, beneficial interests in securitized stranded costs have the characteristics of a financial asset.</td>
</tr>
<tr>
<td>Treasury stock</td>
<td>Treasury stock is recognized as a contra-equity account and is not a financial asset.</td>
</tr>
<tr>
<td>Transfers of in substance nonfinancial assets</td>
<td>“In substance nonfinancial assets” is defined in ASC 610-20, in part, as “a financial asset promised to a counterparty in a contract if substantially all of the fair value of the assets (recognized and unrecognized) that are promised to the counterparty in the contract is concentrated in nonfinancial assets.” This means that an entity is not required to separately account for financial assets in accordance with ASC 860 if substantially all the fair value of the assets that are promised to the counterparty in a contract is concentrated in nonfinancial assets.</td>
</tr>
<tr>
<td>Value-added tax (VAT) receivable</td>
<td>A VAT-related receivable is not considered a financial asset because the receivable arises from the imposition of an obligation (taxes) by law or regulation. To be considered a financial asset, the right to receive cash or another financial asset must arise from a contract between the parties.</td>
</tr>
</tbody>
</table>
ASC 860-10-55-5 through ASC 860-10-55-17C contain implementation guidance to assist a reporting entity in applying the term “financial asset.”

1.2.3 Recognized financial assets as a result of a transfer

A transfer of a contract or an agreement (or an interest therein) may represent a transaction whose accounting is outside the scope of ASC 860. However, the transaction frequently will result in the recognition of a financial asset by the transferee (purchaser) as the parties will have executed a contract governing the exchange, and the transferee will have paid consideration. For example, assume Company A sells to Company B, for cash, an interest in Company A’s right to receive future revenue (currently unrecognized on Company A’s books). Company B would recognize a receivable for the right to receive the future revenue, presumably equal to the cash consideration paid. If, at a later date, Company B were to sell an interest in that receivable to Company C, that exchange would involve the transfer of a financial asset whose accounting would be governed by ASC 860.

Similarly, if Company A were to transfer its right to receive future revenues to a securitization trust, beneficial interests issued by the trust (e.g., trust certificates) would be considered financial assets by their holders.

1.3 Transfers of financial assets subject to ASC 860

ASC 860 defines a transfer.

Definition from ASC 860-10-20

Transfer: The conveyance of a noncash financial asset by and to someone other than the issuer of that financial asset.

A transfer includes the following:

a. Selling a receivable
b. Putting a receivable into a securitization trust
c. Posting a receivable as collateral.

A transfer excludes the following:

a. The origination of a receivable
b. Settlement of a receivable
c. The restructuring of a receivable into a security in a troubled debt restructuring.

In summary, a transfer of a noncash financial asset involves the conveyance of that asset to a party other than the asset’s issuer. After the exchange, the transferred asset remains; that is, the exchange does not result in the settlement or extinguishment of the conveyed contract or instrument. Similarly, the origination of a financial asset is not a transfer, since the transaction does not involve a financial asset previously recognized by the issuer; in these instances, the exchange creates a financial asset.
Figure TS 1-4 lists transactions involving transfers of financial assets that fall within the scope of ASC 860, as discussed in ASC 860-10-05.

**Figure TS 1-4**

Transfers of financial assets within the scope of ASC 860

<table>
<thead>
<tr>
<th>Transfers or transactions that typically qualify for sale accounting</th>
<th>Transfers or transactions typically (or required to be) reported as secured borrowings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transfers of entire receivables or loans to an investor, with or without recourse</td>
<td>Repurchase or reverse repurchase agreements</td>
</tr>
<tr>
<td>Transfers of entire receivables or loans to a securitization entity that issues beneficial interests to third-party investors</td>
<td>Securities lending arrangements</td>
</tr>
<tr>
<td>Transfers of ownership interests in loans (loan participations) that meet ASC 860’s definition of a participating interest</td>
<td>Transfers of ownership interests in loans (loan participations) that do not meet ASC 860’s definition of a participating interest</td>
</tr>
<tr>
<td>Wash sales</td>
<td>Pledges of collateral</td>
</tr>
<tr>
<td>Transfers of accepted drafts arising from banker’s acceptances</td>
<td></td>
</tr>
</tbody>
</table>

The foregoing is not an exhaustive list; there is a broad population of transferred financial assets subject to the guidance in ASC 860.

**1.3.1 Transfers excluded from the scope of ASC 860**

Transactions involving certain transfers are explicitly outside the scope of the guidance.

**Excerpt from ASC 860-10-15-4**

The guidance in this Topic does not apply to the following transactions and activities:

a. Except for transfers of servicing assets (see Subtopic 860-50-40) and for the transfers noted in the following paragraph, transfers of nonfinancial assets

b. Transfers of unrecognized financial assets, for example, lease payments to be received under operating leases

c. Transfers of custody of financial assets for safekeeping

d. Contributions (for guidance on accounting for contributions, see Subtopic 958-605)

e. Transfers of in-substance nonfinancial assets, see Subtopic 610-20

f. Investments by owners or distributions to owners of a business entity

g. Employee benefits subject to the provisions of Topic 712
h. Leveraged leases subject to Topic 842

i. Money-over-money and wrap lease transactions involving nonrecourse debt subject to Topic 842.

**Excerpt from ASC 860-10-15-5**

Paragraph 815-10-40-2 states that transfers of assets that are derivative instruments and subject to the requirements of Subtopic 815-10 but that are not financial assets shall be accounted for by analogy to this Topic.

Even though ASC 860-50 prescribes the accounting for transfers of servicing rights, the derecognition model for those transactions differs from the guidance in ASC 860-10-40, which applies to transfers of financial assets. As noted above, servicing rights (assets) are not considered financial assets—hence the different derecognition requirements.

Question TS 1-2 and Question TS 1-3 illustrate the ASC 860 scope considerations in specific fact patterns.

**Question TS 1-2**

Company X has various interests in a consolidated operating company, including a $20 million subordinated loan. Company X subsequently assigns $10 million of that loan to Investor Co for cash. For purposes of Company X’s consolidated financial statements, does the guidance in ASC 860 apply to this exchange?

**PwC response**

No, this transaction does not fall within the scope of ASC 860, as the assigned loan, prior to transfer, is not recognized in Company X’s consolidated financial statements. Legally, the exchange involves a transfer of a financial asset—an assignment of a portion of a loan owed the parent. However, the level of analysis is Company X’s consolidated financial statements. In the context of those financial statements, the loan to the subsidiary was previously eliminated in consolidation. Therefore, for financial reporting purposes, the assignment is considered an issuance of a liability, and should be accounted for as such. As noted above, the origination of a receivable does not constitute a transfer subject to ASC 860; accordingly, Investor Co is deemed a lender, not a transferee.

**Question TS 1-3**

In connection with a refinancing permitted by the underlying indenture, a reporting entity exchanges one form of beneficial interests (certificates) in financial assets owned by a non-consolidated securitization trust for new certificates issued by the same trust. Is the transaction subject to ASC 860?

**PwC response**

No, the transaction falls outside the scope of ASC 860. The counterparty (trust) is the issuer of the certificates surrendered by the reporting entity, as well as the originator of the new certificates. As noted above, ASC 860-10-20 defines a transfer as “the conveyance of a noncash financial asset by and to someone other than the issuer of that financial asset.” In this instance, the reporting entity would apply the guidance in ASC 310-20-35-9 through ASC 310-20-35-12 when accounting for the exchange.
1.4 **Structures commonly used to securitize financial assets**

Transfers of financial assets may involve special-purpose entities created for the sole purpose of purchasing and holding the financial assets, and issuing securities to finance the assets' acquisition. Holders of those securities look to the cash flows expected to be collected from the acquired assets as the principal (or sole) source of repayment. At a high level, these entities are commonly referred to as a securitization or asset-backed financing entities.

ASC 860-10-20 defines “securitization” as the process by which financial assets are transformed into securities. Although the financial assets acquired by a securitization retain their identity and legal form (e.g., as receivables or loans), the securities issued by the entity are nevertheless considered surrogates of those financial assets—as the cash flows from those assets are intended to serve as the chief source for repaying those securities. Consequently, securities issued by these entities are often referred to as “beneficial interests” in the financial assets that collateralize them, a concept. Beneficial interests are defined in ASC 860 and discussed further in TS 3 and TS 4.

1.4.1 **Shared structural characteristics**

Figure TS 1-5, Figure TS 1-6, Figure TS 1-7, and Figure TS 1-8 illustrate the principal structural characteristics of common securitizations. The particulars of each structure, and roles and economic interests of the parties customarily involved with them, vary—sometimes significantly. Nevertheless, the four securitization platforms incorporate certain common characteristics driven by shared commercial and legal considerations that, in turn, have influenced the evolution of the sale accounting model in ASC 860 and how it is applied in practice. The common elements include:

- Most securitizations use a “two-step” transfer construct. Under these arrangements, the transferor first sells the financial assets to a wholly-owned special-purpose entity intended to be bankruptcy remote (commonly referred to as a “BRE”). The BRE then transfers (sells) the assets to the securitization entity - the "second step" of the transfer. As discussed in TS 3, the two-step process is intended to “legally isolate” the transferred assets from the transferor in the event of the transferor’s bankruptcy or receivership—a condition of keen interest to rating agencies and investors.

- By design, most securitization entities do not have the right to freely pledge or exchange acquired financial assets—as the investors want assurance that the cash flows from those assets will be available to service their beneficial interests. Thus, financial assets acquired by the SPE typically can be disposed of only in limited circumstances prescribed in the controlling agreements. As noted above, beneficial interests in securitized financial assets are considered tantamount to the assets themselves. Accordingly, for purposes of one of ASC 860’s sale accounting requirements, interests issued by the securitization entity to third-party investors may serve as the “unit of analysis,” as discussed in TS 3.
1.4.2 **Participating interest considerations**

Given the prescriptive (and potentially onerous) “participating interest” rules in ASC 860, transferors desiring sale accounting typically strive to ensure that the securitization entity acquires the entire financial asset transferred—in contrast to only a portion or a component of the asset. See TS 2 for an extended discussion of ASC 860’s participating interest rules and potential implementation pitfalls. Figure TS 1-5, Figure TS 1-6, Figure TS 1-7, and Figure TS 1-8 assume that the SPE in each instance acquires the entirety of the financial assets transferred to it, consistent with market practice.

1.4.3 **Consolidation considerations**

As discussed in TS 3, a transferor’s consideration of ASC 860’s sale accounting rules may be a moot exercise if the transferor is required to consolidate the transferee, based on applying the guidance in ASC 810, *Consolidation*. If the transferee is included in the consolidated financial statements of the transferor, the transferred assets continue to be reported on the consolidated entity’s balance sheet, and beneficial interests in those assets held by third parties are reported as liabilities.

1.4.4 **Multi-seller asset-backed commercial paper conduit**

To accelerate receipt of operating cash flows, companies sometimes transfer (sell) trade receivables or short-term consumer loans to a multi-seller asset-backed commercial paper conduit (“conduit”), a limited-purpose securitization entity sponsored and administered by a bank. As the name implies, these entities are structured to acquire receivables from numerous originators (sellers), financed by issuing commercial paper. Although cash collections on the acquired receivables are intended to fully repay the commercial paper, the sponsor bank (sometimes in tandem with other banks) provides liquidity support and credit enhancement to the vehicle. These facilities provide additional assurance to investors that the conduit will have the ability to redeem its commercial paper when due, even in the event of major market disruptions or if the conduit’s assets experience significant unanticipated credit issues. Each seller of receivables also provides credit support to the conduit through the deferred purchase price construct, discussed below.

For various reasons, a conduit typically does not directly purchase the receivables sold by each originator. Rather, as Figure TS 1-5 illustrates, the sponsoring bank of the conduit (or, if multiple conduits are providing financing, one of the conduits’ sponsoring banks), in its capacity as agent for the conduit, will acquire legal title to the receivables transferred by each seller. The agent bank holds the receivables for the benefit of the participating conduits, each of which in turn acquires a beneficial interest in the transferred receivables corresponding to its financing commitment.

In exchange for selling the receivables to the agent bank, the seller receives cash from the conduits for a portion of the purchase price, and a beneficial interest (an obligation of the conduits) for the remainder. This beneficial interest, which is subordinated to the conduits’ investment in the receivables pool, is commonly referred to as the “deferred purchase price,” or DPP, in the industry. The DPP will absorb first any credit losses incurred on the receivables sold, as well as collection timing risk. The DPP is sized to ensure that, under virtually all scenarios, the conduit will not incur a loss on its investment in the receivables pool.

Most financing arrangements with conduits are “revolving;” that is, the seller continues to periodically transfer receivables to the agent bank in exchange for cash and DPP until the arrangement terminates at a prescribed date. Assuming the conduit has fully funded its contractual financing commitment, the cash component of the purchase price for these subsequent transfers can be funded solely from
collections from receivables previously sold to the agent bank. The difference between the cash paid and the all-in purchase price of the transferred receivables is “funded” by a corresponding increase in the seller’s DPP.

At the termination date prescribed, the seller may no longer sell additional receivables to the agent bank, and the arrangement enters “amortization” status. Subsequent collections on the receivables previously transferred are used first to repay the conduit’s investment in the pool. Any remaining collections inure to the seller (return of its DPP). In certain cases, the seller may wind up the arrangement by exercising a servicer clean up call after the principal amount of the receivables pool has declined to a prescribed level.

The banking entity that sponsors a conduit is frequently its consolidator (primary beneficiary) under ASC 810, Consolidation, stemming from the bank’s involvement in the conduit’s design, bank-provided credit enhancements and liquidity facilities, and the bank’s role as the conduit’s administrator. Assuming that a conduit owns financial assets sourced from multiple sellers at any point in time, it would be rare for a seller to consolidate the conduit.

Figure TS 1-5 illustrates the typical conduit financing arrangement and the principal parties involved.
Figure TS 1-5
Multi-seller asset-backed commercial paper conduit

(1) Multiple sellers will transfer eligible financial assets to the typical asset-backed commercial paper conduit; only one transferor is shown here for convenience.

(2) An agent bank (usually the sponsor of the conduit) acquires legal title to the financial assets sold by the BRE, and holds them for the benefit of the conduit, which funds the purchase price. If multiple conduits are involved, each will provide funding in proportion to its financing commitment.

(3) Typically, a limited-liability corporation established in Delaware.

(4) One or more banks will provide liquidity backup facilities intended to fund any cash flow shortfalls between maturing commercial paper and cash inflows from assets or newly-issued commercial paper.

(5) Program-wide credit enhancement, typically written by one or more banks, serves as a backup facility to fund any shortfalls remaining after liquidity facilities have been drawn.
(6) The conduit administrator (usually the sponsoring bank) directs the significant operations of the conduit, including negotiating with sellers, maintaining support arrangements, and managing the commercial paper program.

(7) Typically, a service company that provides officers and ensures that the conduit observes all corporate formalities. The owner receives dividends in exchange for its nominal equity investment.

(8) Each seller services the financial assets sold to the agent bank, and reinvests collections received on those assets to fund periodic sales of additional assets to the agent bank.

1.4.5 Securitizations of commercial loans (issuers of CLOs)

Issuers of collateralized loan obligations (CLOs) typically invest in non-investment grade loans made to commercial and industrial companies. Sponsors of CLO entities will typically acquire the loans from originating banks and hold (“warehouse”) them until it is advantageous to securitize them. At that point, the loans are aggregated and sold to the securitization entity (typically incorporated in the Cayman Islands) in exchange for a series of tranched notes (the CLOs). The sponsor typically arranges for various underwriters to purchase the notes intended to be sold to investors (“offered notes”), while retaining certain of the notes to comply with federal credit risk retention rules and for commercial reasons.

Most CLO issuances have these features:

- Reinvestment of collections: during the so-called reinvestment period, principal collections on the CLO’s loan collateral are used to purchase new loans from the sponsor or from the market. The reinvestment period typically encompasses the first three or four years of the CLO’s life. Thereafter, principal collections on the loans are used to repay the notes, in order of their seniority.

- Optional redemption arrangements: after the so-called “non-call period” expires (typically, two or three years after the CLO has been launched), holders of a majority or super majority of the CLO’s subordinated notes can instruct the collateral manager to sell the CLO’s loan collateral, provided certain conditions have first been satisfied. The proceeds are used to redeem the senior notes at par and accrued interest; the remaining proceeds are distributed to the subordinated noteholders. This feature allows the holders of the subordinated notes (the CLO’s substantive equity, the debt-like form notwithstanding) to monetize their investment at an optimal time.

Figure TS 1-6 illustrates the typical CLO structure and the principal parties involved. As the diagram indicates, the sponsor of a CLO (or an affiliated entity) typically serves as the entity’s collateral manager. Consequently, because many sponsors also hold a consequential position in the CLO’s notes, they often consolidate the issuer. However, if a sponsor holds no interest (or only an insignificant interest) in a managed CLO, it may not be required to consolidate the entity under ASC 810. Strictly speaking, the term “CLO” refers to the notes issued by the securitization entity, collateralized by the loans held by the issuer. However, in practice, the term “CLO” is commonly used as a shorthand reference to the entity that issues these securities—not the securities themselves.
Figure TS 1-6
Securitizations of commercial loans (issuers of collateralized loan obligations)

(1) Typically, the Issuer is an exempted company incorporated with limited liability in the Cayman Islands. The Issuer owns the Co-issuer, usually a Delaware limited liability company or limited partnership.

(2) Frequently an affiliate of the sponsor, the collateral manager directs the significant activities of the Issuer, including selecting loan collateral to be purchased by the Issuer, monitoring the loan collateral, and taking actions to preserve the collateral’s value.
Issued for nominal consideration (and entitled to only insignificant economics), the Issuer’s ordinary shares are typically held in trust by an administrator domiciled in the Cayman Islands. The administrator provides various corporate management functions on behalf of the Issuer.

The collateral manager’s fee consists of three components: a senior fee, subordinated fee, and an incentive fee. Receipt of the incentive fee is contingent upon the subordinated noteholders having received first a prescribed return on their investment.

1.4.6 **Securitizations of credit card receivables**

Banks and other financial institutions that issue credit cards frequently finance their outstanding balances by securitizing them under a master trust arrangement. Typically, on an ongoing (revolving) basis, pursuant to the terms of a forward contract, the sponsor-transferor sells new charges or advances on eligible accounts to the master trust immediately or shortly after the receivables have been originated. In exchange, the transferor receives cash (if available) and a corresponding increase in its interest in the master trust. Cash collections on transferred receivables are periodically disbursed to beneficial interest holders and various reserve accounts, all in accordance with contractual “waterfalls” (priority of payments) whose provisions can be complex.

Under the typical master trust arrangement, one or more issuing trusts will periodically issue securities to investors. Each issuing trust owns an interest in the master trust’s assets, frequently evidenced by a collateral certificate. The master trust remains the legal owner of the receivables acquired from the originator. The sponsor’s beneficial interests in the securitization typically include a transferor’s interest in the master trust, as well as a certificate issued by the master trust that provides credit enhancement to the issuing trust’s third-party investors.

A feature largely unique to credit card securitizations consists of removal-of-accounts provisions, or ROAPs. These arrangements allow a sponsor to periodically remove eligible transferred receivables from the master trust, subject to satisfying certain conditions, in exchange for a corresponding reduction in the sponsor’s transferor interest. The sale accounting implications of ROAPs are discussed in TS 3.

The sponsor/transferor frequently services the credit card receivables sold to the master trust (and thus makes decisions that significantly impact the trust’s economic performance), and holds interests in the trust that expose it to potentially significant benefits or losses. Thus, although transfers of credit card receivables are exchanges subject to ASC 860, sponsors of these securitizations frequently consolidate the master trusts under ASC 810.

Figure TS 1-7 illustrates the typical credit card securitization structure and the principal parties involved.
Figure TS 1-7
Securitizations of credit card receivables (revolving structure)

1. The master trust typically issues a subordinated interest to the BRE that provides structural credit enhancement to the securities held by investors.

2. Represents an undivided ownership interest in the assets of the master trust.

3. Typically, the transferor or an affiliate of the transferor.
1.4.7 **Securitizations of commercial real estate loans**

In a securitization of commercial real estate loans, one or more loans are transferred to a trust (frequently a New York common law trust) created in accordance with a pooling and servicing agreement. The trust typically issues pass-through certificates (commercial mortgage-backed securities, or CMBS) to various investors. Certain of the securities are typically retained by the sponsor (or by a designated third-party purchaser) to comply with the federal credit risk retention rules.

Numerous parties are typically involved with directing or supervising the activities of the issuer of CMBS. This stems in large measure from the characteristics of the underlying loans and the collateral that secures them; real estate loans can be intrinsically complex, and any workouts or restructuring of these loans may entail considerable judgment and involve numerous parties. Consequently, to ensure that appropriate diligence and care is exercised in these circumstances (and in compliance with the provisions of the pooling and servicing agreement), the parties highlighted in the diagram—the special servicer, the directing certificate holder, and the operating advisor—are involved with these structures in a variety of capacities. These include decision-making, consultation, and review.

Figure TS 1-8 illustrates the typical structure for securitization of commercial real estate loans. As noted in Figure TS 1-8, typically the directing certificate holder must approve all significant decisions proposed by the special servicer. In addition, the directing certificate holder usually has the right to unilaterally remove the trust’s special servicer and appoint a replacement, subject to satisfying rating agency conditions. Accordingly, depending on the facts and circumstances, the directing certificate holder may be required to consolidate the trust under ASC 810.
Securitizations of commercial real estate loans

- If a loan experiences a special servicing event, as defined in the pooling and servicing agreement (default, missed payments, etc.), the special servicer undertakes remedial action (loan workout, foreclosure, etc.) deemed most optimal to the trust (e.g., greatest net present value), subject to approval and oversight by the directing certificate holder.

- Typically appointed by a majority of the trust’s then-controlling class (one or more tranches of the subordinated certificates), the directing certificate holder must consent to (or advise with respect to) certain actions proposed by the special servicer. The directing certificate holder usually has the right to replace the special servicer with or without cause, and appoint a replacement.

- The operating advisor provides non-binding advice to the special servicer regarding potential loan remediation strategies, and reviews or prepares various reports as prescribed in the pooling and servicing agreement.
Chapter 2: 
Unit of account and participating interests
2.1 Overview—unit of account and participating interests

For transfers of financial assets in the scope of ASC 860, a reporting entity must first determine whether the exchange involves an entire financial asset or only a portion of the asset. If it involves a portion, the transaction must be analyzed further to determine if the transferred portion qualifies as a “participating interest.” To be eligible for sale accounting, a transferred portion of a financial asset must meet the definition of a participating interest. If it doesn’t, the transfer must be reported as a secured borrowing. Derecognition of the transferred portion of the asset is not permitted.

Applying the participating interest guidance can be among the most challenging aspects of ASC 860’s transfer model because:

- The circumstances in which only a portion of a financial asset should be considered transferred – rather than the entire asset itself – is not always clear as a result of limited implementation guidance in ASC 860.
- The participating interest model is form based and prescriptive. The conditions that a transferred portion of a financial asset must satisfy to qualify as a participating interest are very stringent.
- The economics of a transferred portion of a financial asset, and the economics of a transferred entire financial asset with a retained interest, can be very similar. As such, distinguishing between the two can sometimes be challenging.

2.2 Participating interest

ASC 860-20-20 defines transferred financial assets.

**Definition from ASC 860-20-20**

Transferred Financial Assets: Transfers of any of the following:

a. An entire financial asset
b. A group of entire financial assets
c. A participating interest in an entire financial asset.

The definition of transferred financial assets draws a distinction between an entire financial asset (or a group of entire financial assets) and a participating interest in an entire financial asset. See TS 2.4 for information on the conditions that a transferred portion of a financial asset must satisfy to be considered a participating interest under ASC 860.

2.2.1 GAAP before adoption of the participating interest model

Prior to the introduction of the participating interest concept, the derecognition model in ASC 860 (originally in FAS 140) did not distinguish between a transfer of an entire financial asset and a transfer of a partial ownership interest in an asset. This resulted in otherwise identical financing arrangements being tailored to achieve a desired derecognition (or secured borrowing) accounting outcome.
For example:

A transferor obtaining financing from an asset-backed commercial paper (ABCP) conduit to monetize $100 million of trade receivables under a revolving financing arrangement could choose between the following two structures. Assume the conduit is willing to provide financing equal to 90% of the receivables’ face value and all other relevant terms are the same.

- **Alternative 1:** The BRE transfers to the ABCP conduit an undivided ownership interest in the pool of receivables that the BRE acquires from the transferor.

- **Alternative 2:** The ABCP conduit lends $90 million to the BRE. The BRE grants the conduit a security interest in the pool of receivables, which constitute the BRE’s sole asset.

**Before the adoption of the participating interest model**

- **Alternative 1:** The exchange involved a transfer subject to the provisions of ASC 860 that could have qualified for sale accounting. It would have been a conveyance of an ownership interest in the receivables pool.

- **Alternative 2:** The exchange would have been accounted for as a secured borrowing. The conduit would have lent funds to the BRE in exchange for a security interest in the receivables. The conveyance of a security interest to the conduit would not have resulted in the transferor surrendering control over the receivables.

**After the adoption of the participating interest model**

- **Alternative 1:** The exchange would be accounted for as a secured borrowing. The BRE’s conveyance of the undivided ownership interest to the conduit involves a transfer of only a portion of the receivables pool. That transferred portion (representing, effectively, a senior ownership interest in the receivables) would not satisfy the proportionate (pari passu) condition of a participating interest.

- **Alternative 2:** The exchange would be accounted for as a secured borrowing.

Today, sellers of receivables to asset-backed commercial paper conduits commonly transfer receivables in their entirety to an agent bank, which holds the receivables for the benefit of the funding (owner) conduit. This legal form eliminates the need to consider the participating interest guidance (and allows sellers to achieve derecognition under the current ASC 860 model) as the transfer to the bank does not involve a portion of an asset.

**2.3 Entire vs. portion or component of a financial asset**

To determine the accounting treatment for the transfer of a financial asset within the scope of ASC 860, a transferor must first determine whether the transfer involves an entire financial asset or only a “component” (or a “portion”) of that asset. ASC 860-10-40-4D provides guidance on when sale accounting may be applicable to transfers of a portion of a financial asset.
Excerpt from ASC 860-10-40-4D

To be eligible for sale accounting, an entire financial asset cannot be divided into components before a transfer unless all of the components meet the definition of a participating interest. The legal form of the asset and what the asset conveys to its holders shall be considered in determining what constitutes an entire financial asset (for implementation guidance, see paragraph 860-10-55-17E).

As a general rule, an entire financial asset (or a group of entire financial assets) should be considered transferred when full title to, and ownership of, the financial asset is conveyed to the transferee. That is, as a result of the transfer, the transferee now holds legal title to the asset and, as a consequence, can exercise the rights (and must observe any obligations) prescribed in the underlying assigned contract or instrument negotiated with its issuer. However, as discussed in the following section, to conclude that a transfer involves an entire financial asset, conditions in addition to the conveyance of legal ownership to the transferee may also need to be satisfied.

2.3.1 Transfers of interests involving loans

ASC 860 provides implementation guidance to assist in determining whether a transfer involves a loan in its entirety or only a portion.

ASC 860-10-55-17F

A loan to one borrower in accordance with a single contract that is transferred to a securitization entity before securitization shall be considered an entire financial asset. Similarly, a beneficial interest in securitized financial assets after the securitization process has been completed shall be considered an entire financial asset. In contrast, a transferred interest in an individual loan shall not be considered an entire financial asset; however, if the transferred interest meets the definition of a participating interest, the participating interest would be eligible for sale accounting.

ASC 860-10-55-17G

In a transaction in which the transferor creates an interest-only strip from a loan and transfers the interest-only strip, the interest-only strip does not meet the definition of an entire financial asset (and an interest-only strip does not meet the definition of a participating interest; therefore, sale accounting would be precluded). In contrast, if an entire financial asset is transferred to a securitization entity that it does not consolidate and the transfer meets the conditions for sale accounting, the transferor may obtain an interest-only strip as proceeds from the sale. An interest-only strip received as proceeds of a sale is an entire financial asset for purposes of evaluating any future transfers that could then be eligible for sale accounting.

A lender may seek to reduce its exposure to a borrower by selling a participation in its loan to one or more investors or assigning its rights and obligations under the loan agreement to another party. The legal characteristics of a typical loan assignment and a loan participation and their potential implications on the transfer accounting assessment, are discussed in the following sections.

2.3.1.1 Assignments of loans

Loan assignments typically involve loan agreements with multiple lenders (syndicated loans). The loan agreement frequently contains provisions that allow a member of the lender group to assign all or a
portion of its loan to another party. Sometimes, the lead bank in a loan syndication may be unable to arrange for all investor (lenders) to fund the underlying loan at the origination date. In these circumstances, the lead bank may fund more of the loan at origination than it anticipated or desired. After the loan is originated, the lead bank may assign (sell) a portion of the loan that it has funded to one or more investors in accordance with the loan agreement’s assignment provisions. Other members of the lending group may also assign their loans post-origination.

In a loan assignment, each assignee (transferee) is added to the loan agreement and becomes a legal creditor. The assignee is legally owed interest and principal by the borrower, and is entitled to exercise the rights of a creditor specified in the loan agreement.

An assignor (transferor) may sell the entirety of its loan to the assignee or may retain some of the loan and remain a member of the lender group. When the assignor remains a member of the lender group, we generally believe the assignment should be analyzed as a transfer of a component or portion of the loan held by the assignor. In these circumstances, the transferor must apply the participating interest guidance when evaluating the appropriate accounting for the assigned portion. However, an assignment of a loan may be considered a transfer of an entire financial asset, even when the assignor remains a creditor under an overarching loan agreement. The presumption that an assignment requires consideration of the participating interest guidance when an assignor remains a creditor of the loan obligor may be overcome when:

- The assignment consists of a transfer of the entirety of a loan that is legally separate and distinct from the loan retained by the assignor, even though the two loans may be governed by the same overarching credit agreement (see Example TS 2-2 and Example TS 2-3); or
- The underlying lending agreement involves multiple advances and the assigned loan “retains its identity,” as discussed in TS 2.3.2.

When a loan held by a transferor is part of a larger (syndicated) loan having multiple creditors (with each creditor having funded its portion of the overall loan), from the transferor’s perspective, the entire financial asset consists only of the loan funded and recognized on the transferor’s balance sheet. Consequently, assuming an assignment involves only a portion of a loan, the transferor’s application of the participating interest rules to that assigned portion considers only the characteristics of the loan held by the assignor; loans held by other members of the lending group should be excluded from the analysis.

Example TS 2-1 illustrates this concept.

**EXAMPLE TS 2-1**

**Loan assignment—unit of analysis**

Bank Co, along with other lenders, originates a $500 million syndicated loan to Big Corp. Bank Co’s commitment, fully funded at closing, is $50 million. Under the overarching loan agreement, the note held by Bank Co is subordinate to the other lenders should an event of default, as defined in the loan agreement, take place.

Bank Co subsequently assigns a portion of its loan ($25 million) to Investor Co, who is added to the loan agreement as a subordinated creditor.
When assessing whether the assigned portion has the attributes of a participating interest, should Bank Co consider the entire financial asset to be (1) only the loan originated by Bank Co ($50 million), or (2) the entire $500 million facility originated by the syndicate lending group?

**Analysis**

For purposes of its transfer analysis, Bank Co should consider only its $50 million loan to Big Corp as the entire financial asset. Although Bank Co’s loan is part of the overarching syndicated loan agreement between the lenders and Big Corp, only the outlay that Bank Co made to Big Corp, and the amount that Big Corp now owes Bank Co ($50 million) would be recognized as a loan on Bank Co’s balance sheet. Therefore, Bank Co’s loan constitutes the “entire financial asset” that serves as the starting point for Bank Co’s sale accounting analysis of the assignment, including consideration of ASC 860’s participating interest guidance. Bank Co’s analysis should not consider the loans made by the other syndicate lenders to Big Corp; the senior-subordinate relationship that exists between those loans and Bank Co’s loan is not relevant, since Bank Co’s loan is considered a standalone entire financial asset.

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**Examples of distinguishing between the transfer of an entire financial asset and only a portion**

Example TS 2-2 illustrates when a transferor may consider an assigned loan to consist of an entire financial asset (rather than only a portion) in instances when the transferor continues to be a creditor under an overarching loan agreement.

**EXAMPLE TS 2-2**

**A/B structure—assigned loan considered an entire financial asset**

Bank Co originates a loan to Industrial Corp for $250 million. To expedite the securitization of a portion of the loan at a later date, the lending agreement consists of two notes executed at origination.

- Note A has a face amount of $150 million and yields 5%
- Note B has a face amount of $100 million and yields 6%

The interest rate differential is attributable to Note B’s subordination to Note A in the event of default.

Bank Co subsequently assigns Note A to SPE Co for cash. SPE Co is added to the lending agreement as the senior lender; Bank Co remains a party to the agreement, albeit in a subordinated capacity.

Should Bank Co consider the assigned Note A to be an entire financial asset?

**Analysis**

We believe it would be reasonable for Bank Co to consider Notes A and B to be two separate and distinct loan agreements covered by an overall master credit agreement. This assertion should be supported by a legal analysis affirming that Note A and Note B are separate legal instruments. Accordingly, we believe Note A (and, by extension, Note B) may be considered an entire financial asset.
However, in many A/B loan structures, the different notes will fail to be considered separate financial assets. This depends on the specific facts and circumstances of each transaction, as further illustrated in Example TS 2-3 and Example TS 2-4.

**EXAMPLE TS 2-3**

A/B structure with linked notes—assigned loan not considered an entire financial asset

Bank Co originates a loan to Industrial Corp for $200 million. To expedite the securitization of a portion of the loan at a later date, the lending agreement consists of two notes executed at origination.

- Note A has a face amount of $100 million and yields 5%
- Note B has a face amount of $100 million and yields 6% (the interest rate differential is attributable to Note B’s subordination to Note A in the event of default)
- Upon sale of Note A, the rate on Note B resets so that the total interest on both notes remains unchanged. Industrial Corp is contractually obligated to sign the amended notes in order to effect this change.
- Both notes are secured by the same collateral.

Note A and Note B are separate legal instruments. This assertion is supported by a legal analysis performed by legal counsel.

Bank Co subsequently assigns Note A to SPE Co at par for cash and retains Note B. Based on market interest rates at the time of sale, the interest on Note A resets to 5.1% and, accordingly, the interest rate on Note B decreases to 5.9%. Industrial Corp signs the notes with the amended rates. SPE Co is added to the lending agreement as the senior lender; Bank Co remains a party to the agreement, albeit in a subordinated capacity.

Should Bank Co consider the assigned Note A to be an entire financial asset?

**Analysis**

No. Rate-reset provisions are typically included in lending arrangements in order to enable the loan originator (the lender) to sell one of the notes at par. These provisions stipulate that the total all-in interest on the aggregated loans does not change (or does not exceed a prespecified total aggregated amount). We believe that in this case, the notes would need to be assessed as components of a broader facility, which is “an entire financial asset,” comprised of two separate legal instruments. This is because the rate-reset provision links the two notes such that the later legal separation is not permitted under ASC 860-10-40-4D. This conclusion is further supported by the requirement of Industrial Corp to sign the amended notes.

Therefore, the sale of Note A would be considered a transfer of a portion of a recognized financial asset. The sale accounting analysis must first consider whether Note A has the attributes of a participating interest. However, due to the subordination of Note B, as well as the non-pro rata allocation of cash flows, Note A would fail to meet the characteristics of a participating interest, and its transfer would be accounted for as a secured borrowing.
EXAMPLE TS 2-4

A/B structure—assigned loan considered a portion of an entire financial asset

Bank Co originates a loan to Industrial Corp for $250 million. To expedite the securitization of a portion of the loan at a later date, the lending agreement consists of two notes executed at origination.

- Note A has a face amount of $150 million and yields 5%
- Note B has a face amount of $100 million and yields 6%

The interest rate differential is attributable to Note B’s subordination to Note A in the event of default.

Note B is subsequently replaced by two notes, each having a principal amount of $50 million and yielding 6%. Bank Co assigns one of the new $50 million notes to Hedge Fund Corp, which is added to the lending agreement as a creditor, subordinated to Bank Co (stemming solely from its rights as the holder of Note A).

Should Bank Co consider the assignment of a portion of Note B to Hedge Fund Corp to involve an entire financial asset?

Analysis

Note A and Note B are each considered an entire financial asset for purposes of applying ASC 860, assuming they are legally considered separate instruments. However, Bank Co has assigned only a portion—not the entirety—of Note B to Hedge Fund Corp. Bank Co retains $50 million of Note B. Accordingly, the assignment involves the conveyance of only a portion of Note B, and therefore Bank Co must consider the participating interest guidance in ASC 860 when analyzing its accounting for the transfer.

Different A/B loan structures might include different features. As illustrated in Example TS 2-2, Example TS 2-3, and Example TS 2-4, legal separation and the existence of rate-reset provisions are factors that should be considered when assessing whether each note is a separate financial asset. Other considerations that could be relevant to making the assessment include:

- Whether the notes existed as separate legal instruments at the origination of the loan
- The degree of involvement of the borrower in any modifications to the notes upon their transfer
- Whether the same servicer services the notes, and if so, how the servicer’s fiduciary duties change once the notes are held by different creditors

2.3.1.2 Loan participations

A loan participation conveys an undivided percentage ownership interest in the underlying loan to the participant (transferee). That interest entitles the participant to receive proceeds from the loan (i.e., collections on the loan) consistent with its ownership interest. However, the transferor remains the sole legal owner of the loan. As such, a participation does not convey to the participant a right to directly enforce the provisions of the underlying loan. That right remains with the transferor. The
participant has enforceable rights only against the transferor in accordance with the terms of the participation agreement or based on other principles of law.

Transfers in the form of loan participations are considered to involve only a portion of a loan and are therefore subject to the participating interest guidance. However, in limited circumstances, this presumption may be overcome.

Question TS 2-1 discusses the application of this guidance.

**Question TS 2-1**

An entire financial asset is considered to have been transferred once all portions of the asset have been transferred.

How should the phrase “once all portions have been transferred” be applied? Can this condition be satisfied only once the transferor has conveyed full legal title to the entire underlying financial asset to another party or may this condition be met if the transferor has sold an ownership interest in all of the cash flows from the underlying financial asset to one or more parties (e.g., using participation agreements), but retains legal title to the entire underlying asset?

**PwC response**

If the “all portions” concept could only be met when accompanied by a conveyance of full legal title to a transferee, the guidance in ASC 860-10-40-4E would arguably be unnecessary. We believe that an entire financial asset can be considered transferred even when the transferor retains legal title to the underlying asset, provided both of the following conditions are met:

- A 100% ownership interest in the underlying asset’s cash flows has been sold to a third party (or, if there are multiple transferees, a 100% ownership interest in the aggregate)
- Other than retaining a servicing fee that satisfies the conditions in ASC 860-10-40-6(b)(1), the transferor has no other economic interest in the underlying asset’s cash flows, either directly or indirectly

Our view is that, if these conditions are satisfied, a transferor has effectively transferred the equivalent of an entire financial asset and consideration of the participating interest guidance is not necessary.

Example TS 2-5, Example TS 2-6, and Example TS 2-7 further illustrate this concept.

**EXAMPLE TS 2-5**

Transfer of interests in a loan—all portions have been transferred condition not satisfied

Bank Co originates a five-year $50 million loan to Industrial Corp on January 3, 20X1. On January 31, Bank Co sells a 50% interest in the loan to Transferee A and a 40% interest to Transferee B using participation agreements. Bank Co remains the legal owner of the loan and retains servicing at an at-market rate. Bank Co deducts its servicing fee from the periodic interest payments received from Industrial Co. Otherwise, Bank Co is obligated to remit 90% of all cash collections received from the loan to the two transferees, and keeps the other 10%.
If an event of default occurs under the loan agreement with Industrial Corp, Transferee A is entitled to receive first any collections or proceeds received on the loan until its participation interest is fully repaid (i.e., Transferee A’s right to cash flows from the loan become senior to the interests held by Transferee B and Bank Co).

How should Bank Co account for the transfers to Transferee A and Transferee B?

Analysis

Since Bank Co retains a 10% ownership interest in its loan to Industrial Corp, it cannot assert that “all portions” of the loan were transferred. When evaluating the appropriate accounting for the interests sold to the two transferees, Bank Co must first evaluate whether those interests have the characteristics of a participating interest.

Because the participation sold to Transferee A is senior to the interests owned by Transferee B and Bank Co in the event of Industrial Corp’s bankruptcy or default, the pari passu condition of a participating interest is not satisfied. As such, Bank Co must report the two transfers as secured borrowings.

EXAMPLE TS 2-6
Transfer of interests in a loan—all portions have been transferred

Bank Co originates a five-year $50 million loan to Industrial Corp on January 3, 20X1. On January 31, Bank Co sells a 50% interest in the loan to Transferee A and a 40% interest to Transferee B using participation agreements. On February 28, Bank Co sells the remaining 10% interest in its loan to Industrial Corp to Transferee C through a participation agreement for a cash payment of $5 million. After this exchange, Bank Co has no involvement with the loan (or with any of the interests sold) other than as the loan’s legal owner and servicer. Servicing is performed at an at-market rate.

If an event of default occurs under the loan agreement with Industrial Corp, Transferee A is entitled to receive first any collections or proceeds received on the loan until its participation interest is fully repaid (i.e., Transferee A’s right to cash flows from the loan is senior to the interests held by Transferee B and Transferee C).

Does the transaction with Transferee C on February 28 impact the accounting for the transfers of participations to Transferee A and Transferee B?

Analysis

Yes. As a result of the transaction with Transferee C, Bank Co has sold a collective 100% ownership interest in the loan to the three participants. For purposes of the ASC 860 derecognition analysis, Bank Co may consider “all portions” of the underlying loan to have been transferred as of February 28.

On a standalone basis, the three participations sold do not satisfy the criteria to be participating interests. However, since Bank Co has transferred all portions of the loan, it is not required to further consider the participating interest criteria. Consistent with the guidance in ASC 860-10-40-4E, Bank Co should perform a sale accounting analysis upon the transfer of its final 10% ownership interest to Transferee C.
ASC 860-10-40-4E indicates that the sale requirements are to be applied to the entire financial asset presumably establishing that as the appropriate unit of account. However, the legal structure of the transfer was accomplished using participation agreements. This raises the question of how the requirements in ASC 860-10-40-5 should be applied. In these fact patterns, we believe for Bank Co to achieve sale accounting, all of the three participations must satisfy the derecognition criteria in ASC 860-10-40-5. To illustrate, assume that Bank Co’s transfer of the senior interest to Transferee A does not meet the legal isolation criterion in ASC 860-10-40-5 so that one of the transferred participations does not qualify for sale accounting. Accordingly, Bank Co cannot assert that all of the transferred portions satisfies the conditions for sale accounting. As a consequence, Bank Co would continue to recognize the entire financial asset on its balance sheet and account for each transferred participation as a secured borrowing.

This conclusion is consistent with ASC 860’s principle that the unit of account is the entire financial asset and an entity may not account for a transfer partially as a sale and partially as a secured borrowing.

**EXAMPLE TS 2-7**

Transfer of interests in a loan—all portions have not been transferred

Bank Co originates a five-year $50 million loan to Industrial Corp on January 3, 20X1. On January 31, Bank Co sells a 50% interest in the loan to Transferee A and a 40% interest to Transferee B using participation agreements. On February 28, Bank Co sells the remaining 10% interest in its loan to Industrial Corp to Transferee C through a participation agreement for a cash payment of $3 million. In addition, Transferee C pays $2 million additional consideration consisting of a credit-linked note executed between the parties. The note obligates Transferee C to remit to Bank Co certain amounts it receives from its participation interest in Bank Co’s loan to Industrial Corp. The note is nonrecourse; the only source of repayment is from collections that Transferee C receives from its participation with Bank Co.

Can Bank Co assert that it has transferred “all portions” of the Industrial Corp loan to the three transferees?

**Analysis**

As a legal matter, Bank Co has sold a 100% ownership interest in the proceeds (collections) from its loan to Industrial Corp through the three participation agreements. However, through its note with Transferee C, Bank Co continues to have an indirect economic interest in its loan to Industrial Corp. If the loan to Industrial Corp were to become worthless, so too would the note from Transferee C, thus exposing Bank Co to loss. In our view, to meet the “all portions have been transferred” condition in ASC 860-10-40-4E, a transferor may not retain any economic interest in, or exposure to, the cash flows generated by underlying entire financial asset (either directly or indirectly) other than that arising from a servicing fee.

Example TS 2-8 and Example TS 2-9 illustrate how a transferor’s contingent obligation to fund a make-whole payment to a transferee should be evaluated when identifying the unit of account under ASC 860.
EXAMPLE TS 2-8
Transfer of 50% interest in a loan—consideration of transferor’s make-whole obligation

On July 1, Bank Co sells to Transferee A, for cash, a 50% interest in a $100 million loan previously made to Manufacturing Corp. Transferee A and Bank Co participate equally in cash collections received on the loan on a pari passu basis. However, the participation agreement obligates Bank Co to make a limited make-whole payment to Transferee A in the event that Manufacturing Corp prepays its loan at any point during the first two years of its term. Bank Co will augment the prepayment penalty that Manufacturing Corp must pay in accordance with the underlying loan agreement.

How should Bank Co account for the transfer to Transferee A?

Analysis

Bank Co retains 50% of the loan’s cash flows. As such, Bank Co cannot assert that “all portions” of its loan to Manufacturing Corp have been sold. Bank Co must evaluate whether the participation sold to Transferee A meets the definition of a participating interest.

As discussed in TS 2.4, the make-whole provision is inconsistent with the attributes of a participating interest; therefore, Bank Co and Transferee A would each report the participation agreement as a secured borrowing.

EXAMPLE TS 2-9
Transfer of 100% interest in a loan—consideration of transferor’s make-whole obligation

On July 1, Bank Co sells to Transferee A, for cash, a 50% interest in a $100 million loan previously made to Manufacturing Corp. Transferee A and Bank Co participate equally in cash collections received on the loan on a pari passu basis. However, the participation agreement obligates Bank Co to make a limited make-whole payment to Transferee A in the event that Manufacturing Corp prepays its loan at any point during the first two years of its term. Bank Co will augment the prepayment penalty that Manufacturing Corp must pay in accordance with the underlying loan agreement.

On August 1, Bank Co sells to Transferee B, for cash, its remaining 50% ownership interest in the loan with Manufacturing Corp. No make-whole arrangements exist in the participation agreement executed between Bank Co and Transferee B; Bank Co is obligated simply to remit to Transferee B 50% of any prepayment penalty paid by Manufacturing Corp in accordance with the loan agreement.

How should Bank Co analyze the transfer of its 50% ownership interest in the loan to Transferee B, and what are the implications of that transfer on Bank Co’s accounting for its participation agreement with Transferee A?

Analysis

As a result of the participation agreements executed with Transferee A and Transferee B, as of August 1 Bank Co no longer has any economic interest in the cash flows from its loan to Manufacturing Corp. The participation agreements, viewed together, obligate Bank Co to remit all of the cash collections from the loan to the two transferees. Bank Co has transferred “all portions” of the underlying loan to the two transferees. Consistent with the guidance in ASC 860-10-40-4E, Bank Co should perform its
sale accounting analysis as of August 1st by applying guidance in ASC 860-10-40-5 to the entire financial asset using the approach noted in Example TS 2-6.

The make-whole arrangement with Transferee A should not jeopardize Bank Co’s determination that all portions of the loan to Manufacturing Corp have been transferred. The make-whole simply obligates Bank Co to supplement, in limited circumstances, the portion of the prepayment penalty paid by Manufacturing Corp that Bank Co must remit to Transferee A. The arrangement does not require Bank Co to make a payment to Transferee A in the event that Manufacturing Corp fails to pay interest and principal when due. Similarly, the make-whole does not entitle Bank Co to keep any portion of any prepayment penalty paid by Manufacturing Corp, as Bank Co has sold a 100% ownership interest in all cash inflows from the loan. The make-whole arrangement would need to be considered by Bank Co in its evaluation of the condition in ASC 860-10-40-5.

This example did not stipulate a servicing fee arrangement. However, the conclusion reached would not change were Bank Co to charge the two participants a servicing fee provided the fee approximates a market rate and is not structured to provide credit support to the two investors.

### 2.3.2 Transfers consisting of multiple advances or draws

ASC 860-10-55-17H provides implementation guidance to assist a transferor in evaluating whether a transfer of a loan consisting of multiple advances to the borrower is subject to the participating interest rules.

**ASC 860-10-55-17H**

If multiple advances are made to one borrower in accordance with a single contract (such as a line of credit, credit card loan, or a construction loan), an advance on that contract would be a separate unit of account if the advance retains its identity, does not become part of a larger loan balance, and is transferred in its entirety. However, if the transferor transfers an advance in its entirety and the advance loses its identity and becomes part of a larger loan balance, the transfer would be eligible for sale accounting only if the transfer of the advance does not result in the transferor retaining any interest in the larger balance or if the transfer results in the transferor’s interest in the larger balance meeting the definition of a participating interest. Similarly, if the transferor transfers an interest in an advance that has lost its identity, the interest must be a participating interest in the larger balance to be eligible for sale accounting.

An advance “retains its identity” and “does not become part of a larger loan” when the billing statements (and other similar documents) sent to the borrower separately itemize each advance and any payment made by the debtor clearly indicates which advance the payment is intended to settle. Detailed record-keeping must be maintained by the lender for these conditions to be satisfied.

When the borrower’s payment is applied (credited) against only the all-in amount owed, with no attribution or allocation of that payment against specific draws or charges included in that balance, each advance or charge has lost its identity, even if the billing statement enumerates all current charges against the borrower’s account (advances, interest and other fees). In these circumstances, the borrower’s entire unpaid balance should be the unit of account.
Assuming that an advance retains its identity, its transfer by the originator may be considered to involve an entire financial asset if the conveyance is in the form of an assignment (and as a consequence, the transferee becomes a legal creditor of the borrower) and no changes in the assigned loan’s terms are made in connection with the transfer.

If the entire loan is the unit of account, any transfer of a portion should be analyzed using the participating interest guidance. It has been our experience that, when the loan’s current balance consists of multiple advances or draws that have lost their identity, transfers of a portion of the loan (or the transfer of an interest in a pool of such loans) are frequently executed using participation agreements, thus necessitating consideration of the participating interest rules.

Example TS 2-10 and Example TS 2-11 illustrate the application of this guidance to specific fact patterns.

**EXAMPLE TS 2-10**

Transfer of multiple receivables by the same obligor

ABC Corp produces and sells equipment to industrial clients. It has long-term relationships with its clients and typically sells equipment to each client over extended periods of time, generating revenue from multiple, distinct transactions.

ABC Corp sets up a new program to sell its receivables on a rolling basis to a bank in exchange for cash. The receivables are sold on an invoice-by-invoice basis (i.e., the bank has discretion whether or not to purchase each invoice), and each invoice is sold in its entirety. ABC Corp continues to service the sold receivables at an at-market rate.

Each receivable is tracked on an individual basis, and ABC Corp is capable of tracking payments received from a client to a specific invoice.

Are the sold receivables considered entire financial assets, or should they be assessed under the participating interest guidance?

**Analysis**

ABC Corp should assess whether the receivables retain their identity, do not become part of a larger loan balance, and are transferred in their entirety. The fact that each receivable is tracked on an individual basis, and that ABC Corp is capable of tracking payments received from a client to a specific invoice, helps ABC Corp support the assertion that each invoice is a separate financial asset. Hence, ABC Corp concludes that the factoring arrangement is for transfer of a group of entire financial assets, that does not need to be assessed under the participating interest guidance.

**EXAMPLE TS 2-11**

Transfer of certain receivables only

DEF Corp produces and sells manufacturing equipment. To some of its customers, it sells both services and equipment under a single contract. Both services and equipment are sold and billed under monthly payment plans. The monthly invoice details the separate amounts charged for equipment and for services, and the total amount owed. The invoice also includes language describing how payments
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will be allocated between the equipment and services in case the customer pays less than the entire invoice amount.

DEF Corp enters into a revolving factoring arrangement to sell its equipment receivables to Bank Co. The legal agreement between DEF Corp and Bank Co specifies that full title and ownership of the receivables generated by the equipment sales is transferred to Bank Co. The receivables generated from services are not sold to Bank Co, but retained by DEF Corp.

Are the sold equipment receivables considered entire financial assets, or should they be assessed under the participating interest guidance?

**Analysis**

DEF Corp should assess whether the equipment receivables retain their identity, do not become part of a larger loan balance, and are transferred in their entirety. The fact that the customer invoice details the separate amounts billed for equipment and services, and the allocation mechanism between them, helps DEF Corp support the assertion that the equipment receivables retain their identity and are separate from the services receivables. Hence, DEF Corp concludes that the equipment receivables factoring agreement is for transfer of a group of entire financial assets that does not need to be assessed under the participating interest guidance.

### 2.3.3 Transfers involving leases

A lessor may sell its rights to direct financing or sales-type lease receivables from a lessee, as well as a guaranteed residual value, to a third-party investor or securitization entity. As discussed in TS 1, these types of receivables are recognized financial assets. Transfers involving lease-related financial assets sometimes will require consideration of the participating interest rules in ASC 860.

Question TS 2-2 discusses the unit of account for purposes of applying ASC 860 when evaluating transfers of lease-related financial assets.

**Question TS 2-2**

When evaluating transfers involving lease-related financial assets, what should the lessor-transferor consider when evaluating whether the transfer consists of a conveyance of only a portion of those assets? That is, how should the lessor-transferor identify the unit of analysis for purposes of applying ASC 860?

**PwC response**

If a sales-type or direct financing lease entitles the lessor to both lease payments and a guaranteed residual value, the unit of account (for purposes of applying ASC 860) depends on whether the residual value is guaranteed by the lessee or by a third-party guarantor. In our view, if the lessee guarantees the residual value, the lease payments and guaranteed residual value should be viewed as a single unit of account. In these circumstances, if the transferee receives other than an entire ownership interest in both components of the lease, the conveyed portion must meet the participating interest rules to potentially qualify for sale accounting.
On the other hand, we believe that third-party guaranteed residual values may be treated as a separate unit of account when evaluating whether a transfer of sales type or direct financing lease receivables involves only a portion of those receivables and, if so, whether the transfer satisfies the conditions of a participating interest. We believe ASC 860-10-40-4D supports this view.

Since an unguaranteed residual value is not considered a financial asset subject to the guidance in ASC 860, the analysis of a transfer of a portion of a lease’s minimum lease payments should not consider the unguaranteed residual value when applying the participating interest rules.

### 2.4 Application of the participating interest guidance

ASC 860-10-40-4E provides guidance on the accounting for transfers of a portion of a financial asset.

**Excerpt from ASC 860-10-40-4E**

If a transfer of a portion of an entire financial asset meets the definition of a participating interest, the transferor shall apply the guidance in the following paragraph [the sale accounting guidance in ASC 860-10-40-5]. If a transfer of a portion of a financial asset does not meet the definition of a participating interest, the transferor and transferee shall account for the transfer in accordance with the guidance in paragraph 860-30-25-2 [report the transfer as a secured borrowing with a pledge of collateral].

A transfer of a portion of a financial asset that does not satisfy the characteristics of a participating interest cannot be reported as a sale, even if the transfer otherwise meets the conditions in ASC 860-10-40-5 for derecognition. This stringent framework can be attributed, at least in part, to the concerns expressed by the FASB about the appropriate accounting for transfers of portions or components of entire financial assets in its deliberations that led to the issuance of the participating interest guidance.

To be considered a participating interest, a transferred portion of an entire financial asset must satisfy all of the conditions in ASC 860-10-40-6A.

**ASC 860-10-40-6A**

A participating interest has all of the following characteristics:

a. From the date of the transfer, it represents a proportionate (pro rata) ownership interest in an entire financial asset. The percentage of ownership interests held by the transferor in the entire financial asset may vary over time, while the entire financial asset remains outstanding as long as the resulting portions held by the transferor (including any participating interest retained by the transferor, its consolidated affiliates included in the financial statements being presented, or its agents) and the transferee(s) meet the other characteristics of a participating interest. For example, if the transferor’s interest in an entire financial asset changes because it subsequently sells another interest in the entire financial asset, the interest held initially and subsequently by the transferor must meet the definition of a participating interest.

b. From the date of the transfer, all cash flows received from the entire financial asset are divided proportionately among the participating interest holders (including any interest retained by the transferor, its consolidated affiliates included in the financial statements being presented, or its agents) in an amount equal to their share of ownership. An allocation of specified cash flows is not
an allowed characteristic of a participating interest unless each cash flow is proportionately allocated to the participating interest holders. In determining proportionate cash flows:

1. Cash flows allocated as compensation for services performed, if any, shall not be included provided those cash flows meet both of the following conditions:
   i. They are not subordinate to the proportionate cash flows of the participating interest
   ii. They are not significantly above an amount that would fairly compensate a substitute service provider, should one be required, which includes the profit that would be demanded in the marketplace.

2. Any cash flows received by the transferor as proceeds of the transfer of the participating interest shall be excluded provided that the transfer does not result in the transferor receiving an ownership interest in the financial asset that permits it to receive disproportionate cash flows.

c. The priority of cash flows has all of the following characteristics:

1. The rights of each participating interest holder (including the transferor in its role as a participating interest holder) have the same priority.

2. No participating interest holder’s interest is subordinated to the interest of another participating interest holder.

3. The priority does not change in the event of bankruptcy or other receivership of the transferor, the original debtor, or any other participating interest holder.

4. Participating interest holders have no recourse to the transferor (or its consolidated affiliates included in the financial statements being presented or its agents) or to each other, other than any of the following:
   i. Standard representations and warranties
   ii. Ongoing contractual obligations to service the entire financial asset and administer the transfer contract
   iii. Contractual obligations to share in any set-off benefits received by any participating interest holder.

That is, no participating interest holder is entitled to receive cash before any other participating interest holder under its contractual rights as a participating interest holder. For example, if a participating interest holder also is the servicer of the entire financial asset and receives cash in its role as servicer, that arrangement would not violate this requirement.

d. No party has the right to pledge or exchange the entire financial asset unless all participating interest holders agree to pledge or exchange the entire financial asset.
A set-off right is not an impediment to meeting the participating interest definition. For implementation guidance on the application of the term participating interest, see paragraphs 860-10-55-17I through 55-17N.

At a high level, a participating interest exists when the holder of the transferred interest is entitled to receive cash flows from the underlying financial asset exactly proportionate to its ownership interest. The interest must be exposed to the economic risks and benefits of the underlying asset on a basis that is pari passu with other interest holders. As discussed below, in only very limited circumstances may the holder of a participating interest look to sources other than the underlying financial asset to recoup its investment.

### 2.4.1 Proportionate allocation of cash flows

The implementation guidance in ASC 860-10-55-17I addresses the fundamental characteristic of a participating interest; namely, that it must entitle its holder to all cash proceeds from the underlying financial asset consistent with its proportionate ownership interest. Any arrangements or contractual terms that may cause the transferee to receive cash flows from the underlying asset that do not align with its proportionate ownership interest is inconsistent with the participating interest definition.

#### ASC 860-10-55-17I

Paragraph 860-10-40-6A(b) states that an allocation of specified cash flows precludes a portion from meeting the definition of a participating interest unless each cash flow is proportionately allocated to the participating interest holders. Following are several examples implementing that guidance:

a. In the circumstance of an individual loan in which the borrower is required to make a contractual payment that consists of a principal amount and interest amount on the loan, the transferor and transferee shall share in the principal and interest payments on the basis of their proportionate ownership interest in the loan.

b. In contrast, if the transferor is entitled to receive an amount that represents the principal payments and the transferee is entitled to receive an amount that represents the interest payments on the loan, that arrangement would not be consistent with the participating interest definition because the transferor and transferee do not share proportionately in the cash flows received from the loan.

c. In other circumstances, a transferor may transfer a portion of an individual loan that represents either a senior interest or a junior interest in an individual loan. In both of those circumstances, the transferor would account for the transfer as a secured borrowing because the senior interest or junior interest in the loan do not meet the requirements to be participating interests (see paragraph 860-10-40-6A(c)).

One of the implications of this strict proportionality requirement is that the contractual interest rate of a participating interest must equal that of the underlying loan (after taking into account any servicing fee retained by the transferor). Any difference in the contractual rate of interest between the two will create an allocation of cash flows disproportionate to the transferee's ownership interest, which is inconsistent with the participating interest model.
If the contractual interest rate of an underlying loan is no longer a market rate, the transferred portion will not provide the holder with a contractual yield that allows the transfer to clear at par (i.e., having a purchase price equal to the transferred interest’s par or notional amount). To meet the participating interest requirement in these circumstances, the difference between the current market rate and the underlying loan’s contractual interest rate must be accommodated in the transaction’s purchase price, whose amount will necessarily differ from the transferred portion’s notional amount or ownership interest. The fact that a transfer of a portion of an asset may result in the transferor recording a derecognition gain or loss is not an impediment to satisfying the participating interest rules. See ASC 860-10-55-17K for additional information.

Example TS 2-12 and Example TS 2-13 illustrate the application of this guidance.

**EXAMPLE TS 2-12**

Transfer of interest in a loan—disproportionate allocation of cash flows

Bank Co previously originated, at par, a $50 million loan to Retail Co having an interest rate of 6%. Bank Co now wants to reduce its exposure to Retail Co by selling a 50% interest in the loan to Investor Co. Based on current market conditions, Investor Co is demanding an 8% return. Using a participation agreement, Bank Co sells a 50% interest in the loan’s principal payments, and a 66.7% interest in the loan’s periodic interest payments, to Investor Co for cash. The interests sold to Investor Co are pari passu with those retained by Bank Co; neither interest has priority over the other in the event of Retail Co’s default or bankruptcy.

Could the interest in the loan sold to Investor Co potentially qualify as a participating interest?

Analysis

Investor Co’s ownership interest in the cash flows from Retail Co’s loan are not proportionate. Its interest in the loan’s principal collections (50%) differs from its interest in the loan’s interest payments (66.7%). Even though the portions sold to Investor Co may otherwise have the attributes of a participating interest, the transfer does not meet the proportionality criterion in ASC 860-10-40-6A(b); therefore, it cannot qualify as a participating interest. Bank Co and Investor Co should account for the transaction as a secured borrowing.

**EXAMPLE TS 2-13**

Transfer of interests in a loan—proportionate allocation of cash flows

Bank Co previously originated, at par, a $50 million loan to Retail Co having an interest rate of 6%. Bank Co now wants to reduce its exposure to Retail Co by selling a 50% interest in the loan to Investor Co. Based on current market conditions, Investor Co is demanding an 8% return. Using a participation agreement, Bank Co sells to Investor Co a 50% ownership interest in all collections received from the Retail Co loan (principal, interest, prepayment penalties). The interests sold to Investor Co are pari passu with those retained by Bank Co; neither interest has priority over the other in the event of Retail Co’s default or bankruptcy. To obtain the required 8% yield, Investor Co pays a cash purchase price of $22.5 million, representing a discount of $2.5 from its 50% interest in the par amount of the loan to Retail Co.

Could the interest in the loan sold to Investor Co potentially qualify as a participating interest?
Analysis

In this example, Investor Co is entitled to 50% of all the loan’s cash flows, regardless of their legal characterization. Thus the transfer satisfies the proportionality requirement in ASC 860-10-40-6A(b). Assuming that the terms of the underlying participation agreement satisfy the remaining conditions in ASC 860-10-40-6A, the interest in the Retail Co loan sold to Investor Co would qualify as a participating interest.

If the transfer qualifies as a sale under ASC 860-10-40-5, Bank Co would recognize a loss of $2.5 million. The fact that Bank Co would record a loss does not impact the participating interest conclusion.

2.4.2 Compensation for services performed

Provided certain conditions are met, the participating interest model permits cash flows from an underlying financial asset to be allocated as compensation for services. Those conditions are:

- The fees are not subordinate to the proportionate cash flows of the participating interest.
- The fees are not “significantly above” an amount that would fairly compensate a substitute service provider, including the profit that a marketplace participant would demand. That is, a servicing fee paid to a participant may not be significantly greater than what would be considered “adequate compensation” determined by the market place (see related definition in ASC 860-50-20).

ASC 860-10-55-17J cites three examples of the cash flows that are considered compensation for services performed:

- Loan origination fees paid by the borrower to the transferor
- Fees necessary to arrange and complete the transfer paid by the transferee to the transferor
- Fees for servicing the financial asset

In practice, ongoing fees owed to the servicer of the underlying financial asset will constitute the principal service-related claim on the asset’s cash flows. In many instances, the servicer will be the participating interest’s transferor. Evaluating whether servicing fees are not significantly above adequate compensation (i.e., whether they either reasonably approximate a market rate or are below a market rate) involves judgment and consideration of the relevant facts and circumstances.

Question TS 2-3 discusses some of the considerations when making this assessment.
**Question TS 2-3**

When evaluating the condition in ASC 860-10-40-6A(b)(i)(ii), what should a transferor consider when determining whether its servicing fee is “not significantly above” an amount that would fairly compensate a substitute service provider?

**PwC response**

The FASB did not define or provide implementation guidance on what is meant by “not significantly above an amount that would fairly compensate a substitute servicer.” A reporting entity’s determination of when a servicing fee would represent an amount that is “significantly above” should take into account quantitative as well as qualitative considerations.

Qualitative considerations that a reporting entity should evaluate may include, but are not limited to, (1) the type of financial asset being serviced, (2) the risks associated with providing the servicing function for particular asset types, (3) the servicing agreement’s compensation structure (including consideration of anticipated ancillary income) compared to other agreements in the marketplace and (4) the availability of reliable market information on the asset type being serviced.

A transferor may anticipate recognizing a servicing asset attributable to a transfer of a portion of a financial asset (or the transfer of a portion of a group of assets), assuming that all the conditions for derecognition under ASC 860 are met. Recognition of a servicing asset measured in accordance with the guidance in ASC 860-50 is not necessarily inconsistent with an assertion that the related fee is not significantly above adequate compensation. However, if a transferor of a participating interest believes it is appropriate to record a servicing asset, it should ensure that determination is not inconsistent with its assertion that the fee arrangement will not provide economics significantly above adequate compensation. See TS 6.3.5 for considerations relevant to measuring the fair value of a servicing asset.

2.4.3  **Consideration of arrangements constituting recourse**

Consistent with the principle that a participating interest represents a proportional, pari passu ownership interest in the underlying financial asset, ASC 860-10-40-6A(c)(4) stipulates that the holders of a participating interest may have recourse against the transferor (and its consolidated affiliates and agents) or other participating interest holders only in connection with the following:

- Standard seller (transferor) representations and warranties (see ASC 860-10-55-17N for examples)
- Ongoing contractual obligations arising to service the underlying financial asset and to administer the transfer contract
- Contractual obligations to share in any set-off benefits received by any participating interest holder

In addition to these forms of recourse, ASC 860-10-55-17M clarifies that a participating interest holder may also be the beneficiary of a credit guarantee written by a third party, even if the transferor pays the guarantee fee.
ASC 860-10-55-17M

Paragraph 860-10-40-6A(c) addresses recourse in a participating interest. Recourse in the form of an independent third-party guarantee shall be excluded from the evaluation of whether the participating interest definition is met. Similarly, cash flows allocated to a third-party guarantor for the guarantee fee shall be excluded from the determination of whether the cash flows are divided proportionately among the participating interest holders.

Provided the guarantor is independent of the transferor or other participants, the recourse arrangement is not considered to violate the requirement that a participating interest represents proportionate, pari passu ownership interest in the underlying financial asset. The logic behind this conclusion is that if the underlying obligor defaults and the guarantor is required to satisfy its obligation, the guarantor would become the holder of the participation interest under its subrogation rights. Consequently, for a third-party guarantee to be excluded from the participating interest assessment, the guarantor, as potential holder of the participating interest, can have no greater rights against the transferor or other participating interest holders than those held by the original participating interest holder. Those rights may not differ from, nor extend beyond, those cited in ASC 860-10-40-6A.

2.4.4 Permissible involvement with a participating interest

Permissible forms of a transferor’s subsequent involvement with a transferred participating interest and/or its holder are limited to:

- Providing services relating to the underlying financial asset in exchange for a fee
- Writing recourse to the participating interest holder involving only limited, prescribed contractual representations or obligations (i.e., the three forms cited in TS 2.4.3)

To meet the participating interest definition, a transferor cannot receive a beneficial interest in a transferred portion of an entire financial asset.¹ Nor, as a general rule, may the transferor enter into any other arrangements with the participating interest holder that, when considered all-in, could potentially alter or augment the proportional cash flows that the holder receives (or would otherwise receive) through its interest, exclusive of a third-party guarantee. This restriction may be inferred from ASC 860-20-25-1, which lists the various forms of consideration that a transferor may be required to recognize in connection with a transfer that qualifies for derecognition.

Excerpt from ASC 860-20-25-1

Upon completion of such a transfer, the transferor (seller) shall also recognize any assets obtained or liabilities incurred in the sale, including, but not limited to, any of the following:

- Cash
- Servicing assets

¹ As discussed in TS 4, a beneficial interest in a transferred financial asset consists of a right to receive specified cash inflows from that asset held by a trust or other entity (the transferee).
c. Servicing liabilities

d. In a sale of an entire financial asset or a group of entire financial assets, any of the following:

   1. The transferor’s beneficial interest in the transferred financial assets
   2. Put or call options held or written (for example, guarantee or recourse obligations)
   3. Forward commitments (for example, commitments to deliver additional receivables during the revolving periods of some securitizations)
   4. Swaps (for example, provisions that convert interest rates from fixed to variable).

The items in ASC 860-20-25-1(d) are included solely in the context of a transfer of an entire financial asset or a group of such assets that qualifies for derecognition. They are not cited in the context of a transfer involving a participating interest that qualifies for sale accounting. Restricting the forms of acceptable consideration to items (a) through (c) for a participating interest aligns with one of the model’s fundamental characteristics; that each interest in the underlying financial asset be entitled to cash flows from the asset proportionate to its ownership interest.

Example TS 2-14 and Example TS 2-15 illustrate the application of this principle.

**EXAMPLE TS 2-14**

Transferor’s involvement with a transferred portion of a loan – inconsistent with the participating interest model

Through a participation agreement, Bank Co sells to Investor Co a proportionate, pari passu 50% ownership interest in a $10 million commercial loan. The terms of the participation agreement meet the conditions of a participating interest. However, the purchase price received by Bank Co consists of $4 million of cash and a 20% subordinated interest (a sub-participation) in the transferred participation.

Could the interest in the loan sold to Investor Co potentially qualify as a participating interest?

**Analysis**

Although the terms of the participation agreement may meet the criteria in ASC 860-10-40-6A viewed in isolation, the sub-participation (a beneficial interest in the transferred portion of the loan) causes the transfer to fail the requirement that a participating interest represent a proportionate ownership interest in the underlying financial asset. Bank Co is entitled to receive 60% of the loan’s cash flows all-in, despite having legally conveyed a 50% ownership interest to Investor Co. The sub-participation introduces disproportionality into the allocation of the loan’s cash flows between the two parties, and thus the transferred portion does not satisfy all of the attributes of a participating interest.

This conclusion is consistent with the view expressed by the FASB in paragraph A18 of SFAS 166: “In a transfer of an entire financial asset or group of entire financial assets, the assets obtained may include a beneficial interest in a transferred financial asset that is similar to a component, but only if a transferor transfers and surrenders control over the entire financial asset or the group of entire financial assets [emphasis added].” Here, Bank Co has transferred only a portion of the loan to
Investor Co and has received a beneficial interest in that portion (the sub-participation) as part of the purchase price.

**EXAMPLE TS 2-15**

Transferor’s involvement with a transferred portion of a loan – inconsistent with the participating interest model

Through a participation agreement, Bank Co sells to Investor Co a proportionate, pari passu 50% ownership interest in a $10 million commercial loan for cash. The participation agreement allows Bank Co to reacquire, at par, the transferred interest from Investor Co if an event of default occurs.

How does the contingent call option affect the analysis of whether the transferred interest has the attributes of a participating interest?

**Analysis**

To qualify as a participating interest, a transferred portion must entitle its holder to proportionate cash flows from the underlying entire financial asset. All cash flows received from the underlying asset subsequent to the transfer must be divided proportionately among the participating interest holders as discussed in ASC 860-10-40-6A(b).

We believe that the contingent call arrangement violates the proportionality mandate in ASC 860-10-40-6A(b). If the contingency occurs (borrower default), Bank Co may exercise its right to reacquire the transferred interest, in which case Investor Co will receive a payment from a source other than the loan obligor or a third-party guarantor and, importantly, will no longer be exposed to the underlying loan’s credit risk. Conversely, there will be a corresponding increase in Bank Co’s exposure to the loan’s credit risk going forward.

Question TS 2-4 discusses the application of this guidance when a transferee commits to future purchases in specific circumstances.

**Question TS 2-4**

Originators of revolving lines of credit sometimes sell participations in those lines to one or more investors. In addition to purchasing an interest in the amount funded to-date, each participant frequently commits to purchase a proportional interest in any subsequent advances made by the originator under the credit agreement. Would this commitment, in and of itself, cause the participation agreement to fail the participating interest guidance?

**PwC response**

No, provided that the terms of each participation sold otherwise comply with the requirements in ASC 860-10-40-6A. The forward commitment does not constitute a beneficial interest held by the transferor in any transferred portions; it simply obligates the participant to make incremental investments in subsequent borrower draws funded by the originator. The commitment enhances the participating interest assertion, as the forward ensures that a participant’s relative interest in the funded loan balance will remain unchanged at any point in time.
On the other hand, we do not believe that a participant must agree to purchase an interest in additional draws on a line of credit to comply with the participating interest requirements. ASC 860-10-40-6A(a) indicates that a transferor’s ownership interest in an entire financial asset may vary over time while the entire financial asset remains outstanding, provided that the portions held by the transferor and transferee at any point satisfy the other characteristics of a participating interest. A participant that purchases an interest in a funded loan (accompanied by no commitment to invest in additional advances) may find that its relative ownership interest in the proceeds (collections) from the loan declines over time, but as long as the participation entitles the transferee to cash flows proportionate to its then-current ownership interest, that fact alone will not prevent the transferred portion from meeting the participating interest rules.

### 2.4.5 Reconsideration events

While an underlying entire financial asset remains outstanding, the portion of that asset retained by a transferor, and the portion held by each transferee, must continue to meet all of the conditions in ASC 860-10-40-6A to warrant their characterization as participating interests. If a portion of an entire financial asset does not meet the participating interest criteria when transferred, by extension the portion retained by the transferor (and any previously-transferred portions) will no longer qualify as participating interests – even though the previously-transferred portions (and the portion retained) met the definition of a participating interest at the time they were sold.

Example TS 2-16 illustrates this principle.

**EXAMPLE TS 2-16**

Transfer of a portion of loan that does not meet the participating interest rules—reconsideration implications

Bank Co originates a $50 million commercial loan in 20X1. Later that year, Bank Co sells a 50% participation in the loan to Investor A that satisfies all of the conditions of a participating interest. The transfer qualifies for derecognition based on applying the guidance in ASC 860-10-40-5.

In 20X2, Bank Co sells a 25% participation in the loan to Investor B. However, the transferred participation entitles Investor B to a return disproportionate to its ownership interest in the underlying loan. As such, the interest acquired by Investor B does not satisfy the participating interest definition; specifically, the requirement in ASC 860-10-40-6A(b).

What are the financial reporting implications of Bank Co’s transfer of the interest to Investor B?

**Analysis**

Because the portion of the loan transferred to Investor B does not qualify as a participating interest, Bank Co must report the participations sold to both Investor B and Investor A going forward, as secured borrowings. This will entail a change in the derecognition accounting previously accorded the interest sold to Investor A.

Bank Co’s retained interest in the underlying loan must meet the definition of a participating interest at all times if the bank intends for the portion transferred to Investor A to be similarly respected as a participating interest. In this example, the interest sold to Investor B is not a participating interest and, therefore, by extension, the 25% portion retained by Bank Co no longer has the attributes of a
participating interest. Accordingly, in view of this change in circumstance, Bank Co is required to re-recognize the 50% interest previously transferred to Investor A (at fair value, along with a corresponding liability), consistent with guidance in ASC 860-20-25-8 and ASC 860-20-25-9.

See TS 4.3 for more information about re-recognition accounting.
Chapter 3: Control criteria for transfers of financial assets
3.1 **Overview—control criteria for transfers of financial assets**

The accounting for transfers of financial assets is predicated on determining which entity controls the asset after the exchange. Transferred financial assets are considered sold (and derecognized from the transferor’s balance sheet) when the transferor (including the consolidated affiliates included in the financial statements being presented, and its agents)\(^1\) has surrendered control over the financial assets to the transferee.\(^2\) The sale accounting model in ASC 860 is not a “risks and rewards” model, although the nature and extent of a transferor’s continuing economic involvement with a transferred financial asset may impact the legal isolation analysis.

This chapter addresses the application of the three control criteria in ASC 860-10-40-5 to transfers of financial assets within the scope of ASC 860 and discusses related implementation issues.

3.2 **Control criteria for transfers of financial assets**

To achieve derecognition accounting, transferred financial assets must satisfy the three “surrender of control” conditions cited in ASC 860-10-40-5. ASC 860-10-40-4 frames more generally how a transferor should approach this analysis.

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**Excerpt from ASC 860-10-40-4**

The objective of paragraph 860-10-40-5 and related implementation guidance is to determine whether a transferor and its consolidated affiliates included in the financial statements being presented have surrendered control over transferred financial assets or third-party beneficial interests. This determination:

a. Shall first consider whether the transferee would be consolidated by the transferor (for implementation guidance, see paragraph 860-10-55-17D)

b. Shall consider the transferor’s continuing involvement in the transferred financial assets

c. Requires the use of judgment that shall consider all arrangements or agreements made contemporaneously with, or in contemplation of, the transfer, even if they were not entered into at the time of the transfer.

With respect to item (b), all continuing involvement by the transferor, its consolidated affiliates included in the financial statements being presented, or its agents shall be considered continuing involvement by the transferor.

**Excerpt from ASC 860-10-40-5**

A transfer of an entire financial asset, a group of entire financial assets, or a participating interest in an entire financial asset in which the transferor surrenders control over those financial assets shall be accounted for as a sale if and only if all of the following conditions are met:

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\(^1\) References to a “transferor” throughout this chapter should be read to mean “transferor and its consolidated affiliates” or “transferor, consolidated affiliates and its agents” where the context so requires.

\(^2\) References to “transferred financial asset(s)” in this chapter include transfers of participating interests and groups of entire financial assets.
Control criteria for transfers of financial assets

a. Isolation of transferred financial assets...
b. Transferee’s rights to pledge or exchange [the transferred assets]...
c. Effective control [over the transferred assets is not maintained by the transferor, consolidated affiliates, or its agents]...

If a transfer of a financial asset fails to meet any one of the three criteria in ASC 860-10-40-5, the transferor may not derecognize the asset. In these instances, the transaction should be accounted for as a secured borrowing (see TS 5 for information on secured borrowings). If only a portion of an entire financial asset is transferred, and the transferred portion does not satisfy all of the characteristics of a participating interest, the exchange is also required to be reported as a secured borrowing (see TS 2 for information on participating interests). Therefore, the questions of unit of account and control are central to distinguishing between transfers of financial assets that should be accounted for as sales and those that should be reported as secured borrowings.

Figure TS 3-1 provides a decision tree for applying ASC 860’s sale accounting model.

**Figure TS 3-1**
Framework for accounting for transfers of financial assets
3.3 Interaction of ASC 810 and ASC 860

A transferor of financial assets should consider first whether it is required to consolidate the transferee. ASC 860-10-55-17D provides the following implementation guidance:

Excerpt from ASC 860-10-55-17D

If all other provisions of [ASC 860] are met with respect to a particular transfer, and the transferee would be consolidated by the transferor, then the transferred financial assets would not be treated as having been sold in the financial statements being presented. However, if the transferee is a consolidated subsidiary of the transferor (its parent), the transferee shall recognize the transferred financial assets in its separate entity financial statements, unless the nature of the transfer is a secured borrowing with a pledge of collateral (for example, a repurchase agreement that would not be accounted for as a sale under the provisions of paragraph 860-10-40-24).

If the transferor is required to consolidate the transferee based on applying the relevant provisions in ASC 810, Consolidation, further consideration of ASC 860 is unnecessary, at least in the context of the transferor’s consolidated financial statements, as the transferred assets have not moved beyond the confines of the consolidated reporting group.

For transfers of financial assets between two subsidiaries of a common parent, see TS 3.4.3.

Sometimes a transferee (subsidiary) that has acquired financial assets from its parent must prepare standalone financial statements. In those circumstances, ASC 860-10-55-17D clarifies that the transferee should recognize the acquired assets in its financial statements, unless the transfer has the characteristics of a secured borrowing accompanied by a pledge of collateral.

Question TS 3-1 further discusses situations when a subsidiary/transferee obtains financial assets from its parent.

Question TS 3-1

When a subsidiary/transferee obtains financial assets from its parent, what characteristics would suggest that its “nature” is that of secured borrowing with a pledge of collateral?

PwC response

We believe that the guidance in ASC 860-10-55-17D is intended to provide practical reporting relief in situations when a subsidiary has acquired financial assets from its parent. Absent this relief, one might assert that, under ASC 860’s control-based model, financial assets acquired from a parent could rarely be reported other than as secured borrowing arrangements in the subsidiary’s standalone financial statements – since the parent controls the subsidiary and thus, presumably, could unilaterally arrange for the subsidiary/transferee to return the assets. Further, in many instances, it is unlikely that these transfers would meet the legal isolation criterion in ASC 860-10-40-5(a).

Accordingly, we believe that if the form of the transfer, and related contractual terms, are consistent with transactions with third parties customarily reported as a sale, it is appropriate for the subsidiary to report on its balance sheet financial assets acquired from its parent. Indicators that support this reporting treatment include (1) the subsidiary acquires legal title to the asset, (2) consideration
received by the parent/transferor equals or closely approximates the transferred asset’s fair value and 
(3) the absence of any explicit or implied contractual arrangements that entitle or obligate the parent 
to re-acquire the transferred asset at a fixed or formulaic price. In our view, these conditions, if 
satisfied, support the assertion that the characteristics of the transfer align with those of a purchase 
and sale (or contribution) of a financial asset, in contrast to a secured borrowing arrangement.

3.4 **Continuing involvement with transferred financial assets**

As described in ASC 860-10-40-4, a transferor’s sale accounting analysis should take into account its 
“continuing involvement” with the transferred financial assets. This assessment should consider not 
only the transferor’s involvement, but also those of its consolidated affiliates and agents. When making 
this determination, all arrangements or agreements made contemporaneously with, or in 
contemplation of, the transfer should be considered.

Inventorying all forms of a transferor’s continuing involvement with transferred financial assets can be 
one of the most challenging aspects of the sale accounting analysis. This is generally because 
“continuing involvement” is an expansive concept and can assume many forms, as explained in the 
following sections.

3.4.1 **Forms of continuing involvement**

Continuing involvement encompasses any arrangement that entitles a transferor to receive cash flows 
(or other benefits) attributable to transferred financial assets or, conversely, could obligate the 
transferor to provide additional cash flows or other assets to the transferee (and/or any party related 
to the transfer). A transferor’s continuing involvement may stem from or consist of rights acquired and 
obligations assumed in transfer and servicing agreements, derivative instruments, or beneficial 
interests in transferred financial assets that have been securitized (e.g., debt securities issued by the 
transferee).

Forms of continuing involvement that a transferor may have with transferred financial assets include:

- Providing recourse, or writing guarantees or indemnities, to the transferee
- Servicing the financial assets
- Holding beneficial interests in the transferred financial assets (equity or debt instruments)
- Writing (or acquiring) put/call options on the transferred financial assets (or on beneficial 
  interests in those assets)
- Agreements to purchase or redeem transferred financial assets
- Pledges of collateral

Recourse, a common form of continuing involvement, is defined in ASC 860-10-20.
Definition from ASC 860-10-20

Recourse: The right of a transferee of receivables to receive payment from the transferor of those receivables for any of the following:

a. Failure of debtors to pay when due
b. The effects of prepayments
c. Adjustments resulting from defects in the eligibility of the transferred receivables

It is not uncommon for a transferor to have one or more forms of continuing involvement with transferred financial assets, considering the broad swath of these arrangements. Despite this involvement, the transferor may conclude that the transfer qualifies for sale accounting. Derecognition under ASC 860 is not predicated on the absence of a transferor’s continuing involvement with transferred assets, but rather on whether control over those assets has been ceded to the transferee. However, continuing involvement on the part of the transferor must be considered in connection with the legal isolation analysis, and that involvement may also allow the transferor to maintain control over the transferred assets.

Question TS 3-2 illustrates how to consider normal course representations and warranties in the context of continuing involvement.

Question TS 3-2

A transferor will frequently represent (assert) that transferred financial assets have certain characteristics – for example, that they are valid, free and clear from any liens or counterclaims, and enforceable in accordance with their terms. The transferor will also represent that it has good title to the assets and is their sole owner. If any of these represented conditions are later found not to be true and cannot be cured, the transferee typically has the right to revoke the transfer and/or to seek damages from the transferor.

Do “normal course” representations and warranties constitute a form of continuing involvement that precludes sale accounting?

PwC response

No, we do not believe that normal course representations and warranties about the characteristics of a transferred financial asset constitute a form of continuing involvement that precludes sale accounting. Normal course representation and warranties do not violate any of the criteria for transfer of control over the transferred assets since they do not impact legal isolation, the transferee’s right to pledge or exchange the transferred asset, or the transferor’s effective control over it – all they do is assert that the financial asset is what it is purported to be at the transfer date.

Sometimes transferors are obligated to buy back loans that default shortly after the transfer. In cases when the period in which a default of the loans will trigger a buy back is short, in practice this could be considered part of normal course representations and warranties. The reasoning is that if the period in which a default of the loans will trigger a buy back is short, it can be reasonably presumed that the receivables were already faulty at the transfer date, and hence the buy back is part of normal representations and warranties. However, if that period is extended, the default may have occurred
after the transfer date. Indemnifying defaults occurring after the transfer date would not be included in normal representations and warranties. Hence, they would be considered a form of continuing involvement with the transferred assets, and would need to be considered in the analysis of the three control criteria.

3.4.2 Relevant agreements and arrangements

When assessing the extent and nature of a transferor’s continuing involvement with transferred financial assets, a transferor should consider all arrangements or agreements made contemporaneously with, or in contemplation of, a transfer. In connection with this assessment, ASC 860-10-55-79A emphasizes that all available evidence is to be considered, including, but not limited to, the following:

- Explicit written arrangements
- Communications between the transferor and the transferee or its beneficial interest holders
- Unwritten arrangements customary in similar transfers

Concluding whether agreements and arrangements between a transferor and transferee should be considered to have been made in contemplation of a transfer may entail judgment. In certain instances, consultation with legal counsel may be appropriate, as the legal isolation analysis should include all agreements and arrangements that a court or receiver might consider when evaluating a transfer in the context of the transferor’s bankruptcy or similar proceeding. In any event, conclusions reached in this regard will depend on the individual facts and circumstances.

3.4.3 Continuing involvement: exceptions

There are two narrow instances when a transferor does not need to consider all forms of continuing involvement with transferred financial assets (and all contemporaneous agreements) in connection with its sale analysis:

- If a transfer of a financial asset is accompanied by a related repurchase financing, as defined in ASC 860-10-20, the parties should account for the two transactions separately, without consideration of the other. See ASC 860-10-40-4C and TS 3.4.3.1.

- In a transfer of financial assets between two subsidiaries of a common parent, ASC 860-10-40-4 clarifies that the transferor-subsidiary would not consider the parent’s involvements with the transferred financial assets when evaluating whether, in its standalone financial statements, the transaction should be reported as a sale.

3.4.3.1 Repurchase financing transactions

Repurchase financing transactions are transactions in which a financial asset is transferred from an initial transferor to an initial transferee, and contemporaneously the same counterparties (or their consolidated affiliates) enter into a repurchase agreement on the same asset. Under the repurchase agreement, the initial transferee (the borrower) transfers back the financial asset as collateral to the initial transferor (the lender) and is obligated to repurchase it (or substantially the same asset) at a fixed price within a prescribed time period. These transactions are described in detail in ASC 860-10-55-17A through ASC 860-10-55-17C.
ASC 860-10-40-4C requires that for such transactions, the transferor and the transferee should separately account for the initial transfer of the financial asset and the related repurchase agreement. Once those transactions are not linked and are accounted for separately, the accounting result that is often achieved is that the initial transferor accounts for the initial transfer as a sale of a financial asset (if all derecognition criteria are met), and the initial transferee accounts for the initial transfer symmetrically as a purchase. Both parties account for the repurchase agreement component of the transaction as a secured borrowing. In other words, after step 1 of the transaction takes place, the initial transferor gets the asset off its books and, before step 3 of the transaction takes place, presents a repurchase receivable from the initial transferee, whereas the initial transferee includes the asset on its balance sheet in addition to a repurchase liability.

This accounting applies regardless if the first two steps are net settled. It should not be analogized to for other transactions outside the scope of ASC 860-10-40-4C.

### 3.5 Legal isolation of transferred financial assets

Transferred financial assets must be legally isolated from the transferor, its consolidated affiliates, and its creditors to qualify for sale accounting, as discussed in ASC 860-10-40-5(a).

**ASC 860-10-40-5(a)**

The transferred financial assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership. Transferred financial assets are isolated in bankruptcy or other receivership only if the transferred financial assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its consolidated affiliates included in the financial statements being presented. For multiple step transfers, a bankruptcy-remote entity is not considered a consolidated affiliate for purposes of performing the isolation analysis. Notwithstanding the isolation analysis, each entity involved in the transfer is subject to the applicable guidance on whether it shall be consolidated (see paragraphs 860-
Derecognition of transferred financial assets is allowed only if available evidence provides reasonable assurance that the assets have been put presumptively beyond the reach of the powers of (1) a bankruptcy trustee and (2) creditors of (a) the transferor and (b), if applicable, any consolidated affiliate of the transferor that is not a special-purpose corporation or other entity designed to make remote the possibility that the consolidated affiliate would enter bankruptcy or other receivership. The remainder of this section addresses various implementation issues associated with applying the legal isolation requirement.

### 3.5.1 Involvement by consolidated affiliates of the transferor

Transferred financial assets must be legally isolated not only from the transferor, but also from its consolidated affiliates (other than those intended to be bankruptcy-remote) included in the financial statements being presented. From the perspective of a parent entity's consolidated financial statements, a financial asset transferred by the parent (or a subsidiary) to a third party may not be legally isolated if another entity within the consolidated group has continuing involvement with the transferred asset, such as servicing or providing credit enhancement.

A consolidated affiliate is defined in ASC 860-10-20.

#### Definition from ASC 860-10-20

Consolidated Affiliate: An entity whose assets and liabilities are included in the consolidated, combined, or other financial statements being presented.

An entity that is designed to make remote the possibility that it would enter bankruptcy3 (a bankruptcy-remote entity, or “BRE”) is not considered a consolidated affiliate for purposes of performing the isolation analysis. The typical attributes of a BRE are discussed later in this section.

### 3.5.2 Isolation: legal analysis

Whether a transfer of financial assets satisfies the legal isolation criterion is a legal determination – not an accounting judgment. A legal analysis that considers (1) the statutes and regulations that would apply in the event of a transferor’s bankruptcy and (2) the laws intended to govern the transfer itself (the choice of law cited in, for example, the transaction’s purchase and sale agreement) is typically required to support the assertion that this criterion has been met. In practice, this analysis often entails evaluating whether the transfer would be upheld as a true sale at law (a true sale opinion) and, in certain circumstances, whether the transferee would be substantively consolidated into the bankruptcy estate of the transferor (a substantive consolidation opinion).4

The legal isolation requirement focuses on whether transferred financial assets would be isolated from the transferor even in the event of bankruptcy, regardless of the transferor’s credit rating or financial strength at the transfer date. That is, the legal isolation condition may not be considered satisfied

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3 Unless the context suggests otherwise, references in this chapter to “bankruptcy” and “bankruptcy law” should be read to also include receivership, conservatorship and similar insolvency regimes.

4 Unless indicated otherwise, matters in this chapter dealing with legal isolation are discussed in the context of laws and regulations in the US (Federal and state).
simply because, in view of the transferor’s current credit standing, the likelihood of bankruptcy is deemed remote.

Depending on its terms, a transferor’s contractual right to re-acquire transferred financial assets from the transferee — for example, a call option or removal-of-accounts provision — may not preclude a determination that transferred financial assets have been legally isolated. However, such a right will preclude sale accounting treatment if it allows the transferor to maintain effective control over the transferred financial assets, as discussed more fully in TS 3.4.

### 3.5.2.1 When should a legal opinion be obtained?

A legal opinion would not typically be required for a routine transfer of financial assets that does not result in any continuing involvement by the transferor and its consolidated affiliates, including BREs.

If a transferor has continuing involvement with transferred financial assets, there is a presumption that legal opinions specific to the transaction should be obtained to support the legal isolation assertion. When continuing involvement is present, we do not believe that a transfer of financial assets may be categorized as “routine,” as contemplated in ASC 860-10-55-18(B)(a). Accordingly, when the transferor or its consolidated affiliates have continuing involvement with the transferred financial assets, a true-sale-at-law opinion is customarily required to demonstrate that the assets have been legally isolated. Additionally, substantive consolidation opinions will often be needed when affiliated entities act as a transferee or are otherwise involved in the transfer through some form of continuing involvement. Each of these opinions is discussed in more detail below.

Listed below are the more common transactions for which we would generally expect a transferor to obtain relevant legal opinion(s) to support its assertion that transferred financial assets have been legally isolated. The listing is not intended to be an all-inclusive enumeration of transactions that would require a legal analysis.

- Factoring of trade receivables, when the transferor retains servicing rights and obligations, obtains a beneficial interest or provides credit enhancement
- Transfers of participating interests in loans or other receivables
- Securitizations of transferred financial assets (including both “private label” securitizations and those involving Federal agencies or government-sponsored enterprises)
- Transfers of debt or equity securities accompanied by the transferor’s continuing involvement with the securities or the transferee

Provided certain conditions are met, a transferor may rely on a legal opinion rendered on a previous transfer to support its assertion that a subsequent transfer also meets the legal isolation criterion — thus obviating the need to obtain an opinion that specifically addresses the current transaction. The circumstances in which this approach may be appropriate are discussed in TS 3.5.3.

When evaluating evidence to support its assertion that transferred financial assets have been legally isolated, a transferor should consider the points in Figure TS 3-2.
Figure TS 3-2
Framework for determining evidence required to support legal isolation under ASC 860

3.5.2.2 The “two-step” transfer construct

Figure TS 1-5, Figure TS 1-6, Figure TS 1-7, and Figure TS 1-8 in TS 1 reflect the so-called “two-step” transfer arrangement commonly used in securitizations of financial assets to achieve legal isolation. Transactions involving transferees other than securitization entities may also employ the two-step construct, particularly when the transferor retains a significant economic interest in the transferred assets. Under the typical two-step arrangement, the transferor sells financial assets to a wholly-owned bankruptcy-remote entity (BRE) that, in turn, immediately transfers the acquired assets to the third-party transferee (typically a trust, in the case of a securitization). The two-step configuration is intended to legally isolate the transferred financial assets from the transferor and, at same time, makes the securitized assets attractive to investors by allowing the transferor to provide structural credit enhancement to the securitization trust (for example, by arranging for the BRE to hold the most junior notes issued by the trust).
Legal opinions rendered on two-step securitization structures should consider the transaction taken as a whole to provide persuasive evidence that (1) the transfer to the BRE would be upheld as a true sale at law (“true sale”) and (2) the BRE would not be substantively consolidated into the bankruptcy estate of the transferor parent. Legal opinions that address these matters are usually requested by rating agencies and other parties involved with these transactions. It is common for management to use those opinions to support the legal isolation assertion for financial reporting purposes.

TS 3.5.2.2 provides more information about the typical two-step transfer arrangement.

### Characteristics of a BRE

A BRE is structured to make it unlikely that:

- The entity itself would file for (or be placed into) bankruptcy by its parent or by other parties having an interest in the entity (e.g., any creditors)
- A court would order the substantive consolidation of the entity into the bankruptcy estate of its parent.

There is no controlling statute or authoritative case law that enumerates the conditions a legal entity must satisfy to be considered “bankruptcy-remote.” However, in practice, to be deemed bankruptcy-remote, the entity (typically an LLC incorporated in Delaware, wholly owned by its transferor-parent) generally has the following characteristics:

- Undertakes only limited activities specified in its formative document(s)
- Does not incur indebtedness to third parties (or, if such indebtedness is allowed, subject to stringent conditions, such as satisfactory creditor non-petition covenants)
- Does not commingle its assets with those of its parent or related affiliates
- Maintains corporate and financial records separate from its parent and its affiliates, including separate bank accounts
- Observes all corporate formalities on a standalone basis
- Has at least one director or manager independent of the parent
- Conducts its activities separate from its parent and affiliates
- Pays its obligations with its own funds (i.e., it does not use the funds of its parent to satisfy its obligations)

The foregoing is not an all-inclusive list of the restrictive (or prescriptive) attributes of a BRE.

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5 In most “two-step” transfers, counsel does not (or cannot) render a true sale opinion on the BRE’s conveyance of the financial assets to the ultimate transferee (e.g., a securitization trust). Therefore, if the BRE was to be placed into bankruptcy (or included in the bankruptcy estate of the parent-transferor), a risk exists that the BRE’s transfer of the assets to the ultimate transferee could be recharacterized as a financing. The BRE construct, accompanied by a would-level substantive consolidation opinion, provides assurance that this risk is remote.
3.5.2.4  **True sale opinion**

A true sale opinion from a qualified bankruptcy attorney is frequently obtained to support the conclusion that the transferred financial assets have been isolated. As stated in ASC 860-10-55-18A(a), in the context of US bankruptcy laws, “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 financial assets would not be included in the transferor’s bankruptcy estate.” In addition, ASC 860-10-55-18C states that, “[f]or entities that are subject to other possible bankruptcy, conservatorship, or other receivership procedures (for example, banks subject to receivership by the Federal Deposit Insurance Corporation) in the United States or other jurisdictions, judgments about whether transferred financial assets have been isolated shall be made in relation to the powers of bankruptcy courts or trustees, conservators, or receivers in those jurisdictions.”

A transferor and its consolidated affiliates are not precluded from having recourse exposure to, or an economic interest in, a transferred financial asset for the transfer to be considered a true sale. However, in the US, the level of recourse and/or the nature and extent of any such economic interest are among the principal factors that lawyers consider in determining whether the transfer would be considered a true sale. On the other hand, in certain foreign jurisdictions, a transfer may be considered a legal true sale even if the transferee has substantial (or full) recourse to the transferor for reimbursement of losses stemming from the transferred assets. In those jurisdictions, the transferor’s retention of a transferred asset’s risks and rewards may not be as important to the legal analysis as it is in the US.

Care should be taken as continuing involvement takes many forms, many of which may not, on the surface, appear to constitute retention of risks or rewards. Legal opinions should address all forms of continuing involvement by a transferor and its consolidated affiliates when evaluating whether a transfer would be respected as a “true sale at law.”

3.5.2.5  **Substantive consolidation opinion**

A true sale opinion provides support that the transferred financial assets would not be considered part of the bankruptcy estate of the transferor (that is, the estate of the legal seller). However, a true-sale opinion does not address whether the transferee — and thus, by extension, the transferred assets acquired by the transferee — could be substantively consolidated into the bankruptcy estate of the transferor. Depending on the circumstances, a substantive consolidation opinion may be required to support the assertion that the transferred assets have been legally isolated.

Substantive consolidation is a judicial doctrine arising from the broad powers of equity granted to bankruptcy courts in the United States. Under this doctrine, in limited circumstances, a bankruptcy court can treat a group of affiliated entities as if they are one, merging their assets and liabilities for purposes of the bankruptcy proceeding. That said, no specific provision of the US Bankruptcy Code expressly authorizes a court to order substantive consolidation. A court will weigh a variety of factors related to the entities proposed to be consolidated when evaluating whether to consider substantive consolidation, which typically will include:

- Their organizational structure
- Their inter-corporate or other inter-organizational relationships
Their relationships with their respective creditors and other third parties

A court will also evaluate the impact upon the creditors of each entity if consolidation were to be ordered, and whether such parties would be unfairly prejudiced or treated more equitably by substantive consolidation.

### 3.5.2.6 Consideration of other statutes and legal doctrines

For entities subject to the US Bankruptcy Code, ASC 860 discusses legal isolation largely in the context of true sale and substantive consolidation opinions. Risks addressed in these opinions are typically considered most salient when assessing whether “the available evidence provides reasonable assurance” that the transferred financial assets have been placed beyond the reach of a transferor’s bankruptcy trustee or other receiver, as called for in ASC 860-10-40-8. However, there may be other statutes or legal theories that a creditor or bankruptcy trustee may invoke in an attempt to recover a transferred financial asset in connection with a debtor’s bankruptcy. For example, a bankruptcy trustee may seek to annul or overturn a transfer and reclaim the financial assets as property of the transferor’s bankruptcy estate on the grounds that the transfer was fraudulent. The Bankruptcy Code contains fraudulent transfer provisions, and various US states have fraudulent transfer laws.

In their true sale letters, counsel will often assume that the transferor was not insolvent at the date of the transfer, and the transferred asset does not represent consideration intended to satisfy debt previously owed the transferee (“antecedent debt”). In other words, they will “assume away” conditions potentially relevant to the assessment of whether there has been a fraudulent conveyance. In other instances, counsel will explicitly state in their letter that they assume the transfer is not a fraudulent conveyance.

The discussion of legal isolation and related legal opinions in the remainder of this chapter focuses on true sale and substantive consolidation. Management should discuss with counsel the risks that other laws or doctrines could pose in light of the facts and circumstances of the transfer, and assess whether additional evidence—that is, evidence incremental to a true sale opinion and, if applicable, substantive consolidation opinion—is necessary to ensure that management can support its legal isolation conclusion in accordance with the “reasonable assurance” threshold called for in ASC 860-10-40-8.

### 3.5.3 Reliance on legal opinions previously rendered

A transaction-specific true sale opinion and, if applicable, a substantive consolidation opinion provide the best evidence that the related transfer satisfies the legal isolation criterion. However, in certain circumstances, management may assert that legal opinions rendered on a previous transaction may be relied upon to support its assertion that subsequent transfers also achieve legal isolation. In our view, the presumption that a transaction-specific legal opinion is required to evidence legal isolation may be overcome if:

- Management has obtained a legal opinion for previous transfers with facts and circumstances (including contractual terms and forms of consideration received) identical (or substantially the same) to the current transaction, and

- Both the previous transfers and the current transaction are governed by the same bankruptcy statutes/regulations and contract law.
Management has concluded that the laws and regulations in the relevant jurisdiction (including case law relating to how those laws and regulations have been interpreted and applied) have remained unchanged since the date of the earlier opinion.

If these conditions are met, the previously-issued opinion may be used to satisfy the legal analysis otherwise required for the current transaction, consistent with the guidance in ASC 860-10-55-18B(b). Caution should be exercised in making this determination. In practice, transactions are rarely structured in an identical way, typically stemming from the need to tailor each to accommodate the commercial requirements of the parties, or in response to changes in market conditions. This may be the case even when the transferee is the same counterparty. The financial assets being transferred may also have different attributes. Since an attorney is typically the only party who can evaluate the bankruptcy-related implications of changes or differences in transactions, management should seek advice from legal counsel as to whether a new opinion is warranted, even when those changes or differences appear to be inconsequential.

When no legal opinion is obtained for a transfer based on a determination that the facts and circumstances of that transaction are identical (or substantially the same) as those that governed a previous transfer of financial assets for which a legal opinion was obtained, and those laws and regulations have remained unchanged, a transferor should document the basis for that conclusion to support its assertion that the current transfer satisfies the legal isolation requirement.

### 3.5.3.1 Transfers involving revolving structures

A transferor may transfer financial assets on an ongoing basis in accordance with the terms of a master purchase or similar agreement. These forward arrangements are most commonly seen in securitizations of trade accounts receivables or credit card receivables under so-called revolving structures. Transfers of newly-originated receivables to the securitization trust may take place as frequently as daily, and typically continue until such time as the arrangement enters its scheduled amortization phase, at which point transfers cease and the structure winds down.

For these arrangements, it is customary for transferors to obtain true sale and substantive consolidation opinions coincident with the execution of the governing purchase agreement and the initial transfer of receivables under the program. However, each subsequent transfer of receivables under these arrangements must also meet the legal isolation requirement to qualify for derecognition. Accordingly, to support this ongoing assertion, transferors should have a process in place to ensure that it may continue to rely on the opinions received at the program’s inception. This process may include obtaining periodic affirmations from counsel that the opinions previously provided remain appropriate, based on counsel’s updated consideration of relevant statutes, regulations, and case law. Further, any changes in the terms and provisions in the governing agreements may require an updated legal analysis.

### 3.5.4 Use of external legal counsel

As noted above, whether a transfer meets the legal isolation condition in ASC 860-10-40-5(a) is a legal matter requiring the advice of competent counsel. Appropriate consideration of the complexities of bankruptcy statutes and related case law requires specialized expertise. Further, to serve as competent evidential matter, the form of advice must be a formal opinion that provides “would level” assurance. Would-level opinions rendered by external counsel will have undergone a rigorous process of due diligence and review. As such, we believe that, as a general rule, it would be inappropriate for
management to rely on internal white papers, memos, or even opinions prepared by internal counsel to support its assertion that transferred financial assets have been legally isolated.

3.5.5 Management’s analysis of a legal opinion

In the absence of any guidance directed specifically to management, the PCAOB and AICPA guidance directed to auditors may be helpful to inform a transferor’s management regarding the appropriate form and content of legal opinions intended to serve as evidence of legal isolation. AU Section 9336, *Using the Work of a Specialist: Auditing Interpretations of Section 336* (AU 9336), issued by the AICPA, is intended to assist auditors in assessing the sufficiency of a legal opinion obtained by management to support its assertion that transferred financial assets meet the isolation criterion in paragraph ASC 860-10-40-5(a). PCAOB Auditing Interpretation 11, *Using the Work of a Specialist: Auditing Interpretations (As Amended for FYE 12/15/2020 and After)* incorporates AU 9336’s content. Among other things, the guidance provides that, when assessing the adequacy of a lawyer’s opinion, consideration be given to the following:

- Whether the lawyer has experience in such matters: the lawyer should be well-versed in the US Bankruptcy Code and relevant case law, and knowledgeable of other federal, state, or foreign laws that may govern, or bear on, the transfer. For transferors subject to the provisions of the Federal Deposit Insurance Act, management and the auditor should consider whether the legal specialist has experience with the rights and powers of receivers, conservators, and liquidating agents under that Act. Similar specialized expertise may be necessary in other regulated industries (for example, insurance).

- Whether the legal opinion rendered explicitly considers (1) the laws of the State or country intended to govern the transfer and (2) the laws of the jurisdiction that would govern the transferor’s bankruptcy or receivership. As laws vary from jurisdiction to jurisdiction, a transaction that qualifies as a true sale in one jurisdiction may not qualify as such in another.

- Whether the transferor’s auditor is precluded from relying on a legal opinion because the letter restricts the use of the findings. The legal opinion should specifically state that the auditor is permitted to rely on the conclusions reached in the letter as evidential matter that supports management’s assertion that the transferred assets have been legally isolated. Alternatively, counsel may grant such permission in a separate cover letter. Generally, if this permission is not granted, the letter is considered to contain an audit scope limitation.

In the United States, findings of a lawyer relating to bankruptcy matters are expressed in the form of a reasoned legal opinion that (1) is restricted to the particular facts and circumstances that are relevant to the transaction and (2) relies on analogy to legal precedents and case law that may or may not involve comparable facts. Management should ensure that the legal analysis assumes facts consistent with the transaction, and that other enumerated assumptions (e.g., regarding certain attributes of the transferor, the transferee, and the transferred assets) are appropriate in the circumstances. Inconsistencies in this regard could lead to a conclusion that legal isolation of the transferred assets under ASC 860 has not been demonstrated. Moreover, a legal opinion that does not consider all forms of continuing involvement by the transferor and any of its consolidated affiliates in the financial statements being presented, or an opinion that does not consider all agreements entered into in

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6 The AICPA has a task force that is currently focused on improving the guidance in AU 9336, in order to better align it with auditing literature and address certain aspects not currently addressed.
connection with the transfer, would not be sufficient to demonstrate that the legal isolation condition has been met.

A legal letter that includes an inadequate opinion, inappropriate limitations and assumptions, a disclaimer of opinion, or conditions that effectively limit the scope of the opinion to facts and circumstances that are not applicable to the transaction would not provide persuasive evidence that the transferred assets have been put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership. The same would be true for a legal opinion that merely states, with no corresponding discussion of relevant statutes and case law, that a transfer is a legal true sale and, if applicable, that the transferee would not be consolidated with the transferor in the event of the latter’s bankruptcy.

3.5.5.1 **Form of the opinion**

To provide reasonable assurance that the assets have been isolated from the transferor and any of its consolidated affiliates and its creditors, the legal opinion should provide “would level” assurance with respect to the subject matter addressed; that is, an opinion as to the decision a court would reach in a properly presented and argued case, and the court followed analogous legal precedents (case law). “Would level” is the strongest degree of assurance that an attorney can provide when opining on bankruptcy matters. Note, however, that even an appropriately-worded “would” opinion may not satisfy the requirements of ASC 860 if the assumptions are not accurate (see TS 3.5.5.3) or if the enumerated qualifications unduly limit the scope of the opinion (see TS 3.5.5.4).

Legal opinions stating that the transfer “should” or “would likely” be “construed to be a true sale at law or that “there is a substantial chance” that a true sale at law has occurred do not provide an adequate level of assurance regarding legal isolation. A legal opinion that includes a conclusion expressed using any of the following language would likewise not provide persuasive evidence:

- “We are unable to express an opinion…”
- “It is our opinion, based upon limited facts…”
- “We are of the view…” or “it appears…”
- “We would be prepared to make such arguments that…”
- “There is a reasonable basis to conclude that…”
- “In our opinion, the transfer would either be a sale or a grant of a perfected security interest…”
- “In our opinion, there is a reasonable possibility…”
- “It is our opinion that the company will be able to assert meritorious arguments…”
- “In our opinion, it is more likely than not…”
- “In our opinion, the transfer would presumptively be…”
- “In our opinion, it is probable that…”
An attorney’s conclusions about a hypothetical transaction may not be relevant to an executed transfer subject to ASC 860. Perhaps most importantly in this regard, counsel may not contemplate nor address all facts and circumstances relevant to the executed transaction nor consider all provisions in the transfer’s controlling agreements. As such, legal conclusions with respect to a hypothetical transaction generally do not provide sufficient evidence that transferred financial assets have been legally isolated.

### 3.5.5.2 Examples of legal opinions (Bankruptcy Code)

Examples of “would level” legal opinions for an entity subject to the US Bankruptcy Code appear below. See TS 3.5.8.1 for excerpts of opinions for an entity subject to receivership or conservatorship under the provisions of the Federal Deposit Insurance Act (FDIA).

#### True sale opinion

Based on and subject to the assumptions, qualifications and limitations set forth in this letter, in the event that the Seller were to become a debtor under the Bankruptcy Code, it is our opinion that, in a properly presented and argued case, a court of relevant jurisdiction exercising reasonable judgment and considering all relevant factors would hold the transfer by the Seller to the Purchaser pursuant to the Receivables Purchase Agreement of all right, title and interest of the Seller in and to the Receivables and the proceeds thereof to constitute a true sale of such Receivables and not a borrowing by the Seller secured by a pledge of such Receivables and, accordingly, such Receivables would not be property of the Seller’s bankruptcy estate under Section 541(a)(1) of the Bankruptcy Code and not be subject to the automatic stay provisions of Section 362(a) of the Bankruptcy Code.

#### Substantive consolidation opinion

Based on and subject to the assumptions, qualifications and limitations set forth in this letter, in the event that the Seller were to become a debtor under the Bankruptcy Code, it is our opinion that, in a properly presented and argued case, a court of relevant jurisdiction exercising reasonable judgment and considering all relevant factors would not order the substantive consolidation of the assets and liabilities of the Depositor with those of the Seller.

A legal opinion will normally address bankruptcy matters with respect to the entity that is the legal seller of the financial assets. However, if the transferor’s consolidated affiliates are involved with those assets, opinions that address such matters with respect to those affiliates may be required to support the assertion that the transferred assets have been legally isolated in the context of the consolidated reporting entity (see TS 3.5.6).

### 3.5.5.3 Facts and assumptions

A lawyer will make various assumptions about the underlying transaction when opining on legal isolation. These assumptions typically encompass a wide array of matters, including counsel’s understanding of key provisions in the transaction documents and attributes of the assets sold, as well as assumptions about various procedural matters and organizational protocols that the parties intend to observe. These assumptions are generally cited in the forepart of the letter.

Management must evaluate if a lawyer’s enumeration of facts and assumptions reflect, or are consistent with, the specifics of the transaction. It would be inappropriate for management to conclude that the opinion rendered by counsel is sufficient if it has reason to believe that the attorney’s
conclusion is based on incorrect facts and assumptions, or if the letter omits material facts and assumptions that could impact counsel’s analysis. The assumptions in the legal opinion should also be compared to assumptions in the tax analysis to make sure they do not conflict.

Example TS 3-1 illustrates how to analyze a specific assumption in a legal opinion.

**EXAMPLE TS 3-1**

**Analysis of assumptions in a legal opinion**

Company XYZ plans to securitize its existing portfolio of customer accounts receivables. The standard terms and conditions in the underlying agreements between Company XYZ and its customers require that the customer receive prior written notification before any transfer of its receivables takes place. Company XYZ has engaged a law firm to issue a true sale opinion on Company XYZ’s proposed securitization. The letter includes the following language under the heading “Assumptions of Fact:”

“We have assumed that there are no agreements to which Company XYZ is a party or by which it is bound prohibiting, restricting or conditioning the sale or assignment of any asset other than such required consents or notices as have been obtained and given.”

What are the implications of counsel’s assumption with respect to management’s reliance on the opinion?

**Analysis**

True sale opinions commonly assume that the seller has complied with all contractual obligations to notify customers of its intent to sell their receivables to another party. For the legal opinion to be valid, Company XYZ must have, in fact, issued the requisite notifications. If not, it would be inappropriate to place reliance on the opinion until such time as the stated assumption is accurate.

In many true sale opinions, counsel will state their assumption that the transfer will be reported as a sale for financial reporting purposes. This assumption is circular, since derecognition is predicated, among other things, on satisfying the legal isolation requirement, for which receipt of counsel’s opinion will be the chief supporting documentation. As such, if the attorney will not delete this assumption, it should be worded to say that counsel assumes the transfer will satisfy the other conditions for sale accounting except for legal isolation, regarding which counsel’s opinion will serve as the principal evidence. Alternative language to this effect is also acceptable.

**3.5.5.4 Limitations and qualifications**

Counsel will frequently cite various limitations and qualifications with respect to the opinion rendered. Management should ascertain the reasons for any limitations and qualifications, and evaluate their potential implications on the opinion. Management should ensure the enumerated matters do not call into question the sufficiency of the attorney’s analysis and do not compromise the “would level” assurance regarding the legal isolation assertion expressed.

**3.5.6 Legal isolation: additional considerations**

The analysis of legal isolation can be challenging when various entities within the consolidated group have continuing involvement with transferred financial assets. Similarly, transactions involving multiple jurisdictions or the laws of different countries may pose unusual complexity. This section
Control criteria for transfers of financial assets

highlights those circumstances in which multiple legal opinions may be required to support the assertion that transferred financial assets have been isolated from all entities that constitute the consolidated reporting enterprise, other than those entities designed to be bankruptcy remote. In all instances, a transferor should determine what evidence is required to support meeting the legal isolation criterion based on the advice of counsel.

3.5.6.1 Transfers involving multiple legal jurisdictions

In our experience, a transferor may be required to obtain multiple legal opinions when a transfer has any of the following characteristics:

- The laws intended to govern the transfer (contract law) are not the same as those of the country in which the transferor is organized/domiciled. For example, a transferor subject to the bankruptcy laws of Country X sells receivables to a bank in Country Y, and the parties agree that the transfer agreement is to be governed by the laws of Country Y (or Country Z).

- Financial assets transferred by an entity to a third party were acquired or originated by another entity within the consolidated group governed by the laws of a country other than that of the transferor. For example, Parent Co and its subsidiaries (all subject to the laws of Country A) transfer originated loans to Subsidiary B (subject to the laws of Country B) in connection with Subsidiary B’s securitization of the loans.

3.5.6.2 Multiple entities in a group have continuing involvement

Multiple legal opinions may be required when a transfer of financial assets involves various members of a consolidated group. A subsidiary within a consolidated reporting group that is not bankruptcy remote may transfer financial assets to a third party and conclude that, in its standalone financial statements, the transaction meets ASC 860’s conditions for sale accounting, including legal isolation. To conclude that sale accounting remains appropriate in the consolidated GAAP financial statements of the parent, the parent must conclude that the transfer continues to meet the three sale accounting conditions in ASC 860-10-40-5 in the context of those financial statements. Thus, the parent must conclude that the transferred financial assets are legally isolated viewed not only from the lens of the legal seller’s financial statements, but also from the parent’s perspective and that of any consolidated subsidiaries involved with the transferred assets.

In these circumstances, there must be sufficient legal evidence to conclude that a court charged with adjudicating the bankruptcy of the parent company would hold that the assets transferred by a subsidiary would not be considered the property of the bankruptcy estate of the parent and its subsidiaries (other than those subsidiaries intended to be bankruptcy remote), taking into account the various forms of involvement by those subsidiaries with the transferred assets.

A transferor subsidiary may be domiciled outside the US and subject to the laws of a foreign jurisdiction while its parent or ultimate parent may be subject to the US Bankruptcy Code. The fact that the transferor is an overseas entity does not mitigate the requirement that there be sufficient legal evidence to support the legal isolation assertion in the consolidated financial statements of the US parent. Accordingly, at the consolidated level, the legal isolation evaluation should consider all forms of the continuing involvement on the part of all consolidated affiliates with the transferred assets. As such, opinions obtained to support legal isolation for purposes of the standalone financial statements of the transferor foreign subsidiary may need to be augmented by additional legal analysis that considers whether, in the event that the parent was involved in a proceeding under the Bankruptcy...
Control criteria for transfers of financial assets

Code, a court would re-characterize the transfer of financial assets executed by the foreign subsidiary. Additional analysis may be particularly warranted if other consolidated affiliates or the parent were previously involved with the financial assets sold by the foreign subsidiary, and/or if the foreign subsidiary (and any other entities in the consolidated group) have continuing involvement with the assets post-transfer.

Example TS 3-2 illustrates the evidence (legal opinions) required in a group situation.

**EXAMPLE TS 3-2**

Consideration of legal isolation – various entities within consolidated group having continuing involvement with transferred financial assets

Subsidiary A, wholly owned by Parent Co, transfers a group of originated loans to Investor Co, an unrelated third party, in exchange for cash and a beneficial interest in the transferred loans. A subsidiary of Subsidiary A will service the loans post-transfer. In addition, Parent Co provides limited recourse (credit enhancement) to Investor Co on the transferred loans. There are no other forms of involvement by Parent Co and its subsidiaries with the transferred loans or Investor Co.

Parent Co prepares consolidated financial statements, and Subsidiary is required to submit standalone financial statements to certain lenders. Both entities have concluded that the transfer of the loans will meet the conditions for sale accounting, subject to obtaining satisfactory opinions from counsel to demonstrate legal isolation. Parent Co and its subsidiaries are each subject to the US Bankruptcy Code.

In assessing whether this criterion is met, what evidence (legal opinions) should be obtained by Subsidiary A and Parent Co for purposes of their respective sets of financial statements?

**Analysis**

ASC 860-10-40-4 affirms the general decision principle that the sale accounting analysis must consider all forms of continuing involvement by the transferor and any of its consolidated affiliates included in the financial statements being presented. Consistent with this principle, ASC 860-10-40-8 also requires that the analysis of the legal isolation requirement consider not only the transferor but also its consolidated affiliates included in the financial statements being presented.

Accordingly, the legal analysis prepared for purposes of Subsidiary A’s stand-alone financial statements should consider Subsidiary A’s continuing involvement with the transferred loans – in this instance, its beneficial interest in the loans as well as the servicing retained, as the latter is performed by an entity consolidated into Subsidiary A’s financial statements.7

For purposes of Parent Co’s consolidated financial statements, management would be required to obtain a legal analysis that addresses whether, if the parent and its subsidiaries were subject to a proceeding under the US Bankruptcy Code, the transferred loans would be respected as a true sale at law. As part of its true sale analysis, counsel should address how it believes a court would consider the parent’s obligation to provide credit enhancement when evaluating whether the transferred loans should be considered part of Parent Co’s consolidated bankruptcy estate.

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7 This example stipulates that Subsidiary A sells the loans directly to Investor Co (a “one-step” exchange). If the parties utilized a “two-step” transfer construct involving a BRE, the legal isolation analysis would involve consideration of matters of true sale and substantive consolidation in the context of Subsidiary A’s transfer of the loans to the BRE.
In this example, depending on the judgments reached by counsel, it is possible that management may conclude that the transfer of the loans to Investor Co meets the legal isolation condition only in the context of Subsidiary A’s standalone financial statements. In that case, Subsidiary A would report the transfer as a sale. However, in Parent Co’s consolidated financial statements, the same transaction would be reported as a secured borrowing.

3.5.6.3 Set-off rights

A set-off right is a common law right of a party that is both a debtor and a creditor to the same counterparty to reduce its obligation to that counterparty if that counterparty fails to pay its obligation. ASC 860-10-40-5(a) is explicit that “A set-off right is not an impediment to meeting the isolation condition.” The reasoning behind this provision, is that the existence of set-off rights is not considered by a court when assessing whether a transaction would be deemed to be a true sale. In the event of the bankruptcy or receivership of either the obligor or the transferor of the financial asset, both parties could retain the ability to exercise a set-off right involving a financial asset that had been transferred. In the event of the bankruptcy of the transferor, the transferee may have only an unsecured claim against the transferor for its share of the amount set off (rather than a claim to the cash flows from the originally transferred asset).

When developing this guidance, the FASB contemplated whether set-off rights related to a transferred financial asset should be severed in order to meet the isolation requirement. However, they were advised that it may not be possible to sever set-off rights related to transferred financial assets. For example, certain consumer protection rules prevent consumers from waiving their ability to exercise set-off rights against a seller of goods financed under a contract with the seller. In other cases, it may be impractical or infeasible for a transferor to sever set-off rights related to transferred financial assets because doing so would require the involvement of an obligor on the original financial assets who may not even be aware of or otherwise involved in the transfer. The Board was advised that a court likely would compel a transferor that benefited from an exercise of set-off rights on a transferred financial asset to pass through a proportionate share of that benefit to any transferee that held a share of the related original financial asset. In addition, set-off risks are assessed and included in the price for the transaction like other dilutive risks, such as warranties and returns. Hence, the Board ultimately decided that set-off rights would not be an impediment to meeting the isolation requirement or the participating interest definition.

3.5.7 How two-step structures meet the legal isolation requirement

In many instances, a key motivation of the typical securitization transaction is to achieve a lower cost of funding. The credit risk in the securities issued to third parties (beneficial interests) directly affects the interest rate that the securities must pay to attract investors. A reduction in the credit risk to all or certain of those investors can take the form of credit enhancement to the assets through a third-party guarantee, subordinating the claims of certain investors to the underlying assets’ cash flows to other (senior) investors, or both. Further, investors do not want exposure to the credit risk (bankruptcy) of the securitization’s sponsor/transferor; investors may demand a higher interest rate to compensate them as such risk increases.

To facilitate the execution of securitization transactions at the lowest possible funding cost, the “two-step” transfer construct is commonly used in the marketplace. As discussed in ASC 860-10-55-22, the two-step securitization structure, taken as a whole, is generally judged under present US law to
successfully isolated the transferred assets beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.

In two-step securitization transactions, the key considerations in assessing whether legal isolation has been achieved are whether, relative to the first step (that is, the legal sale of assets by the transferor(s) to an affiliated BRE):

- the transfer of the financial assets by the seller(s) to the BRE would be upheld as a true sale at law in the event of a seller's bankruptcy, and
- the BRE would not be substantively consolidated into the bankruptcy estate of its parent.

The integrity of the two-step transfer construct to support legal isolation hinges on obtaining the “would level” true sale and substantive consolidation opinions discussed in TS 3.5.5.1. This requirement stems from the fact that, typically, the BRE’s subsequent transfer of the acquired assets to the securitization trust or other legal vehicle may not be upheld as a true sale. This is because the extent and nature of credit or yield protection provided by the BRE to the trust’s third-party investors (say, through the BRE’s retention of the trust’s subordinated notes) may suggest that the BRE’s transfer has the characteristics of a secured borrowing. Consequently, a risk exists that a bankruptcy court could find the exchange between the BRE and the trust to be a financing, rather than a true sale. However, the two-step construct mitigates this re-characterization risk provided that (1) the transfer of financial assets to the BRE is a true sale, and (2) by design, a BRE has a remote possibility of entering into bankruptcy, either by itself or by substantive consolidation in the event of bankruptcy by its parent. As such, in these circumstances, even though the BRE is frequently included in a transferor’s consolidated financial statements, ASC 860’s legal isolation condition is satisfied.

Because the true sale opinion addresses only the first step in most of these transactions, frequently there is no corresponding legal analysis that may be leveraged when evaluating whether the second step transfer (that is, the exchange between the BRE and securitization trust or third-party transferee) involves an entire financial asset (or group of such assets) or, conversely, a portion of a financial asset subject to the participating interest definition. Entities should focus on the legal form of the asset (interest) sold by the BRE, and what rights that asset conveys to the transferee, when evaluating whether an entire financial asset, or only a portion, has been transferred in the second step. If only a portion has been exchanged, the participating interest guidance in ASC 860-10-40-6A must be considered first in the sale accounting evaluation.

3.5.8 **Transferors subject to FDIC receivership**

As conservator or receiver, the FDIC has the authority to repudiate or disaffirm contracts of an insured depository institution (IDI) with respect to transfers of financial assets involving a securitization or a participation. However, provided certain conditions are met, the FDIC provides a “safe harbor” that limits the exercise of that authority. These limitations are intended to provide certain protections to investors, particularly those that hold beneficial interests in financial assets securitized by an IDI. The FDIC rules clarify the application of the safe harbor to securitization and participation transactions that meet the criteria for sale accounting and, to a greater extent, to those transactions that do not result in the IDI’s derecognition of the underlying transferred financial assets.

The safe harbor rule is published in 12 CFR section 360.6.
3.5.8.1 Examples of legal opinions (FDIA)

As discussed in AU 9336.14, management can choose between two alternate forms of legal opinions that provide acceptable legal isolation assurance to transferors of financial assets subject to receivership or conservatorship under the provisions of the FDIA. The first example is excerpted below; see AU 9336.14 for the second example, which is rarely seen in practice.

Excerpt from AU 9336.14

“We believe (or it is our opinion) that in a properly presented and argued case, as a legal matter, in the event the Seller were to become subject to receivership or conservatorship, the transfer of the Financial Assets from the Seller to the Purchaser would be considered to be a sale (or a true sale) of the Financial Assets from the Seller to the Purchaser and not a loan and, accordingly, the Financial Assets and the proceeds thereof transferred to the Purchaser by the Seller in accordance with the Purchase Agreement would not be deemed to be property of, or subject to repudiation, reclamation, recovery, or recharacterization by, the receiver or conservator appointed with respect to the Seller.”

AU 9336.14 also provides an example of a substantive consolidation opinion that may be required when the transferee is an affiliate of a transferor subject to the FDIA (e.g., a BRE in a two-step transaction involving an IDI).

Excerpt from AU 9336.14

“Based upon the assumptions of fact and the discussion set forth above, and on a reasoned analysis of analogous case law, we are of the opinion that in a properly presented and argued case, as a legal matter, in a receivership, conservatorship, or liquidation proceeding in respect of the Seller, a court would not grant an order consolidating the assets and liabilities of the Purchaser with those of the Seller.”

3.5.9 Legal opinions that address foreign laws and regulations

The legal isolation criterion in ASC 860 applies to all transfers of financial assets, irrespective of whether a transferor is subject to the US Bankruptcy Code or, alternatively, subject to the bankruptcy statutes and related laws and regulations of a foreign jurisdiction. Accordingly, other than for routine transfers of financial assets that entail no continuing involvement by a transferor or its affiliates, there is a presumption that a foreign legal opinion is required to support an assertion that financial assets transferred by a foreign entity have been legally isolated.8

The laws and conventions that a foreign court would consider in concluding whether financial assets transferred by a foreign entity have been legally isolated may differ significantly from those in the US. Further, legal opinions rendered outside the US frequently omit an extended analysis of relevant case law and/or factors that a court or bankruptcy trustee would consider in its assessment of the transaction. Nevertheless, as a general rule, the requirements and considerations of bankruptcy opinions rendered in the US apply similarly to foreign legal opinions. The sections that follow

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8 “Foreign entity” or “foreign transferor” refers to legal entities whose bankruptcy or receivership would be governed by laws or regulations other than those of the US. Similarly, a “foreign legal opinion” or “foreign bankruptcy opinion” refers to an opinion written by counsel that addresses the relevant bankruptcy-related laws and regulations of the jurisdiction to which the foreign entity or foreign transferor is subject.
highlight matters to consider when evaluating whether a foreign legal opinion provides the requisite “reasonable assurance” that transferred financial assets have been legally isolated.

3.5.9.1 Scope and content of foreign legal opinions

Counsel outside the US may not be familiar with a requirement to obtain a legal opinion to support a financial reporting conclusion. This stems from the fact that legal isolation is a requirement unique to US GAAP’s sale accounting framework; under IFRS, for example, the derecognition model for transferred financial assets does not include this criterion. In some cases, a foreign legal opinion may be prepared at the request of rating agencies or the transferee. However, these opinions may require enhancement to ensure that their scope comports with the requirements in ASC 860 – for example, to ensure that, where applicable, the analysis and opinion expressed considers consolidated affiliates of the transferor’s involvement with the transferred assets.

The discussion of legal isolation in ASC 860 is written in the context of US law. Thus “true sale” and the doctrine of substantive consolidation may not be relevant legal concepts in other jurisdictions. Further, statutory and regulatory regimes in other countries can vary widely. For this reason, a foreign attorney’s conclusions regarding legal isolation may be expressed in a manner (and using terms) unfamiliar to transferors accustomed to legal opinions prepared in the United States. Nevertheless, legal isolation is not specific to legal jurisdiction, in which case a foreign bankruptcy opinion can be used to provide the equivalent of would-level assurance with respect to the following matters:

- The assets have been irrevocably transferred in accordance with an enforceable contract
- A court or party with jurisdiction over the foreign entity would hold or conclude that the transferred assets have been legally isolated from the foreign transferor, even in the event of the latter’s bankruptcy or receivership
- In a bankruptcy or receivership proceeding, a court or party with jurisdiction over the foreign entity would not recharacterize the transfer as a secured borrowing

3.5.9.2 Choice of law considerations

For a variety of reasons, the laws specified in a transfer arrangement as governing the transfer of financial assets may be those of a country other than the country in which the transferor is organized and domiciled. For example, a transferor subject to the laws of Spain may periodically sell receivables to a bank (organized in another country) in accordance with a master purchase and sale agreement governed by English law. Accordingly, the Spanish transferor should discuss with counsel whether, in addition to obtaining a legal opinion that addresses the application of Spanish insolvency laws to the transaction, an opinion that addresses relevant matters in the context of English law is also required. For example, if the opinions expressed by counsel with respect to Spanish bankruptcy matters (or legal isolation more generally) are materially predicated upon assumed findings of an English court regarding the application of English law to the purchase and sale agreement, a legal analysis by English counsel to support the propriety of those assumptions may be warranted. Absent an opinion from English counsel in these circumstances, the opinion provided by Spanish counsel may not meet ASC 860’s “reasonable assurance” threshold regarding legal isolation.
3.5.9.3 **Assumptions and qualifications**

Similar to legal opinions issued in the US, foreign legal opinions will enumerate numerous assumptions of fact and various qualifications regarding the conclusions expressed. Opinions rendered with respect to transferors domiciled in Europe frequently cite numerous assumptions and qualifications relating to the controlling civil law regimes in the applicable country and the regulatory framework within which the entity operates. Among others, these assumptions frequently stipulate that the transferor has complied with various procedures mandated by law or regulation to effect the transfer.

Given the extent and nature of these assumptions and qualifications, it is particularly important that the transferor fully understands the potential implications on the attorney’s opinion. As discussed in TS 3.5.5, management should review all assumptions for propriety. If counsel has assumed that the transferor has or will observe certain protocols or perform certain procedures, management should ensure that those actions have or will be undertaken. Finally, as also noted in TS 3.5.5, management should conclude that the nature and scope of the qualifications do not call into question whether the opinions expressed omit consideration of laws or legal doctrines that could materially impact the legal isolation assertion.

3.5.9.4 **Auditor reliance language**

Similar to practice in the US, a foreign attorney may restrict the use of its letter to only those parties who have engaged it, and state that only they may rely on it. In these instances, if a transferor intends to provide a foreign bankruptcy opinion to its auditors as evidence in support of its legal isolation assertion, management should ensure that the letter (or a cover letter) expressly permits it to provide the opinion to its auditors.

Language that authorizes management to make a bankruptcy opinion available to its auditors is commonly seen in opinions written in the US, having been negotiated between the accounting and legal professions years ago. Inclusion of standard language to this effect is a widely-accepted practice. Outside the US, management may need to negotiate with foreign counsel to include this permission language in its opinion (or in a cover letter).

3.6 **Transferee’s right to pledge or exchange transferred financial assets**

The second criterion that must be met for a transaction to qualify for sale accounting requires the transferee to obtain the right to freely pledge or exchange the transferred assets.
Excerpt from ASC 860-10-40-5(b)

This condition is met if both of the following conditions are met:

1. Each transferee (or, if the transferee is an entity whose sole purpose is to engage in securitization or asset-backed financing activities and that entity is constrained from pledging or exchanging the assets it receives, each third-party holder of its beneficial interests) has the right to pledge or exchange the assets (or beneficial interests) it received.

2. No condition does both of the following:
   
   i. Constrains the transferee (or third-party holder of its beneficial interests) from taking advantage of its right to pledge or exchange
   
   ii. Provides more than a trivial benefit to the transferor (see paragraphs 860-10-40-15 through 40-21).

If the transferor, its consolidated affiliates included in the financial statements being presented, and its agents have no continuing involvement with the transferred financial assets, the condition under paragraph 860-10-40-5(b) is met.

Upon completion of a transfer, the transferor and transferee must determine whether, in fact, the transferee (or, if the transferee is an entity whose sole purpose is to engage in securitization or asset-backed financing activities and that entity is constrained from pledging or exchanging the assets it receives, each third-party holder of its beneficial interests) is able to freely pledge or exchange the assets (or beneficial interests). If the transferee (or holder) is not constrained from doing so, then the criterion is met. Conversely, if the transferee (or holder) is constrained by the transferor, a consolidated affiliate, or an unaffiliated agent, and that constraint provides more than a trivial benefit to the transferor, sale treatment for the transfer would be precluded.

Figure TS 3-3 illustrates the application of ASC 860-10-40-5(b).
Figure TS 3-3
Ability of transferee to pledge or exchange transferred financial assets

3.6.1 Unit of account: the beneficial interest “look-through” accommodation

If the transferee entity’s sole purpose is to engage in securitization or asset-backed financing activities, the sale accounting analysis considers the ability of the transferee’s third-party beneficial interest holders to pledge or exchange their interests. This ability to “look through” the transferee entity acknowledges that securitization trusts and similar asset-backed financing entities must pledge the acquired financial assets coincident with their acquisition to protect the interests of the transferee’s beneficial interest holders and, in addition, may not freely dispose of or sell the assets while those interests remain outstanding. In these circumstances, the beneficial interests held by third-party investors are considered surrogates for the transferred assets themselves, and thus those beneficial interests serve as the “unit of account” or point of reference when applying ASC 860-10-40-5(b).

Although the look through guidance in ASC 860-10-40-5(b) is written in the context of “each third-party holder of [the transferee’s] beneficial interests,” we do not believe the guidance is intended to imply that a third party beneficial interest holder must exist. For example, we believe that a transfer of financial assets to a guaranteed mortgage securitization entity, whereby the transferor retains all of the securities issued, may still meet this criterion. Further, it is our understanding that the reference to “each third-party holder” was intended to allow potential transfers in which the transferor is required to hold a certain amount of securities/beneficial interests (and is precluded from pledging or exchanging them) to achieve sale accounting, provided that the third-party holders, if any, could pledge or exchange their interests.

Depending on the facts and circumstances, an entity that arguably constitutes a securitization or an asset-backed financing entity will not qualify for ASC 860-10-40-5(b)’s look through accommodation. Example TS 3-3 illustrates this concept.
EXAMPLE TS 3-3

Evaluation of whether an asset-backed financing entity qualifies for the beneficial interest “look through” approach in ASC 860-10-40-5(b)

Transferor Co originates and periodically transfers loans to Warehousing Co, an unconsolidated LLC created specifically to acquire Transferor Co’s loans. A substantial portion of Warehousing Co’s financing consists of a credit line provided by Big Bank. In exchange for extending credit, Big Bank has a security interest in Warehousing Co’s loans, and thus Warehousing Co may not re-pledge them. Big Bank may look only to the loan collateral for repayment. The loan agreement further provides that, in the event Warehousing Co subsequently sells the loans, the proceeds must first be used to repay Big Bank’s loan. However, the loan agreement does not restrict Warehousing Co from selling the loan collateral to third parties and, similarly, there are no provisions in the LLC agreement that constrain Warehousing Co from doing so.

In connection with its assessment of the condition in ASC 860-10-40-5(b), should Transferor Co consider Warehousing Co to be an asset-backed financing entity constrained from pledging or exchanging the loans acquired from Transferor Co?

Analysis

No. To qualify for the “look through” test in ASC 860-10-40-5(b), a transferee must satisfy two conditions, namely (1) it engages solely in securitization or asset-backed financing activities, and (2) it is constrained from pledging or exchanging the assets received. Although Warehousing Co may be considered to meet the first condition, it does not satisfy the second. Given Big Bank’s security interest in the loans, Warehousing Co cannot re-pledge them. However, the loan agreement does not constrain Warehousing Co from exchanging (selling) the loans. Although the proceeds from any such sales must be used first to repay any indebtedness to Big Bank, that provision does not constrain Warehousing Co from converting the loans into cash (i.e., monetizing the loans).

Consequently, when assessing whether Warehousing Co meets the sale accounting requirement in ASC 860-10-40-5(b), the unit of account should be the transferred loans themselves – not the interests issued by Warehousing Co.

3.6.2 Constraints on pledging or exchanging financial assets or beneficial interests

Under ASC 860, determining whether a transferor has surrendered control over transferred financial assets involves, among other things, evaluating whether transferee (or, if applicable, a holder of a beneficial interest in those assets) has the ability to obtain all or most of the cash inflows from those assets (or beneficial interests), either by exchanging them or pledging them as collateral. This evaluation focuses on the owner’s ability to obtain all or most of the cash inflows, which is the primary economic benefit of a financial asset (or beneficial interest). It does not matter what method is used to accomplishing this end (i.e., by exchanging it or pledging it as collateral).

Constraints on a transferee’s (or holder’s) contractual right to pledge or exchange transferred financial assets may be explicitly imposed by provisions in the transfer agreement, or in other contemporaneous agreements. As observed in ASC 860-10-40-16, a condition imposed by a transferor that constrains a transferee is presumed to provide the transferor with more than a trivial benefit – in which case the
condition in ASC 860-10-40-5(b) would not be satisfied. However, in other cases, the constraints may stem from facts and circumstances unrelated to the transfer and related agreements. Examples include regulatory constraints (e.g., regulations that allow only qualified parties to acquire particular assets) or market conditions (e.g., limited investor appetite for the financial asset in question). Constraints or conditions of this type are presumptively not considered to constrain a transferee for purposes of the sale accounting analysis.

ASC 860-10-40-17 cites various conditions that both constrain the transferee and presumptively provide more than a trivial benefit to the transferor. Examples include:

- Prohibition on the transferee’s subsequent sale or pledge of the financial assets
- Transferor-imposed constraints that narrowly limit the timing or terms of any subsequent pledge or exchange (e.g., allowing a transferee to pledge assets only on the first day, or allowing the transferee to sell assets only on terms agreed with the transferor)
- Right of transferor approval before any asset may be transferred by the transferee (unless contractually such approval cannot be unreasonably withheld)
- Prohibition on the sale of the financial assets by the transferee to a competitor of the transferor, if that competitor is the only potential willing buyer of the transferred asset
- Call option written by a transferee to the transferor on transferred assets not readily obtainable (this constrains a transferee because it might default if the call is exercised and it has previously exchanged or pledged the assets)

On the other hand, ASC 860-10-40-18 lists examples of conditions relating to transferred financial assets that presumptively would not, in isolation, preclude sales treatment under ASC 860-10-40-5(b):

**Excerpt from ASC 860-10-40-18**

a. A transferor’s right of first refusal on the occurrence of a bona fide offer to the transferee from a third party...

b. A requirement to obtain the transferor’s permission to sell or pledge that is not to be unreasonably withheld

c. A prohibition on sale to the transferor’s competitor if other potential willing buyers exist

d. A regulatory limitation such as on the number or nature of eligible transferees (as in the circumstance of securities issued under Securities Act Rule 144A or debt placed privately)

e. Illiquidity, for example, the absence of an active market

Certain economic constraints, such as a transferee (or holder of a beneficial interest) incurring significant tax liability upon sale of the asset, are not considered to preclude sale treatment. These types of constraints are beyond the control of the transferor.

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9 TS 3.6.3 discusses the “more than a trivial benefit” criterion.
Question TS 3-3, Question TS 3-4, Question TS 3-5, and Question TS 3-6 illustrate specific aspects of the guidance.

**Question TS 3-3**
How do restrictions on the sale of transferred assets to several competitors, rather than a single competitor, impact the analysis under ASC 860-10-40-5(b)?

**PwC response**
As long as there are other potential buyers, a provision that prohibits the transferee from selling a transferred financial asset to a single competitor would not violate the “ability to pledge or exchange” condition. Similarly, restrictions on sales to several competitors would not be problematic if, exclusive of those competitors, the universe of potential buyers is consequential. The determination of “consequential” in this context is a matter of judgment and should be based on the specific facts and circumstances.

**Question TS 3-4**
ASC 860-10-40-18(b) refers to a transferor’s permission to sell or pledge “that is not to be unreasonably withheld.” Under what circumstances could this language be considered to constrain the transferee from pledging or constraining the transferred financial asset?

**PwC response**
ASC 860-10-40-18(b) presumes that a requirement to obtain permission to sell or pledge that may not be unreasonably withheld does not call into question the transferee’s right to pledge or exchange the acquired financial asset. However, before concluding, a reporting entity should consider why this restriction was imposed. A condition to obtain the transferor’s permission may be imposed by a transferor for business or competitive purposes. For example, if a transferor’s refusal to approve a proposed sale of a transferred financial asset to a competitor could be upheld under their discretionary right to consent – and all potential buyers of the asset in question are competitors of the transferor – then the consent right would likely be considered constraining. In practice, we would expect situations like this to be rare. Nevertheless, if uncertainty exists regarding the scope and nature of a potentially constraining consent right, advice of legal counsel may be warranted.

**Question TS 3-5**
Assume a transferee does not have the ability to pledge acquired loans, nor can the transferee sell the loans in their entirety to third parties. That is, the transferee may not transfer legal title to any acquired loan to a buyer. However, the transferee has an unconstrained right to sell participation interests in the loans (ownership interests in the loans’ cash flows). In view of this participation right, does the transferee meet the condition in ASC 860-10-40-5(b)?

**PwC response**
Potentially, yes. To conclude that the test in ASC 860-10-40-5(b) may be considered met in the circumstances described above, two conditions must be satisfied:
The transferee must have the unilateral contractual right (either explicit or implicit) to transfer participation interests in the loans that allow it to monetize substantially all (i.e., 90% or more) of the cash flows from the loans.

There are no other provisions in the transaction agreements (or other facts and circumstances regarding the transferee or the characteristics of the transferred assets) that call into question whether the contractual right to sell participations is, in fact, substantive.

If these conditions are met, we believe a transferee’s right to sell participations in transferred financial assets may be sufficient, in and of itself, to conclude that the transferee has the right to freely exchange those assets. The requirement in ASC 860-10-40-5(b) focuses on a transferee’s ability to obtain all or most of the financial asset’s cash inflows, not on the legal form of that ability (by pledging or exchanging the asset). We do not believe that a conclusion that a transferee has the ability to exchange a transferred financial asset requires a contractual right to convey legal title to another party. A transferee can potentially monetize all the cash inflows of a financial asset (e.g., a debt instrument or equity security) by selling participation (ownership) interests that collectively entitle the participants to 100% of the asset’s cash inflows, and at the same time remain the legal owner of the financial asset.

**Question TS 3-6**

Assume a transferee can only pledge an acquired debt instrument and any such pledge must be on a full-recourse basis. The transferee owns other unencumbered assets that may be pledged to secure financing, along with the acquired asset. This asset base permits the transferee to obtain financing substantially in excess of the fair value of the debt instrument.

Based on these facts and circumstances alone, can the transferor assert that the condition in ASC 860-10-40-5(b) is satisfied regarding the transferred debt instrument?

**PwC response**

No. Additional analysis is required. ASC 860-10-55-27 affirms that the condition in ASC 860-10-40-5(b) may be met even in instances when a transferee can only pledge transferred financial assets, albeit conditional on a careful analysis of the facts and circumstances.

To conclude that the requirement in ASC 860-10-40-5(b) is satisfied, a transferee must have the unconstrained right to obtain all or most of an acquired financial asset’s cash inflows, as those cash flows constitute the asset’s primary economic benefit.

In this example, it would be inappropriate to evaluate the “substantially all” hurdle based on financing that could be obtained by pledging both the debt instrument and other assets of the transferee. The unit of account is solely the transferred debt instrument, and thus the evaluation should exclude the financing capacity stemming from the transferee’s other assets. Accordingly, in our view, the condition in ASC 860-10-40-5(b) would be considered satisfied only if the transferor concludes that the incremental cash flows attributable to pledging only the debt instrument would meet the “substantially all” threshold – even though, as a legal matter, the financial asset in question may be pledged on a full recourse basis only.

When evaluating whether a transferee has the right to pledge or exchange a transferred financial asset, not only should the provisions in the relevant agreements that explicitly address this matter be
considered, but also any other provisions in those agreements that could indirectly impact the transferee’s ability to exercise its stated rights to pledge or exchange. Particularly in this regard, conditional or contingent call options on transferred financial assets held by the transferor should be carefully evaluated to determine whether the options effectively constrain the transferee from pledging or exchanging the assets.

Example TS 3-4 and Example TS 3-5 illustrate how to apply this guidance in specific fact patterns.

**EXAMPLE TS 3-4**

Consideration of contingent call options – potential impact on transferee’s ability to pledge or exchange transferred financial assets

Originator Co sells consumer loans to Bank Co on a periodic basis. Originator Co continues to service the loans and holds a subordinated interest in the transferred pool. Originator Co has the right to repurchase any transferred loan that becomes delinquent, as defined in the servicing agreement. Given the credit quality of the loans, delinquencies are expected to occur with some degree of frequency, and Originator may find it advantageous to exercise its call to facilitate loan remediation/collection efforts. Bank Co has the contractual right to freely pledge or exchange any factored loan.

Since Bank Co is contingently obligated to return any delinquent loan to Originator Co, should its contractual right to pledge or sell the loans be considered substantive?

*Analysis*

It depends. Further analysis of the specific facts and circumstances would be required. The examples cited in ASC 860-10-40-17(c) can be read to suggest that the contingent call in this example presumptively should be considered to constrain Bank Co and provide more than a trivial benefit to Originator Co. However, upon further review, if commercially-feasible means exist that would allow Bank Co to monetize substantially all the value of the factored receivables if it so desired – the contingent call provisions and Originator Co’s subordinated interest notwithstanding – the condition in ASC 860-10-40-5(b) may be satisfied. For example, if Bank Co can unilaterally (and feasibly) sell undivided interests (participations) in the pool of factored receivables that would allow it to convert substantially all of the current value of its investment into cash, it may be appropriate to conclude that Bank Co has an unconstrained right to freely exchange the acquired loans.

**EXAMPLE TS 3-5**

Transferee’s ability to exchange transferred financial assets – consideration of all forms of transferor involvement

Transferor Co originates and periodically transfers loans to Warehousing Co, an unconsolidated LLC created specifically to acquire Transferor Co’s loans. Transferor Co, as Warehousing Co’s managing member, serves as Warehousing Co’s collateral manager. In that capacity, Transferor Co has the sole discretion to direct Warehousing Co to dispose of loans purchased from Transferor Co, including selling them to term securitization vehicles organized by Transferor Co.

A substantial portion of Warehousing Co’s financing consists of a credit line provided by Big Bank. In exchange for extending credit, Big Bank has a security interest in Warehousing Co’s loans, and thus Warehousing Co may not re-pledge them. Big Bank may look only to the loan collateral for repayment. The loan agreement further provides that, in the event Warehousing Co subsequently sells the loans,
the proceeds must first be used to repay Big Bank’s loan. However, the loan agreement does not restrict Warehousing Co from selling the loan collateral to third parties and, similarly, there are no provisions in the LLC agreement that constrain Warehousing Co from doing so.

Should Warehousing Co be considered to have the unconstrained right to exchange (sell) the loans acquired from Transferor Co?

**Analysis**

No, it would be inappropriate to conclude that Warehousing Co has the right to freely sell the loans (and thus satisfy the condition in ASC 860-10-40-5(b)). Although, as a contractual matter, Warehousing Co has the unconstrained right to exchange loans acquired from Transferor Co, any such sale can be initiated only at the direction of Transferor Co in its capacity as the transferee’s collateral manager. ASC 860-10-40-17’s enumeration of conditions that both constrain a transferee and presumptively provide a transferor with a more than trivial benefit includes arrangements where a transferee can pledge or exchange transferred financial assets only on terms agreed to with the transferor. Transferor Co is the only party that can direct Warehousing Co to sell a loan. Warehousing Co cannot freely pledge the loans, given the security interest held by Bank Co.

Question TS 3-7 illustrates how to apply this guidance when the restriction is for a limited time period.

**Question TS 3-7**

A transferor initiates a plan to sell large blocks of receivables over a two-year period to reduce its credit risk. The transferor transfers the first block of receivables. To prevent the transferee from competing with it during the transferor’s next sale, the transferor restricts the transferee from selling or pledging the receivables for a period of 90 days. Does this restriction prevent sale treatment under paragraph ASC 860-10-40-5(b)?

**PwC response**

Yes. Sale treatment is precluded until the sale restriction lapses. Even if it were for only a week or a year. Transferor-imposed contractual constraints that narrowly limit timing or terms, such as those that allow the transferee to pledge only on the terms agreed to by the transferor, constrain the transferee and presumptively provide “more than a trivial” benefit to the transferor. Under this arrangement, the transferor benefits from knowing who currently owns the receivables and, further, the restriction ensures that the transferor will not be competing with the transferee as it seeks to sell additional receivables. By constraining the transferee, the transferor has not surrendered control over the transferred assets.

The transferor and transferee would initially account for the transfer as a secured borrowing, regardless of the length of the restriction. After the restriction is removed, the transfer would be recorded as a sale if the other conditions for derecognition are also met.

3.6.2.1 **“Third-party purchaser” arrangements for CMBS**

Under the Dodd-Frank rules, sponsors of commercial mortgage backed securities (CMBS) transactions are required to comply with certain “risk retention” obligations. This obligation can be satisfied if a third-party purchaser agrees to purchase and hold a prescribed interest in the securitization trust
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(sometimes referred to as the structure's "B-piece") for an extended period of time. During this extended period, the third-party purchaser is precluded from selling the prescribed interest. Accordingly, a question arose whether these transactions met the requirement for all third-party holders of beneficial interests issued in a securitization to have the right to freely pledge or exchange their investment.

In response to a submission by the Securities Industry and Financial Markets Association (SIFMA), the staff of the SEC's Office of the Chief Accountant (OCA) has indicated that it would not object to a conclusion by a transferor (securitizer) of commercial real estate loans that use of the "third-party purchaser" option permitted under the Dodd-Frank risk retention rules does not, in and of itself, jeopardize the transfer qualifying for derecognition (sale accounting) in the transferor's financial statements. In a letter dated December 4, 2017, SIFMA confirmed its understanding of the SEC staff's position based on discussions held in November.

The SEC staff reached its view based on a broad array of considerations, which were not limited to its interpretation of the relevant provisions in ASC 860. The SEC staff considered the unique facts and circumstances described in SIFMA's submission, which arose as a result of a change in regulation in the securitization market, as well as the stated regulatory intent of the third-party purchaser option, which is to balance two overriding goals - namely, not to disrupt B-piece investor arrangements commonly seen in the CMBS market, while at the same time ensuring that risk retention promotes good underwriting. As a result, it would be inappropriate to extend the SEC staff's conclusions to other fact patterns.

3.6.3 More than a trivial benefit

A transferee may be constrained from taking advantage of its right to pledge or exchange a transferred financial asset. If the constraint provides the transferor with more than a trivial benefit, the transfer does not satisfy the requirement in ASC 860-10-40-5(b), and the exchange must be reported as a secured borrowing.

“More than a trivial benefit” is not a defined term. However, in practice, it connotes a very low bar or threshold. This may be inferred from the guidance in ASC 860-10-40-16:

ASC 860-10-40-16

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.

A restriction imposed by a transferor presumptively provides more than a trivial benefit to the transferor; to assert otherwise begs the question why the transferor introduced the constraint in the first place. In our view, although all relevant facts and circumstances must be considered, this presumption can rarely, if ever, be overcome.
There are instances, however, when a transferor may be considered not to benefit from a constraint. These situations include:

- The transferor is unaware of the constraint, as noted in ASC 860-10-40-16
- As discussed in ASC 860-10-40-16A, although a transferor may be aware of a constraint, if it has no continuing involvement with the transferred financial assets, the condition in ASC 860-10-40-5(b) is nevertheless considered met

Example TS 3-6 illustrates how to apply this guidance to a specific fact pattern.

**EXAMPLE TS 3-6**

**Evaluation of more than a trivial benefit**

Company A transfers a group of loans to Company B, an operating entity that is highly leveraged, in exchange for cash and a beneficial interest in the loans. Company B is subject to covenants in debt agreements unrelated to the transfer that constrain it from pledging or otherwise monetizing the acquired loans. Company A is unaware of the constraints imposed by these debt covenants, and there are no provisions in the transaction’s purchase and sale agreement that impose any transfer restrictions on Company B.

How do the constraining covenants in the various lender agreements affect Company A’s assessment of Company B’s ability to pledge or exchange the transferred loans?

**Analysis**

Since Company A has no knowledge of the constraints imposed in the various lending agreements, it should not be considered to obtain more than a trivial benefit from them. The beneficiaries of the constraining covenants are presumptively Company B’s lenders – not Company A.

On the other hand, if Company A was aware of the constraining debt covenants at the time of the transfer, additional analysis would be required, since Company A has continuing involvement with the transferred loans. ASC 860-10-40-16 indicates that a constraining condition not imposed by a transferor may – or may not – provide more than a trivial benefit to the transferor, but provides no additional guidance in this regard. In this instance, if circumstances indicate or suggest that a constraining loan agreement was executed in contemplation of the transfer (so as to provide Company B with the funds necessary to acquire the loans from Company A), it may be appropriate to conclude that Company A obtains a more than trivial benefit from the constraint. Additionally, if Company A agreed to forego imposing its usual constraints due to corresponding provisions in the loan agreement, this too would suggest the existence of more than a trivial benefit.

**3.6.3.1 Absence of continuing involvement**

If a transferor has no continuing involvement with transferred financial assets, the condition in ASC 860-10-40-5(b) is considered met in all circumstances.
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ASC 860-10-40-16A
In some circumstances in which the transferor has no continuing involvement with the transferred financial assets, some conditions may constrain a transferee from pledging or exchanging the financial assets. Paragraph 860-10-40-5(b) states that if the transferor, its consolidated affiliates included in the financial statements being presented, and its agents have no continuing involvement with the transferred financial assets, the condition under paragraph 860-10-40-5(b) is met. For example, if a transferor receives only cash in return for the transferred financial assets and the transferor, its consolidated affiliates included in the financial statements being presented, and its agents have no continuing involvement with the transferred financial assets, sale accounting is allowed under paragraph 860-10-40-5(b) even if the transferee entity is significantly limited in its ability to pledge or exchange the transferred assets.

Question TS 3-8 explains the rationale behind this guidance.

Question TS 3-8
How does the absence of continuing involvement affect a transferor’s evaluation of the “right to pledge or exchange” criterion in ASC 860-10-40-5(b)?

PwC response
ASC 860-10-40-16A indicates that if the transferor has no continuing involvement with transferred financial assets, the lack of continuing involvement would be a determinative factor in concluding that the condition in ASC 860-10-40-5(b) is satisfied – even if the transferee is constrained from pledging or exchanging the assets, and regardless of the source of those restrictions. The rationale for this conclusion is that, even if a transferee is constrained, the transferor derives no benefit from the arrangement, as the transferor no longer has any interest in (or obligation to augment) the transferred assets’ cash flows. Said differently, if a transferor no longer has continuing involvement with a transferred asset’s cash flows, it would be anomalous to continue to report the asset on its balance sheet. Accordingly, absent continuing involvement, a transferor may consider the criterion in ASC 860-10-40-5(b) to be satisfied, even if the transferee is constrained.

3.6.4 Consideration of freestanding option or forward contracts
A transferor and transferee may enter into a freestanding option or forward contract that entitles or obligates the transferor to re-acquire the transferred financial asset.10 If the asset is not readily obtainable in the marketplace, ASC 860-10-40-17 indicates that these arrangements should be considered to benefit the transferor, and likely to constrain the transferee. In these circumstances, careful analysis of the facts and circumstances is warranted if it is asserted that, the option or forward contract notwithstanding, the transferee nevertheless has the unconstrained ability to monetize substantially all the asset’s flows by pledging or exchanging it.

Similarly, a freestanding in-the-money put held by a transferee that entitles it to sell a transferred financial asset to the transferor should be evaluated carefully to assess whether the put constitutes a “constructive forward” contract, stemming from the option’s beneficial economic terms. If so, and if

10 A freestanding option or forward contract does not “travel” with the underlying asset, in contrast to an “attached” arrangement. The underlying trades separately from the contract.
the underlying asset is not readily obtainable, it may be appropriate to conclude the contract constrains the transferee—as it may be unable to monetize substantially all the asset’s cash flows by pledging or exchanging it, and still be assured that it can deliver the asset to the transferor and benefit from the put’s beneficial terms.

A call option on transferred assets, depending on its features, could cause a transfer to fail either the condition in ASC 860-10-40-5(b) if it constrains the transferee as described above, or the condition in ASC 860-10-40-5(c) if it provides the transferor with effective control, or both. Hence, options on the transferred assets should be analyzed to see if they meet the requirements of both conditions. For example, a deep-in-the-money put held by a transferee may also be considered to provide the transferor with effective control. Another example is an attached call option which might not constrain the transferee from pledging or exchanging the asset, but could result in the transferor’s maintaining effective control because it gives the transferor the unilateral ability to cause whoever holds that specific asset to return it (see TS 3.7.2).

3.6.5 Summary

Most transferor-imposed constraints on a transferee’s ability to pledge or exchange acquired financial assets lead to a conclusion that the transfer does not satisfy the criterion of ASC 860-10-40-5(b). As such, sale accounting is precluded because control is not considered to have passed to the transferee. Conditions not imposed by a transferor that potentially constrain a transferee require additional analysis to determine their implications on sale accounting.

When performing this analysis, all arrangements involving the transferee and the transferor, its consolidated affiliates in the financial statements being presented, and its agents should be considered.11 Although a contractual provision may not constrain the transferee (or holder) when evaluated on a standalone basis, certain terms or conditions may constrain the transferee (or holder) when evaluated collectively. Ultimately, the analysis of the impact of conditions imposed by the transferor or by others should be specific to the facts and circumstances of the transaction.

Finally, a transferor having no continuing involvement with transferred financial assets may conclude that the condition in ASC 860-10-40-5(b) is satisfied, even if the transferee is constrained from selling or pledging the assets.

3.7 Assessment of effective control

For a transfer to qualify for sale accounting, the transferor may not maintain effective control over transferred financial assets. A transferor’s retention of effective control is incompatible with derecognition. Under ASC 860, sale accounting is predicated on the transferor having surrendered control over the financial assets transferred.

ASC 860-10-40-5(c) summarizes those arrangements through which a transferor is considered to retain effective control over transferred financial assets.

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11 If an agent is acting on behalf of a transferor, any transfer restrictions imposed by the agent in connection with the transaction should be considered the equivalent of a transferor-imposed constraint. If a more-than-trivial benefit is attributed to the constraint, then the transfer may fail the criterion in ASC 860-10-40-5(b).
**ASC 860-10-40-5(c)**

The transferor, its consolidated affiliates included in the financial statements being presented, or its agents do not maintain effective control over the transferred financial assets or third-party beneficial interests related to those transferred assets (see paragraph 860-10-40-22A). A transferor’s effective control over the transferred financial assets includes, but is not limited to, any of the following:

1. An agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (see paragraphs 860-10-40-23 through 40-25)

2. An agreement, other than through a cleanup call (see paragraphs 860-10-40-28 through 40-39), that provides the transferor with both of the following:
   
   i. The unilateral ability to cause the holder to return specific financial assets
   
   ii. A more-than-trivial-benefit attributable to that ability.

3. An agreement that permits the transferee to require the transferor to repurchase the transferred financial assets at a price that is so favorable to the transferee that it is probable that the transferee will require the transferor to repurchase them (see paragraph 860-10-55-42D).

A transferor may maintain effective control directly (that is, as a result of a specific contractual provision) or indirectly (that is, through a combination of contractual arrangements that, when considered together, provide effective control). Accordingly, when evaluating this sale accounting criterion, it is important that the transferor consider all forms of continuing involvement with transferred financial assets (including, if applicable, involvements with third-party beneficial interests in those transferred assets). This analysis should also take into account involvements on the part of the transferor’s consolidated affiliates and agents.\(^{12}\)

### 3.7.1 Agreements to repurchase or redeem the transferred financial assets

The excerpts below describe the circumstances when a transfer would fail the “effective control” condition in paragraph ASC 860-10-40-5(c) through an agreement of the type described in ASC 860-10-40-5(c)(1). In practice, this guidance applies principally to transfers of financial assets governed by repurchase agreements or securities lending contracts, which are typically reported as secured borrowings.

\(^{12}\) Subsequent references in this section to a transferor also include consolidated affiliates and agents of the transferor.
Excerpt from ASC 860-10-40-24

An agreement that both entitles and obligates the transferor to repurchase or redeem transferred financial assets from the transferee maintains the transferor’s effective control over those assets as described in paragraph 860-10-40-5(c)(1), if all of the following conditions are met:

a. The financial assets to be repurchased or redeemed are the same or substantially the same as those transferred. To be substantially the same, the financial asset that was transferred and the financial asset that is to be repurchased or redeemed need to have all of the following characteristics:

1. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which circumstance the guarantor and the terms of the guarantee must be the same)

2. Identical form and type so as to provide the same risks and rights

3. The same maturity (or in the circumstance of mortgage-backed pass-through and pay-through securities, similar remaining weighted-average maturities that result in approximately the same market yield)

4. Identical contractual interest rates

5. Similar assets as collateral

6. The same aggregate unpaid principal amount or principal amounts within accepted good delivery standards for the type of security involved. Participants in the mortgage-backed securities market have established parameters for what is considered acceptable delivery. These specific standards are defined by the Securities Industry and Financial Markets Association and can be found in Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities, which is published by the Securities Industry and Financial Markets Association.

See paragraph 860-10-55-35 for implementation guidance related to these conditions.

b. Subparagraph superseded by Accounting Standards Update No. 2011-03.

c. The agreement is to repurchase or redeem the financial assets before maturity, at a fixed or determinable price.

d. The agreement is entered into contemporaneously with, or in contemplation of, the transfer.

ASC 860-10-40-24A states that a repurchase-to-maturity transaction, as defined, should be accounted for as a secured borrowing as if the transferor maintains effective control over the underlying financial assets. These transactions are required to be reported as secured borrowing arrangements.

To conclude that a transferred financial asset should be reported as a secured borrowing in accordance with ASC 860-10-40-5(c)(1), the transferor must have both the contractual right and contractual obligation to repurchase financial assets identical to (or substantially the same as) those transferred. Conditional arrangements, or contractual rights involving optionality on the part of the transferor or transferee, are not subject to this guidance. ASC 860-10-40-25 emphasizes this distinction.
ASC 860-10-40-25

With respect to the condition in (a) in paragraph 860-10-40-24 to maintain effective control under the condition in paragraph 860-10-40-5(c) as illustrated in paragraph 860-10-40-5(c)(1), the transferor must have both the contractual right and the contractual obligation to repurchase or redeem financial assets that are identical to those transferred or substantially the same as those concurrently transferred. Transfers that include only the right to reacquire, at the option of the transferor or upon certain conditions, or only the obligation to reacquire, at the option of the transferee or upon certain conditions, may not maintain the transferor’s control, because the option might not be exercised or the conditions might not occur. Similarly, expectations of reacquiring the same securities without any contractual commitments (for example, as in wash sales) provide no control over the transferred securities.

See TS 5 for a discussion of the accounting for repurchase agreements, dollar rolls, and securities lending transactions.

3.7.2 Ability to unilaterally cause the return of specific transferred financial assets (call options)

As a general principle, for a transfer of financial assets to potentially qualify for derecognition, a transferor cannot (1) have the unilateral ability to cause the holder to return specific financial assets and (2) derive a more-than-trivial benefit attributable to that ability. This unilateral ability frequently stems from a call option held by the transferor attached to the transferred financial assets or, in other instances, a freestanding call option held by the transferor. In either case, assuming the two conditions are present, the transferor is considered to maintain effective control over the transferred financial assets, and sale accounting would be inappropriate.

Concluding whether a call option (or similar right) held by a transferor allows it to maintain effective control over transferred financial assets sometimes requires judgment. This stems, in part, from the fact that multiple factors may collectively bear on the analysis, including (1) the terms of the option’s strike price (underlying’s fair value, fixed or formulaic), (2) the characteristics of the underlying financial asset (readily obtainable in the market place or not), (3) if not unilaterally exercisable at the transfer date, the circumstances under which the call may be exercised, and (4) other forms of transferor involvement with the transferee or its beneficial interests.

As discussed in TS 3.6.4, a call option on transferred assets, depending on its features, could cause a transfer to fail either the condition in ASC 860-10-40-5(c) if it provides the transferor with effective control as described above, or the condition in ASC 860-10-40-5(b) if it constrains the transferee from pledging or exchanging the asset, or both. Hence, options on the transferred assets should be analyzed to see if they meet the requirements of both conditions.

3.7.2.1 More-than-trivial benefit

The assessment of a right to cause the return of a transferred asset must also consider whether that right provides the transferor with “a more-than-trivial benefit.” As discussed in TS 3.6.3, this concept also must be considered when evaluating the “ability to freely pledge or exchange” condition in ASC 860-10-40-5(b). As noted there, the threshold beyond which a benefit is deemed to be “more than trivial” is not defined, but is intended to be a low bar. In practice, it is difficult to demonstrate that a transferor-imposed restriction is not providing a more-than-trivial benefit. We believe that this
presumption should also be observed when evaluating whether the terms of a call option provide the transferor with effective control.

An exception to the foregoing presumption is cited in ASC 860-10-40-28(c), which indicates that a call option to reacquire readily-obtainable assets at their current fair value may not provide the transferor with a more-than-trivial benefit. In these instances, additional analysis of the facts and circumstances is required. Conversely, a fixed-price call option held by the transferor that allows it to reacquire specific transferred financial assets should be presumed to provide a more-than-trivial benefit. However, if the call option is so far out of the money that it is probable when the option is written that the transferor will not exercise the call, ASC 860-10-40-28(a) indicates that the transferor does not receive a more-than-trivial benefit from the arrangement—and thus the option does not preclude sale accounting.

**3.7.2.2 Effective control indirectly maintained**

Concluding whether a call option (or similar arrangement) allows a transferor to maintain effective control sometimes entails consideration of other forms of involvement that a transferor has with the transferred financial assets. For example, as noted above, it may be appropriate to conclude that a fair value call option on transferred financial assets readily obtainable in the marketplace, viewed in isolation, does not provide a transferor with effective control. However, as observed in ASC 860-10-40-35 and discussed further in ASC 860-10-55-42A, this conclusion would be inappropriate if the transferor holds a residual interest in the transferred assets.

**ASC 860-10-55-42A**

This guidance illustrates the concept in paragraph 860-10-40-35 that a transferor maintains effective control if it has a right to reclaim specific transferred assets by paying fair value and also holds the residual interest in the transferred financial assets. If a transferor holds the residual interest in securitized financial assets and can reclaim the transferred financial assets at termination of the securitization entity by purchasing them in an auction, and thus at what might appear to be fair value, then sale accounting for the transfer of those financial assets it can reclaim would be precluded. Such circumstances provide the transferor with a more-than-trivial benefit and effective control over the financial assets, because it can pay any price it chooses in the auction and recover any excess paid over fair value through its residual interest in the transferred financial assets.

ASC 860-10-40-28A also indicates that, if the transferee is a securitization entity, options attached to beneficial interests may also allow the transferor to maintain effective control, either directly or indirectly, over transferred financial assets:
ASC 860-10-40-28A

Effective control over transferred financial assets can be present even if the right to reclaim is indirect. For example, if a call allows a transferor to buy back the beneficial interests at a fixed price, the transferor may maintain effective control of the financial assets underlying those beneficial interests. If the transferee is an entity whose sole purpose is to engage in securitization or asset-backed financing activities, that entity may be constrained from choosing to pledge or exchange the transferred financial assets. In that circumstance, any call held by the transferor on third-party beneficial interests is effectively an attached call on the transferred financial assets. Depending on the price and other terms of the call, the transferor may maintain effective control over the transferred financial assets.

In summary, to ensure that their impact on the effective control analysis has been fully vetted, call options granted to a transferor in connection with a securitization of transferred financial assets warrant careful analysis. See TS 3.7.2.4 and TS 3.7.2.5 for a discussion of removal-of-account provisions and cleanup calls, arrangements that are frequently found in securitization structures.

3.7.2.3 Embedded call options

ASC 860-10-40-32 clarifies that a call option embedded in a transferred financial asset by its issuer should not be considered to convey effective control to a transferor.

Excerpt from ASC 860-10-40-32

An embedded call option would not result in the transferor’s maintaining effective control because it is the issuer rather than the transferor who holds the call option and the call option does not provide more than a trivial benefit to the transferor. For example, a call embedded by the issuer of a callable bond or the borrower of a prepayable mortgage loan would not provide the transferor with effective control over the transferred financial asset.

Question TS 3-9 illustrates the application of this guidance.

Question TS 3-9

If Company A issues a callable debt instrument to Company B, can Company B obtain sale accounting treatment on a subsequent transfer of the financial instrument with the embedded call option?

PwC response

Yes. Sale accounting would not be precluded for Company B. The call option was embedded by, and is held by, Company A, the issuer of the underlying debt instrument. The call does not cause the transferor (Company B) to maintain effective control because the issuer (Company A), not the transferor, holds the call.

Alternatively, assume Company B transfers financial assets to a securitization trust. The trust issues beneficial interests containing a fixed-price call option that allows Company B to acquire those interests from its holders at any time. In these circumstances, Company B retains effective control over the financial assets held by the trust and, as such, sale accounting would be precluded.
3.7.2.4 **Removal-of-accounts provisions**

Commonly seen in securitization transactions, removal-of-accounts provisions (ROAPs) allow a transferor to reclaim assets sold to a securitization trust or asset-backed financing entity. The “trigger” events underlying a ROAP that permit a transferor to reclaim transferred financial assets can differ from deal to deal, and terms of these provisions can vary. As a general decision principle, however, a transferor is considered to have maintained effective control if the ROAP allows the transferor to remove specific transferred financial assets at its discretion, or in response to an event within the transferor’s control. ASC 860-10-40-37 cites two examples in this regard.

**ASC 860-10-40-37**

The following are examples of removal-of-accounts provisions that preclude transfers from being accounted for as sales:

a. An unconditional removal-of-accounts provision or repurchase agreement that allows the transferor to specify the financial assets that may be removed and that provides a more-than-trivial benefit to the transferor, because such a provision allows the transferor unilaterally to remove specific financial assets

b. A removal-of-accounts provision conditioned on a transferor’s decision to exit some portion of its business that provides a more-than-trivial benefit to the transferor, 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 to unilaterally remove specific financial assets.

On the other hand, if a right to reclaim transferred financial assets is contingent upon a third-party action or an event that is (1) outside the control of the transferor and (2) not certain to occur (e.g., a default by a receivable’s obligor), the transferor is not considered to maintain effective control over the assets subject to that right. As such, the transfer may be accounted for as a sale, provided the other derecognition criteria in ASC 860-10-40-5 are met. ASC 860-10-40-38 cites various examples of ROAPs that do not allow a transferor to maintain effective control at the transfer date:

**ASC 860-10-40-38**

The following are examples of removal-of-accounts provisions that do not preclude transfers from being accounted for as sales:

a. A removal-of-accounts provision for random removal of excess financial assets, if the provision is sufficiently limited so that the transferor cannot remove specific transferred financial assets, for example, by limiting removals to the amount of the transferor’s interests and to one removal per month

b. A removal-of-accounts provision 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 removal-of-accounts provision 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
d. A removal-of-accounts provision that does not allow the transferor to unilaterally reclaim specific financial assets from the transferee. For related implementation guidance, see paragraph 860-10-55-41.

Once the third-party action or event has occurred that, under the terms of the ROAP, permits a transferor to unilaterally reclaim transferred financial assets, the transferor is considered to have regained effective control over those assets – and thus must recognize them on its balance sheet. Effective control stems from the existence of the transferor’s right to re-acquire specific assets, not from the exercise of those rights. Rerecognition is required at that point – that is, when the ROAP first becomes exercisable – regardless of whether the transferor intends to exercise the ROAP and reclaim the assets. Refer to TS 4.3 for further discussion of the accounting for ROAPs that have become exercisable.

Question TS 3-10 illustrates how to apply this guidance in a specific fact pattern.

**Question TS 3-10**

Company A retains a par-value call option that allows it to repurchase a group of amortizing transferred loans when the loans’ aggregate principal balance declines to 30% of the balance outstanding at the transfer date, or two years after the transfer, whichever occurs first. Because Company A cannot unilaterally exercise the call option at the transfer date, may it assert that the arrangement should be considered a contingent ROAP that does not impede sale accounting under ASC 860-10-40-5(c)(2)?

**PwC response**

No. The call option permits Company A to maintain effective control over the transferred group of loans. Although Company A cannot exercise the call until one of the two conditions takes place, either condition is certain to occur in the future. Thus the call does not have the attributes of a contingent arrangement that could allow Company A to assert that it has surrendered effective control at the transfer date. Although a portion of the loans’ aggregate principal balance will have amortized prior to the call becoming exercisable, ASC 860’s derecognition model does not allow a transferor of an entire financial asset to account for the transfer partially as a sale and partially as a secured borrowing. See ASC 860-10-55-68 and ASC 860-10-55-68A.

**3.7.2.5 Cleanup calls**

ASC 860-10-20 provides the definitions of a cleanup call option and an affiliate.

**Definitions from ASC 860-10-20**

Cleanup Call Option: An option held by the servicer or its affiliate, which may be the transferor, to purchase the remaining transferred financial assets, or the remaining beneficial interests not held by the transferor, its affiliates, or its agents in an entity (or in a series of beneficial interests in transferred financial assets within an entity) if the amount of outstanding financial assets or beneficial interests falls to a level at which the cost of servicing those assets or beneficial interests becomes burdensome in relation to the benefits of servicing.
Affiliate: A party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with an entity.

The right of a servicer (or an affiliate, including the transferor) to exercise a cleanup call (as defined) is not considered an arrangement that permits the holder to maintain effective control over the financial assets transferred. Therefore, transferred assets subject to a qualifying cleanup call held by a transferor or a consolidated affiliate may qualify for derecognition in financial statements that include the transferor, provided the transfer meets the other sale accounting requirements. Cleanup calls are an exception to the general rule that a call option on transferred financial assets that becomes exercisable solely due to the passage of time maintains effective control.

A cleanup call confers effective control only when it enables the servicer to call more than a de minimis level of outstanding assets or beneficial interests. The de minimis level is deemed to be the level of outstanding assets or beneficial interests below which the cost of servicing those assets or interests becomes “burdensome” in relation to benefits of servicing. The point at which servicing costs become burdensome is not specifically addressed in ASC 860. In practice, however, a cleanup call that first becomes exercisable when the remaining aggregate outstanding principal balance of the serviced loans (or beneficial interests) represents 10% or less of the aggregate principal balance of the loans (or beneficial interests) at the transfer date is generally considered to meet the “burdensome” condition. However, the specific facts and circumstances of a transaction (including the characteristics of the underlying assets) may suggest that the burdensome criterion is first satisfied at a lower (or higher) threshold.

Parties other than the servicer or its affiliates cannot be considered to hold a cleanup call. Only a servicer is impacted when the outstanding assets (or beneficial interests) fall or amortize to a level at which the cost of servicing becomes burdensome (the definition of a cleanup call). Any other party would be motivated by some other incentive in exercising a call. See ASC 860-10-55-42B for more detail on this distinction.

Example TS 3-7 illustrates a cleanup call option held by an affiliated entity.

**EXAMPLE TS 3-7**

**Cleanup call held by affiliated entity**

Two subsidiaries (A and B) are each directly owned by Parent Co. Subsidiary A transfers loans to SPE X, a securitization entity that neither Parent Co nor its subsidiaries is required to consolidate. Subsidiary B obtains the servicing rights to the loans. In addition, Subsidiary A has the right to purchase all, but not less than all, of the transferred loans when their outstanding aggregate balance falls below 10% of their aggregate balance at the transfer date. Subsidiary B has determined that its servicing costs become burdensome at the 10% threshold.

For purposes of its standalone financial statements, does the call option held by Subsidiary A affect its sale accounting evaluation of the loans transferred to SPE X?

**Analysis**

No. As Subsidiary A, the holder of the call, is an affiliate of Subsidiary B, the servicer, and the call is triggered at the same level at which servicing becomes burdensome, the call held by Subsidiary A meets the definition of a cleanup call. Accordingly, for purposes of Subsidiary A’s standalone financial
statements, the call would not be an impediment to sale accounting. Similarly, in the consolidated financial statements of Parent Co, the call option would also meet the definition of a cleanup call and would not preclude sale accounting.

If a cleanup call is set at a threshold at which the cost of servicing is not burdensome in relation to the benefits of servicing, the arrangement will not qualify for the cleanup call exception in ASC 860. For example, given the facts above, if servicing became burdensome only when the serviced loan pool declined to 5% of its aggregate principal balance at the transfer date, the option would not qualify as a cleanup call under ASC 860. In this instance, the call option would preclude sale accounting by Subsidiary A — as it would be considered to have maintained effective control over the transferred loans.

### 3.7.2.6 Summary table and implementation questions

Figure TS 3-4 summarizes how various physically-settled call options held by the transferor to reacquire an entire transferred financial asset or a group of financial assets (or to acquire beneficial interests in those assets) generally would be viewed under paragraph ASC 860-10-40-5(c).

**Figure TS 3-4**

**Evaluation of call options**

For purposes of Figure TS 3-4, the call option is presumed to provide more-than-a-trivial benefit.

<table>
<thead>
<tr>
<th>Type of option</th>
<th>Eligible for sale accounting?</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Fixed-price call option attached to transferred entire financial assets or to a group of entire transferred financial assets:</strong></td>
<td></td>
</tr>
<tr>
<td>On any (all) transferred financial asset(s), and unilaterally exercisable at any time</td>
<td>No, because the transferor can unilaterally cause the holder to return the transferred financial assets and the call’s fixed price provides a more-than-trivial benefit. See ASC 860-10-55-41(a).</td>
</tr>
<tr>
<td>On certain specified assets within a group of transferred assets, and the transferor can unilaterally reclaim (call) the specific assets at any time</td>
<td>Specific transferred assets subject to the call option are not eligible for sale accounting, as the transferor maintains effective control over them. However, sale accounting is precluded only for the specified loans subject to the call, not the entire transferred group.</td>
</tr>
<tr>
<td>On excess financial assets from a group of transferred financial assets and the transferor cannot unilaterally choose the assets (random removal)</td>
<td>Yes, provided the ability to randomly remove the transferred financial assets is sufficiently limited, and the circumstances giving rise to any such excess are not within the control of the transferor. See ASC 860-10-55-41(b).</td>
</tr>
<tr>
<td>Type of option</td>
<td>Eligible for sale accounting?</td>
</tr>
<tr>
<td>----------------</td>
<td>--------------------------------</td>
</tr>
<tr>
<td>On a remaining portion of a transferred financial asset (e.g., when the remaining principal balance of a transferred amortizing loan (or group of transferred loans) reaches 20% of its (or the group’s) unpaid principal balance at the transfer date), and the arrangement does not qualify as a cleanup call.</td>
<td>No, because the option becomes exercisable in response to an event certain to occur (amortization of the underlying loans), and a transfer cannot be accounted for partially as a sale and partially as a secured borrowing. Thus, sale accounting for the entire transferred asset is precluded. See ASC 860-10-55-68 and ASC 860-10-55-68A.</td>
</tr>
<tr>
<td>Conditional call option (contingency not within the control of the transferor and not certain to occur)</td>
<td>Yes, but it must be reassessed as an unconditional call option if and when the contingent condition occurs.</td>
</tr>
</tbody>
</table>

2. Unconditional fixed-price call option embedded in transferred entire financial assets or beneficial interests therein:

| Embedded by issuer of the asset | Yes, because it is the issuer that holds the call, not the transferor, and thus the call does not provide the transferor with effective control. See ASC 860-10-40-32. |
| Embedded by a transferor in beneficial interests in transferred financial assets held by third parties | Evaluate whether embedded option allows the transferor to indirectly maintain control. May be considered an attached call on the underlying transferred financial assets in certain instances. See ASC 860-10-40-28A. |

3. Unconditional attached call option at fair value on entire financial assets or groups of entire financial assets:

| On assets readily obtainable | Possibly yes, as a call at fair value may not convey more-than-a-trivial benefit to a transferor, subject to considering all relevant facts and circumstances, including the commercial rationale for the call. See ASC 860-10-40-28(c). However, if the transferor holds the residual interest in transferred financial asset that have been securitized, the call is presumed to provide more-than-a-trivial benefit, and sale accounting will be precluded. See ASC 860-10-55-42(b). This conclusion extends to transferred financial assets subject to auction arrangements in which the transferor may participate, as discussed in ASC 860-10-55-42A. |
| On assets not readily obtainable | No. By providing the transferor with the ability to reacquire financial assets not readily obtainable in the marketplace, the call provides the transferor with more-than-a-trivial benefit. |

Question TS 3-11 and Question TS 3-12 address common questions regarding the existence of call options.
Question TS 3-11

Are wash-sale transactions, in which a transferor sells a financial asset for cash and repurchases the same asset shortly thereafter (generally within 15–30 days) at its current fair value, treated as financings under ASC 860?

PwC response

No. ASC 860-10-55-57 clarifies that a wash-sale transaction is to be accounted for as a sale unless the transferor and transferee execute a contract concurrent with the transfer that allows the transferor to repurchase or redeem the transferred financial asset at a later date. In the absence of any such arrangement, the transferor is not considered to maintain effective control over the transferred financial asset, even if it repurchases the asset within a short period of time. Accordingly, the sale criteria in ASC 860-10-40-5 are satisfied in these instances, and derecognition is appropriate.

Considering the short-term nature of the separate sale and purchase transaction and considering ASC 860’s requirements to evaluate all arrangements entered into in contemplation of a transfer, some factors to consider that would support sale accounting for a wash-sale include:

- Sale and subsequent purchase executed on readily obtainable assets
- No contemporaneous agreement exists that entitles and obligates the seller to repurchase the readily obtainable financial assets at a later date
- The sale and subsequent purchase are not executed with the same counterparty

Question TS 3-12

A transferor retains an option to repurchase, at par, a group of transferred loans. The option becomes exercisable 10 years after the transfer date. The contractual maturities of the transferred loans range between 20 and 30 years. How should this option be assessed under ASC 860-10-40-5(c) when evaluating whether the transferor has maintained effective control over the loans?

PwC response

The repurchase option will likely preclude sale treatment under ASC 860-10-40-5(c). Under ASC 860-10-40-5(c)(2), a transferor is considered to maintain effective control over transferred financial assets if there is an agreement that provides the transferor with the unilateral ability to cause the holder to return specific financial assets and provides more-than-a-trivial benefit to the transferor.

Absent the borrowers’ prepayment of the loans (or another maturity event), the option becomes exercisable when the non-call period lapses (i.e., after 10 years). Although there is no implementation guidance in ASC 860 that addresses this specific fact pattern, a similar fact pattern is discussed in ASC 860-10-55-42(c). In that fact pattern, a transferor holds an option that allows it to repurchase a group of transferred assets when the group amortizes to 20% of its value (determined at the transfer date). The arrangement does not meet the conditions to be considered a cleanup call. The guidance asserts that sale accounting is precluded in this instance, as the option allows the transferor to unilaterally cause the return of the transferred group of assets once an event certain to occur takes place – namely, amortization of the loan pool to 20% of its initial value – assuming that the loans have not been prepaid.
We believe that the “passage of time” principle that underlies the guidance in ASC 860-10-55-42(c) is applicable to the fact pattern in this example. As such, the ability of the transferor to repurchase the loans after 10 years would preclude sale accounting at the transfer date. Despite the 10-year non-call period, the transferor is still considered to maintain effective control; exercise of the option is not contingent upon an event that may (or may not) occur.

3.7.3 Transferee can require repurchase at a favorable price

As a general rule, a put option held by (written to) a transferee does not provide the transferor with effective control over the underlying transferred financial asset. An exception to this presumption is described in ASC 860-10-40-5(c)(3) and re-affirmed in ASC 860-10-55-42D(b). According to the guidance in those paragraphs, a transferor is considered to maintain effective control over a transferred financial asset through an agreement that permits the transferee to require the transferor to repurchase the transferred financial asset at a price that is so favorable to the transferee (at the date of the transfer) that it is probable that the transferee will require the transferor to repurchase it. This conclusion is consistent with the decision principle in ASC 860-10-40-4; namely, that all arrangements or agreements made with respect to transferred financial assets must be considered when evaluating whether, in fact, the transferor has surrendered control those assets.

3.7.4 Consideration of agents

Question TS 3-13 further clarifies when the involvement of agents needs to be considered.

**Question TS 3-13**

A transferor and transferee may have the same decision-maker agent (e.g., each shares the same investment advisor). In these circumstances, when evaluating whether the transferor has surrendered effective control over financial assets sold to the transferee, how should the common agency relationship be considered?

**PwC response**

When assessing whether it retains effective control over a transferred financial asset, a transferor must consider all continuing involvement by it, its consolidated affiliates included in the financial statements being presented, and its agents. However, ASC 860-10-40-22A clarifies that the transferor needs to consider the involvements of an agent only when the agent acts for and on behalf of the transferor. If the transferor and transferee have the same decision-maker agent, the agent’s activities on behalf of the transferee should not be considered in the transferor’s assessment of effective control.

For example, an investment advisor of an investment company (fund) has a fiduciary responsibility to make investment decisions on behalf of investors that are solely in their best interest. An investment advisor that executes transfers of financial assets between funds under common management is not acting solely on behalf of the transferor, but rather as an agent representing both the transferor and transferee. Consistent with the advisor’s fiduciary obligations to each entity, transfers of financial assets between the two funds must be on terms fair and equitable to both parties. As a result, absent an explicit agreement that entitles or obligates a transferor fund to reacquire the transferred financial assets, we do not believe that the existence of an agent with investment discretion over both the transferor and transferee should lead to a conclusion that the transferor maintains effective control over the transferred assets, stemming from common management.
Note that this conclusion, in addition to aligning with the guidance in ASC 860-10-40-22A, is also consistent with the guidance in ASC 860-10-55-78, which states that the sale accounting analysis of transfers of financial assets involving two subsidiaries should disregard the involvement of their parent.
Chapter 4:
Accounting for transfers that qualify as sales
4.1 Accounting for transfers that qualify as sales—overview

A transfer of financial assets qualifies for sale accounting if the transferor (including all entities in the transferor’s consolidated financial statements) has surrendered control over the transferred financial assets. That is, if the transfer meets the derecognition criteria in ASC 860, Transfers and Servicing. This chapter discusses the accounting for a transfer of financial assets that qualifies for sale accounting. The transfer can be of an entire financial asset, a group of entire financial assets, or a participating interest in an entire financial asset.

See TS 3 for information on the application of the sale accounting criteria in ASC 860-10-40-5, including Figure TS 3-1 in TS 3.2, which provides a decision tree for applying ASC 860. See TS 5 for information on accounting for transfers of financial assets required to be reported as secured borrowings.

4.2 Derecognition accounting—transferor

When a transfer qualifies for sale accounting, the transferor should derecognize the transferred assets, record all assets received and liabilities assumed, and recognize any resulting gain or loss on the transfer. ASC 860 provides guidance on a transferor’s accounting for the sale of a participating interest and the sale of an entire or group of entire financial assets.

**ASC 860-20-40-1A**

Upon completion of a transfer of a participating interest that satisfies the conditions in paragraph 860-10-40-5 to be accounted for as a sale, the transferor (seller) shall:

a. Allocate the previous carrying amount of the entire financial asset between both of the following on the basis of their relative fair values at the date of the transfer:
   1. The participating interest(s) sold
   2. The participating interest that continues to be held by the transferor

b. Derecognize the participating interest(s) sold

c. Apply the guidance in paragraphs 860-20-25-1 and 860-20-30-1 on recognition and measurement of assets obtained and liabilities incurred in the sale

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

e. Report any participating interest(s) that continue to be held by the transferor as the difference between the following amounts measured at the date of the transfer:
   1. The previous carrying amount of the entire financial asset
   2. The amount derecognized.
Accounting for transfers that qualify as sales

ASC 860-20-40-1B
Upon completion of a transfer of an entire financial asset or a group of entire financial assets that satisfies the conditions in paragraph 860-10-40-5 to be accounted for as a sale, the transferor (seller) shall:

a. Derecognize the transferred financial assets
b. Apply the guidance in paragraphs 860-20-25-1 and 860-20-30-1 on recognition and measurement of assets obtained and liabilities incurred in the sale
c. Recognize in earnings any gain or loss on the sale

If the transferred financial asset was accounted for under Topic 320 as available for sale before the transfer, item (a) requires that the amount in other comprehensive income be recognized in earnings at the date of transfer.

Regardless of whether a transfer involves a participating interest or an entire financial asset, the derecognition guidance in ASC 860 may be viewed as three steps:

□ Determine the recorded amounts of the transferred item to be derecognized

□ Identify, measure, and record all proceeds from the transfer (i.e., all assets obtained and liabilities incurred) at fair value

□ Measure and recognize any resulting gain or loss on the transfer

The remainder of this chapter discusses the application of these steps, supplemented by illustrative examples. For presentation in the statement of cash flows, see FSP 6.7.3.3.

Question TS 4-1 discusses the appropriate timing of recording a transfer transaction.

**Question TS 4-1**
At what point in a transfer of financial assets that qualifies for sale accounting should a transaction be recorded?

**PwC response**
As a general rule, most transfers of financial assets are recorded at the settlement date. The settlement date is the date on which consideration is legally exchanged between the transacting parties. Said differently, it is the point in time at which all rights in and title to the underlying asset (or an interest in that asset) are conveyed to the transferee and the transferor receives corresponding consideration. However, ASC 860-20-25-2 clarifies that the recognition guidance in ASC 860-20 does not modify other GAAP (e.g., that applicable to investment companies and broker-dealers) that requires trade date accounting.
4.2.1 Determining the carrying amount of a transferred item

Whether a transfer involves the derecognition of a participating interest or of an entire financial asset, the transferor must first determine the transferred asset’s carrying amount. If the transfer involves a participating interest, ASC 860-20-40-1A(a) requires the transferor to allocate the previous carrying amount of the underlying entire financial asset between the interest sold and portion retained, based on their relative fair values at the transfer date.

Question TS 4-2 discusses the term “carrying amount” in the context of ASC 860 sale accounting.

**Question TS 4-2**

What is the “carrying amount” in the context of ASC 860’s sale accounting model? When derecognition involves a participating interest, what should the transferor consider when allocating the underlying asset’s carrying amount between the interest sold and the interest retained?

**PwC response**

The carrying amount of a financial asset consists of its recorded investment (amortized cost adjusted for any fair value-related measurements, including those recognized in OCI) and allowances for credit losses and lower-of-cost-or-market adjustments.

ASC 860 states that the transferor should allocate the carrying amount of the underlying financial asset between the interest sold and portion retained based on the relative fair value of the two items at the transfer date. However, in certain instances, it may be appropriate to allocate the underlying financial asset’s carrying amount based on each participating interest holder’s relative ownership interest as the relative fair value of each interest should presumably equal or closely approximate its proportionate, pari passu ownership interest (an essential characteristic of a participating interest). This approach will not be appropriate in all cases, however. For example, if a participating interest’s transferee is the sole beneficiary of a third-party guarantee, an allocation based solely on each interest’s percentage ownership would be inappropriate, as only the transferred interest has credit enhancement. Additional analysis will be required in instances like these to establish the fair values of the guaranteed transferred interest and the unguaranteed interest retained by the transferor on a standalone basis.

4.2.2 Transaction costs in transfers that qualify as sales

As discussed in ASC 860-20-35-10, transaction costs incurred in connection with a sale are not an asset, and thus should be included in the measurement of the transfer’s gain or loss on sale. However, a potential exception to this rule involves transaction costs incurred in connection with revolving securitization structures, when receivables will be transferred over a period of time. In those instances, ASC 860-20-35-10 allows transaction costs to be deferred and amortized in a rational and systematic manner over the reinvestment period (the period deemed to benefit from costs incurred at inception) unless the transactions result in a loss.

Although ASC 860 does not define “transaction costs,” we believe they should be limited to amounts paid to external parties that clearly relate to the transaction in question. These costs may include legal, accounting and consulting fees, underwriter and rating agency fees, and other service provider-related expenses (e.g., costs to print offering materials).
4.2.3 Gain or loss recognition on transfers that qualify as a sale

As discussed in ASC 860-20-25-6, it is not appropriate for a transferor to defer any portion of a gain or loss resulting from a sale of a financial asset (or otherwise fail to observe gain-on-sale accounting, as it is sometimes described in practice), measured in accordance with ASC 860.

4.2.4 Sale accounting examples—cash proceeds

Example TS 4-1 and Example TS 4-2 illustrate how the derecognition accounting model is applied to a transfer of a participating interest and to a transfer of an entire asset that in each instance meets the requirements in ASC 860-10-40-5 for sale accounting. In these examples, the transferor receives only cash consideration; see Example TS 4-3 and Example TS 4-4 for an illustration of the accounting when the transferor receives other forms of sale proceeds.

EXAMPLE TS 4-1

Sale of a participating interest

Transferor Corp transfers a participation in a $100 loan to Transferee Inc for a cash purchase price of $55. The participation entitles Transferee Inc to 50% of the loan’s cash flows. The loan’s carrying amount is $98, which includes deferred origination fees that Transferor Corp has been amortizing. The transfer of the loan qualifies for derecognition.

Transferor Corp concludes that the fair value of its retained portion of the loan (a 50% interest) closely approximates the exchange price of the portion sold to Transferee Inc ($55).

Since the fair value of both the participating interest sold and the portion retained by Transferor Corp is $55, the implied fair value of the entire loan is $110.

How should Transferor Corp record the sale of the participating interest?

Analysis

Transferor Corp would first allocate the carrying amount of the underlying loan between the participating interests sold and retained, based on their relative fair values.

<table>
<thead>
<tr>
<th></th>
<th>Fair value</th>
<th>Percentage of total fair value</th>
<th>Allocated carrying value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Participating interest sold</td>
<td>$55</td>
<td>50%</td>
<td>$49</td>
</tr>
<tr>
<td>Participating interest retained</td>
<td>55</td>
<td>50%</td>
<td>49</td>
</tr>
<tr>
<td>Total</td>
<td>$110</td>
<td>100%</td>
<td>$98</td>
</tr>
</tbody>
</table>

Transferor Corp would record the following journal entry to derecognize the transferred participating interest at the transfer date.
Accounting for transfers that qualify as sales

Dr. Cash $55
Dr. Deferred loan fees $1
Cr. Loan $50
Cr. Gain on sale $6

Since the participation interest retained by Transferor Corp is not considered proceeds of the sale, its allocated carrying amount ($49) may not be remeasured to its implied fair value of $55 in connection with the transaction.

**EXAMPLE TS 4-2**

Sale of an entire financial asset

Transferor Corp transfers an entire $100 loan to Transferee Inc for a cash purchase price of $55 and a beneficial interest in the transferred loan that entitles Transferor Corp to 50% of the transferred loan’s cash flows. The beneficial interest has a fair value of $55. The loan’s carrying amount is $98, which includes deferred origination fees that Transferor Corp has been amortizing. The transfer of the loan qualifies for derecognition.

How should Transferor Corp record the sale of the loan?

**Analysis**

In accordance with the guidance in ASC 860-20-40-1B, Transferor Corp would derecognize the entire carrying amount of the transferred loan and recognize the consideration received at fair value by recording the following journal entry at the transfer date.

Dr. Cash $55
Dr. Beneficial interest in loan $55
Dr. Deferred loan fees $2
Cr. Loan $100
Cr. Gain on sale $12

The transferor (Transferor Corp) in Example TS 4-1 and Example TS 4-2 is in the same economic position after the transfer (i.e., it has received $55 of cash and has a 50% interest in the loan’s subsequent cash flows). Nevertheless, the gain on the sale of the participating interest in Example TS 4-1 is less than the gain that would be reported upon the transfer of the entire loan in Example TS 4-2. This difference is the result of not remeasuring the carrying amount of the participating interest retained by a transferor under the participating interest derecognition rules because the retained interest is not considered proceeds of the sale. Its carrying amount is determined based on the relative fair value allocation calculation illustrated in Example TS 4-1. However, if the financial asset was previously carried at fair value with unrealized gains and losses included in earnings that measurement convention would continue to apply to the retained participating interest.
In contrast, when an entire financial asset is transferred and qualifies for sale accounting, no allocation of carrying amounts between the portion sold and retained is necessary; the entirety of the carrying amount associated with the transferred item is derecognized. In addition, all assets obtained and liabilities incurred by the transferor in connection with a sale must be initially recognized at fair value. The FASB has acknowledged that, depending on their legal form, transfers having similar economic effects could be accounted for differently.

4.2.5 Recognition of assets obtained and liabilities incurred in the transfer

As discussed in ASC 860-20-25-1 and ASC 860-20-30-1, upon completion of a transfer that qualifies for derecognition, the transferor (seller) should recognize, at fair value, all proceeds from the sale. Proceeds include all assets obtained and liabilities incurred in connection with a transfer, and may include:

- Cash
- Servicing assets
- Servicing liabilities
- In a sale of an entire financial asset or a group of entire financial assets, any of the following:
  - The transferor’s beneficial interest in the transferred financial assets
  - Put or call options held or written (e.g., guarantee or recourse obligations)
  - Forward commitments (e.g., commitments to deliver additional receivables during the revolving periods of some securitizations)
  - Swaps (e.g., provisions that convert interest rates from fixed to variable).

If a transfer involves only a portion of an entire financial asset intended to qualify as a participating interest, only cash and a servicing asset (or liability) may be obtained as part of the transfer. Beneficial interests, put or call options, forward commitments, and swaps generally may not be obtained in a transfer of a portion of a financial asset to comply with the definition of a participating interest. See TS 2.4 for exceptions to this rule.

As discussed in TS 4.2.1, a retained participating interest is initially measured based on an allocation of the underlying financial asset’s carrying amount between the participating interest sold and the participating interest retained. A retained participating interest is not considered proceeds of a sale.

All consideration received in a sale constitutes, by definition, proceeds required to be measured at fair value in accordance with ASC 820, Fair Value Measurement. ASC 860-20-25-4 clarifies that any asset obtained constitutes proceeds from a sale -- even if the asset is a beneficial interest in the transferred asset that entitles the transferor to certain of the transferred asset’s economics subsequent to the exchange. Similarly, the fair value of any liability incurred reduces proceeds, even if it relates to the transferred assets. ASC 860-20-25-4 also clarifies that any derivative entered into concurrent with a transfer of financial assets is also considered part of the transaction’s proceeds, and should be recognized at fair value.
The values ascribed to assets obtained or liabilities incurred in a transfer accounted for as a sale will impact the amount of gain or loss booked on derecognition. Determining the fair value of assets received and liabilities assumed may involve judgment, and may require the use of specialists.

The remainder of this section discusses the more common forms of sale proceeds.

4.2.5.1 **Servicing rights**

A transferor may retain the contractual right to service transferred financial assets that have been derecognized. In that case, ASC 860-50-25 requires the transferor to recognize a separate servicing asset or servicing liability at the date of the exchange, measured at fair value. Thereafter, the recognized servicing asset or liability should be accounted for separately in accordance with the guidance in ASC 860-50.

If a transfer involves a participating interest, ASC 860-50-25-1 clarifies that a recognized servicing asset or liability should relate only to the participating interest sold.

See TS 6 for information on accounting for servicing assets or servicing liabilities.

4.2.5.2 **Beneficial interests obtained in a transfer**

As part of the proceeds from a sale, the transferor may obtain rights to receive specified cash inflows from (collections on) a transferred financial asset or group of transferred financial assets held by the transferee. These rights to cash inflows can take various legal forms (e.g., a provision in a contract, a debt instrument and/or equity interests), and are collectively referred to in ASC 860 as “beneficial interests” in the underlying transferred asset. Beneficial interests obtained are considered part of the proceeds on a sale transaction and should be initially recognized at fair value.

See LI 3.2.2.1 and LI 6.7 for information on the accounting for beneficial interests subsequent to initial recognition after the adoption of ASC 326 (CECL).

Beneficial interests may be derivative instruments within the scope of ASC 815 in their entirety or may contain embedded derivatives requiring separate accounting under ASC 815. See DH 2 for information on determining whether an instrument meets the definition of a derivative in its entirety and DH 4.4.6 for information on determining whether a beneficial interest contains an embedded derivative that should be accounted for separately.

4.2.5.3 **Credit enhancements to transferred assets**

Certain transfers may require the transferor to provide credit enhancement to the transferee. Under these arrangements, the transferor retains exposure to a portion of the transferred asset’s credit risk – thus reducing the credit risk that the transferee is exposed to, or in other words “enhancing” (from the transferee’s perspective) the credit risk profile of the acquired financial asset. Some transactions require a cash reserve account (funded by the transferor using proceeds from the sale) as a form of credit enhancement. If the transferee subsequently suffers credit losses on the transferred assets, it is entitled to reimbursement from the reserve account. Depending on the contractual arrangements, amounts in the account may be remitted to the transferor at periodic intervals or only upon extinguishment of the underlying assets.
Another type of credit enhancement sometimes seen in securitization structures requires cash flows that would be payable to the residual tranche to be collected and held by the transferor (and potentially other investors) in a cash reserve account for potential distribution to the other beneficial interest holders if specified collection targets (or other metrics, such as overcollateralization ratios) are not met. If those targets or metrics are satisfied, periodic distributions are made from the cash reserve account to the holders of the residual tranche in accordance with the entity’s priority of payments waterfall.

ASC 860-20-25-6 provides guidance on determining whether any credit risk retained by a transferor (credit enhancement provided by the transferor) should be reported as a separate liability or, alternatively, considered when measuring the initial carrying amount of a beneficial interest (asset) obtained by the transferor. If the transferee can look only to the cash flows from the underlying financial assets, then the transferor has retained a portion of the credit risk through its beneficial interest and should not recognize a separate obligation. In contrast, if the transferor could be required to reimburse the transferee for credit-related losses on the underlying assets – that is, the transferor may be required to “write a check” to the transferee – the transferor should record a separate liability for that contingent obligation.

When estimating the fair value of a credit enhancement, a transferor should consider inputs and assumptions that would be used by market participants, consistent with the guidance in ASC 820. If the credit enhancement is embedded in a transferor’s beneficial interest, the determination of the fair value of that interest should consider the credit enhancement that the beneficial interest implicitly provides to the transferee (or other beneficial interest holders).

### 4.2.5.4 Derivatives obtained in a transfer

Derivatives obtained in a transfer of an entire financial asset should be recognized at fair value. Those derivatives can be either assets (i.e., proceeds on the sale) or liabilities (i.e., reduction of proceeds on the sale). Derivatives obtained in sale transactions often include call options, put options, and swaps.

Even if no formal derivative contract is involved, the structure of a transfer transaction may imply a derivative within the scope of ASC 815. For example, a securitization may involve the transfer of fixed-rate receivables to a trust that issues variable-rate certificates. The transferor may enter into an agreement with the trust to periodically receive the fixed-rate interest collections on the receivables in exchange for paying a floating rate that corresponds to the certificates’ interest rate. This type of agreement is a swap subject to ASC 815.

See DH 2 for information on the ASC 815 definition of a derivative and DH 4.4.6 for information on determining whether a beneficial interest contains an embedded derivative that should be accounted for separately.

### 4.2.5.5 Forward sale agreements in a transfer

Under certain securitization arrangements, the transferor is obligated to transfer all eligible receivables originated during the program’s reinvestment period to the securitization entity. These provisions are most commonly seen in revolving securitization arrangements involving credit card receivables and trade accounts receivable. Cash collections on receivables previously transferred to the securitization entity are used to purchase new receivables, sometimes daily. To the extent that cash collections are insufficient to pay the transferred receivables’ purchase price, the remainder of the purchase price is funded by the transferor’s receipt of a beneficial interest in the transferred items.
Typically, the purchase price required to be paid by the securitization entity under these revolving programs is the transferred receivables’ then-current fair value. If so, it may be appropriate to conclude that the forward arrangement conveys little or no value to either party; therefore, from a materiality perspective, no related asset or liability need be recognized by the transferor despite the arrangement potentially meeting the definition of a derivative. However, there may be instances when the terms of the forward could result in the transferor receiving purchase price consideration that may not equal or closely approximate the transferred receivables’ fair value. Accordingly, when receivables are first sold to the securitization entity under a revolving program, the transferor should consider whether it is appropriate to record an asset or liability arising from any forward commitment (that is, the contract’s fair value at that date), as called for in ASC 860-20-25-1(d)(3).

See DH 2 for information on the ASC 815 definition of a derivative.

4.2.5.6 **Recourse obligations in a transfer**

ASC 860-10-20 provides a definition of recourse.

**Definition from ASC 860-10-20:**

Recourse: The right of a transferee of receivables to receive payment from the transferor of those receivables for any of the following:

a. Failure of debtors to pay when due
b. The effects of prepayments
c. Adjustments resulting from defects in the eligibility of the transferred receivables.

Recourse obligations can arise from a variety of contractual obligations assumed by a transferor. For example, a credit enhancement that potentially obligates a transferor to “write a check” to compensate a transferee for credit losses on transferred financial assets is a form of recourse. A transferee’s right to be compensated due to defects in a transferred asset’s eligibility typically stems from representations and warranties made by the transferor about the characteristics of the asset at the transfer date. As noted in TS 3.4.1, most recourse arrangements are considered a form of continuing involvement by a transferor with a transferred financial asset.

Recourse obligations related to the sale of an entire financial asset (or group of such assets) should initially be recognized on the transfer date as a liability at fair value.

As noted in TS 2, transfers of portions of entire financial assets cannot retain any recourse obligations (exclusive of standard representations and warranties, servicing obligations and obligations to share in any set-off benefits) and assert that the transferred portion meets the definition of a participating interest. ASC 860-20-55-24A explains that any other forms of recourse assumed by a transferor in connection with a transfer of a portion of an entire financial asset will cause the exchange to be reported as a secured borrowing.

Provisions in financial asset purchase and sale agreements should be analyzed to determine whether they involve recourse. Though sometimes termed nonrecourse, “early payment default” programs require the seller to repurchase any loan sold that becomes delinquent during a specified time period.
Accounting for transfers that qualify as sales

(e.g., during the first 90 days following the sale). If the borrower is not delinquent on its loan payments during the specified time period, the repurchase provision becomes void and the loan transfer becomes fully nonrecourse. However, during the specified time period, the contingent repurchase obligation is effectively a form of recourse.

Depending on their nature and extent, recourse arrangements may jeopardize the ability of a transferor to satisfy ASC 860’s legal isolation requirement. For example, standard representations and warranties written by a transferor subject to the US Bankruptcy Code typically will not, in and of themselves, prevent counsel from rendering a true sale opinion. On the other hand, counsel may be unable to provide a true sale opinion if a transferor is obligated to absorb subsequent credit losses on the financial assets sold.

Subsequent accounting for recourse obligations

ASC 860 does not provide guidance on the how a transferor should subsequently measure recourse obligations; other GAAP should be applied. The transferor may need to assess whether a recourse obligation meets the definition of a derivative in ASC 815. If it does, it should also assess whether the recourse obligation qualifies for the financial guarantee scope exception in ASC 815-10-15-58. If a recourse obligation meets the definition of a derivative but fails to meet the financial guarantee scope exception, it should be subsequently accounted for at fair value, with changes in value recognized in earnings. If the recourse obligation is outside the scope of ASC 815, it should be evaluated to determine whether the arrangement qualifies as a guarantee that should be remeasured based on the guidance in ASC 460. See DH 2 for information on the ASC 815 definition of a derivative and FG 2 for information on guarantees.

4.2.6 Sale accounting examples—various forms of proceeds

Example TS 4-3 and Example TS 4-4 illustrate the application of the recognition guidance in ASC 860-20 to a transfer that qualifies as a sale when the transferor receives other forms of proceeds in addition to cash consideration.

**EXAMPLE TS 4-3**

Sale of entire financial assets

Transferor Corp sells a group of loans having an aggregate carrying amount of $1 million in a transaction that qualifies for sale accounting. Transferor Corp receives cash of $940,000 and a senior beneficial interest in the transferred loans with a fair value of $110,000.

Transferor Corp will continue to service the loans in exchange for compensation that is more than adequate. In addition to retaining an option to purchase certain of the transferred loans at fair value (each of which is readily obtainable in the marketplace), Transferor Corp also assumes a limited recourse obligation to repurchase delinquent loans at par.

The following table summarizes the fair value of the assets received and liabilities incurred by Transferor Corp.

<table>
<thead>
<tr>
<th>Item</th>
<th>Fair value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$940,000</td>
</tr>
<tr>
<td>Item</td>
<td>Fair value</td>
</tr>
<tr>
<td>---------------------------</td>
<td>------------</td>
</tr>
<tr>
<td>Beneficial interest</td>
<td>$110,000</td>
</tr>
<tr>
<td>Call option</td>
<td>$2,000</td>
</tr>
<tr>
<td>Servicing asset</td>
<td>$30,000</td>
</tr>
<tr>
<td>Recourse obligation</td>
<td>$20,000</td>
</tr>
</tbody>
</table>

How should Transferor Corp record the sale of the group of loans?

**Analysis**

Transferor Corp would calculate the net proceeds received (fair value of the assets obtained in the transfer less the fair value of the liabilities incurred) and the gain on sale as follows.

Cash $940,000

Plus: beneficial interest 110,000

Plus: call option 2,000

Plus: servicing asset 30,000

Less: recourse obligation (20,000)

Net proceeds $1,062,000

Less: carrying amount of loans sold (1,000,000)

Gain on sale $62,000

Transferor Corp would record the following journal entry at the transfer date.

Dr. Cash $940,000

Dr. Call option $2,000

Dr. Beneficial interest $110,000

Dr. Servicing asset $30,000

Cr. Loans $1,000,000

Cr. Recourse obligation $20,000

Cr. Gain on sale $62,000
**EXAMPLE TS 4-4**  
**Sale of participating interest**

Transferor Corp transfers a portion of an entire loan in exchange for cash consideration of $980,000, the portion’s presumed fair value. The portion of the loan retained by Transferor Corp has a fair value of $110,000. The carrying amount of the entire loan prior to the transfer is $1 million.

Transferor Corp will continue to service the loan after the transfer, and will deduct its servicing fee from the periodic interest payment to be remitted to the transferee. Although the servicing contract provides compensation that is more than adequate, the servicing fee is not significantly above the amount that would fairly compensate a substitute service provider. In accordance with ASC 860-50-55-4, Transferor Corp estimates that the fair value of the servicing asset attributable to the portion sold is $10,000.

The transferred portion meets the definition of a participating interest in ASC 860-10-40-6A and the transfer qualifies for sale accounting under ASC 860-10-40-5.

The following table summarizes the fair values of the transaction’s sale proceeds (cash and a servicing asset) and the participation interest retained by Transferor Corp.

<table>
<thead>
<tr>
<th>Item</th>
<th>Fair value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$980,000</td>
</tr>
<tr>
<td>Participating interest retained</td>
<td>$110,000</td>
</tr>
<tr>
<td>Servicing asset</td>
<td>$10,000</td>
</tr>
</tbody>
</table>

How should Transferor Corp record the sale of the participating interest?

**Analysis**

Transferor Corp should first allocate the carrying amount of the underlying loan between the participating interests sold and retained, based on their relative fair values.

<table>
<thead>
<tr>
<th>Item</th>
<th>Fair value</th>
<th>Percentage of total fair value (nearest whole percent)</th>
<th>Allocated carrying value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Participating interest sold</td>
<td>$980,000</td>
<td>90%</td>
<td>$900,000</td>
</tr>
<tr>
<td>Participating interest retained</td>
<td>110,000</td>
<td>10%</td>
<td>100,000</td>
</tr>
<tr>
<td>Total</td>
<td>$1,090,000</td>
<td>100%</td>
<td>$1,000,000</td>
</tr>
</tbody>
</table>

Transferor Corp would then calculate the proceeds received and the gain on sale as shown in the following table.
Transferor Corp would record the following journal entry at the transfer date.

Dr. Cash $980,000
Dr. Servicing asset $10,000
Cr. Loan $900,000
Cr. Gain on sale $90,000

After the sale, Transferor Corp would report a loan on its balance sheet having a carrying value of $100,000, along with a servicing asset initially measured at $10,000.

4.3 Re-recognition of financial assets previously sold

Events may occur that result in a transferor regaining control over a previously-derecognized financial asset. If so, ASC 860 requires that the transferor re-recognize the transferred financial asset on its balance sheet, with corresponding derecognition by the transferee.

4.3.1 Re-recognition of a financial asset

ASC 860-20-25-8 provides guidance on the re-recognition of a transferred financial asset.

ASC 860-20-25-8

Paragraph 860-10-40-41 explains that a change in law or other circumstance may result in a transferred portion of an entire financial asset no longer meeting the conditions of a participating interest (see paragraph 860-10-40-6A) or the transferor’s regaining control of transferred financial assets after a transfer that was previously accounted as a sale, because one or more of the conditions in paragraph 860-10-40-5 are no longer met.

A transferor is considered to have regained control over transferred financial assets if the transaction no longer satisfies all of the sale accounting conditions in ASC 860-10-40-5. A wide array of events can potentially trigger this outcome. For example:

- Amendments to the underlying transfer agreement obligate the transferor to provide additional recourse to the transferee. As a consequence, the transfer no longer satisfies the legal isolation criterion, based on counsel’s updated true sale analysis.
Accounting for transfers that qualify as sales

- Changes in law or regulations, or developments in case law, subsequent to the transfer lead to a conclusion that the legal isolation criterion is no longer met.

- Amendments to the underlying transfer agreement impose various constraints on the transferee's ability to pledge or exchange the acquired asset to the extent that the condition in ASC 860-10-40-5(b) is no longer satisfied.

- A contingent event has occurred, thereby allowing a transferor to re-acquire a transferred asset in accordance with a removal-of-accounts provision in the underlying transfer agreement (see TS 4.3.3 for information on ROAPs).

In addition, ASC 860-10-40-41 states that a transferred portion of a financial asset that no longer meets the conditions of a participating interest is also subject to ASC 860’s re-recognition provisions. A transferred participating interest may subsequently fail to meet the criteria in ASC 860-10-40-6A as a consequence of the transferor selling, at a later date, another portion that does not satisfy the participating interest rules. Example TS 4-5 illustrates this guidance.

**EXAMPLE TS 4-5**

**Re-recognition of a transferred financial asset**

In 20X1, Bank Co transfers a 50% interest in a commercial loan to Investor A. The transferred interest meets both the participating interest criteria and the conditions for derecognition under ASC 860. Accordingly, Bank Co reports the transfer as a sale in its 20X1 financial statements.

In 20X2, Bank Co transfers a 30% interest in the same loan to Investor B. The participation agreement executed between the parties provides that, in the event of a payment default by the loan obligor, Bank Co and Investor B will share all subsequent cash collections disproportionately. Thus the interest sold to Investor B and the portion retained by Bank Co each do not qualify as participating interests. Investor A’s pro rata entitlement to 50% of the underlying loan’s cash flows remains unchanged in accordance with the previously-executed participation agreement.

What implications, if any, does Bank Co’s transaction with Investor B have on Bank Co’s accounting for the interest previously sold to Investor A?

**Analysis**

In accordance with ASC 860-10-40-6A(a) and ASC 860-10-40-6A(b), as long as a transferred portion of an entire financial asset remains outstanding, each portion (including the portion retained by the transferor) must continue to meet the characteristics of a participating interest for the transferred interest to qualify for derecognition. If at any time a transferred portion no longer satisfies the participating interest rules, the transfer must be re-characterized as a secured borrowing transaction.

In this example, prior to Bank Co’s transfer of the 30% interest to Investor B, the participation sold to Investor A, and the portion retained by Bank Co, each qualified as participating interests. However, neither the participation sold to Investor B nor the interest retained by Bank Co qualify as participating interests, as the two parties will not share cash inflows from the loan on a proportionate basis if the loan obligor defaults. Thus, the condition in ASC 860-10-40-6A(b) is no longer met. As a consequence, the participation held by Investor A no longer qualifies as a participating interest (as its interest is, effectively, now senior to the interest retained by Bank Co in the event of the loan obligor’s
4.3.2 Re-recognition accounting—measurement principles

ASC 860-20-25-9 stipulates that changes cited in ASC 860-20-25-8 have accounting implications for a transferor and transferee.

ASC 860-20-25-9

Such changes shall be accounted for in the same manner as a purchase of the transferred financial assets from the former transferee(s) in exchange for liabilities assumed unless they arise solely from either:

a. Consolidation of an entity involved in the transfer at a subsequent date (see paragraph 860-20-25-10)
b. A change in market prices (for example, an increase in price that moves into the money a freestanding call option on a non-readily-obtainable, transferred financial asset that was originally sufficiently out of the money that it was judged not to constrain the transferee).

If an event occurs that results in a transferor regaining control over a transferred financial asset (or, if a transferred portion no longer qualifies as a participating interest), the transferor is required to record the asset (or portion) on its balance sheet at its current fair value, along with a corresponding liability to the transferee. ASC 860-20-25-10 provides guidance for the transferor’s re-recognition accounting, both at initial recognition and thereafter. The transferor is required to:

□ Recognize on its balance sheet the transferred financial assets together with the liabilities to the former transferee (or beneficial interest holders of the former transferee).

□ Introduce no changes in the accounting for any servicing asset related to the now re-recognized financial assets. Although the transferor may have re-recognized all or certain of the serviced financial assets for financial reporting purposes, the transferor remains contractually obligated to service the assets on behalf of the transferee and its beneficial interest holders in exchange for a fee. The servicing asset should continue to be measured and reported separately.

□ Continue to account for any other interests in the transferred financial assets separate and apart from the re-recognized assets. Any such interests in the transferred assets should continue to be measured and reported in accordance with applicable GAAP. Those interests, and the re-recognized financial assets, represent separate units of account.

This guidance also applies if the re-recognized asset consists of a transferred portion of an entire financial asset that no longer qualifies as a participating interest.

In addition, the transferor should measure an allowance for credit losses in accordance with ASC 326, if applicable. ASC 860-20-25-13 explains that for assets that are not purchased credit deteriorated (PCD) financial assets, the transferor recognizes the allowance for credit losses with a corresponding charge to credit loss expense. For assets that are PCD assets within the scope of ASC 326, the
transferor recognizes an allowance with a corresponding increase to the amortized cost basis of the asset (see LI 9).

4.3.3 Re-recognition accounting—ROAPs

In many instances, re-recognition is attributable to a removal-of-account-provision (ROAP) becoming exercisable. Commonly seen in securitization transactions involving credit card receivables or mortgage loans, ROAPs allow a transferor to reclaim previously-transferred financial assets under certain circumstances. As discussed in TS 3.7.2.4, if the transferor’s right to reclaim is contingent upon a third-party action outside the control of the transferor that has yet to occur – for example, default by a transferred loan’s obligor – a ROAP would not preclude a transferor’s accounting for the transfer as a sale. However, if the third-party action or contingent event subsequently occurs that, in turn, permits the transferor to exercise the ROAP, the transferor has regained control over the transferred asset – a re-recognition event.

Given the prevalence of ROAPs, ASC 860 provides tailored guidance on how to apply its re-recognition provisions to these arrangements.

**ASC 860-20-25-11**

Whether the removal-of-accounts provision is exercised or not, the transferor shall recognize any financial assets subject to the removal-of-accounts provision if all of the following conditions are met:

a. A third party’s action (such as default or cancellation) or decision not to act (expiration) occurs.

b. The occurrence allows removal of assets to be initiated solely by the transferor.

c. The provision provides a more-than-trivial benefit to the transferor.

For example, once a contingency is met (such as when a given loan goes into default), the call option on that asset (loan) is no longer contingent.

In our view, to conclude that a now-exercisable ROAP provides no more than a trivial benefit to a transferor would be rare.

As indicated in ASC 860-20-25-11, when a transferor can first exercise a ROAP, re-recognition of the underlying financial assets is required because the transferor has regained effective control over the previously-transferred financial assets. Under ASC 860’s control-based derecognition framework, whether the transferor intends to exercise the ROAP is irrelevant. In these circumstances, the transferor should record the financial assets at their current fair value, with a corresponding liability to the transferee.

ASC 860 does not address how a transferor should subsequently account for a re-recognized financial asset subject to a ROAP that has yet to be exercised. The transferor should account for the asset in accordance with GAAP and its accounting policies. For example, if re-recognition is triggered by a credit event (e.g., the underlying transferred loan goes into payment default), the transferor should consider whether the re-recognized loan is subject to the guidance in ASC 326 regarding purchased financial assets with credit deterioration (PCD assets – see LI 9). However, upon exercise of the ROAP (subsequent to recognizing the underlying financial asset), the consideration paid to reacquire the
financial asset may differ from its current fair value. ASC 860-20-25-12 acknowledges that the transferor may record a gain or loss if the ROAP or similar contingent right is not accounted for as a derivative under ASC 815-10, and is not at the money when exercised. In these instances, the fair value of the repurchased asset will likely differ from the outlay required to settle the related obligation to the transferee.

Figure TS 4-1 summarizes the principal accounting guidance that a transferor may need to consider upon the occurrence of a re-recognition event.

**Figure TS 4-1**  
Accounting for re-recognition events

<table>
<thead>
<tr>
<th>Issue</th>
<th>Guidance</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>At re-recognition date (no contemporaneous re-acquisition of underlying financial asset)</strong></td>
<td></td>
</tr>
<tr>
<td>How should a re-recognized financial asset and the corresponding liability be measured?</td>
<td>Upon re-recognition, the financial asset should be measured at fair value, along with a corresponding liability. No gain or loss should be recognized.</td>
</tr>
<tr>
<td>Upon re-recognition, should a loan-loss allowance be recognized for loans that do not meet the definition of a security?</td>
<td>Yes. An allowance for credit losses should be recognized based on the requirements of ASC 326.</td>
</tr>
<tr>
<td>What impact does re-recognition of a transferred financial asset have on a transferor’s accounting for any beneficial interests in the re-recognized asset?</td>
<td>There is no change in the transferor’s separate accounting for its beneficial interests, including measurement of income and periodic assessments for impairment.</td>
</tr>
<tr>
<td>How does re-recognition impact the accounting for any servicing asset or liability related to the re-recognized financial assets?</td>
<td>There is no change in the accounting for the servicing asset or liability. Any such amounts should continue to be reported and remeasured separately.</td>
</tr>
<tr>
<td><strong>Re-acquisition of the underlying financial asset (subsequent to asset’s re-recognition)</strong></td>
<td></td>
</tr>
<tr>
<td>When a ROAP or contingent call is exercised, should a gain or loss be recognized upon the reacquisition of the transferred financial assets?</td>
<td>Yes, assuming the fair value of the repurchased asset differs from the consideration paid to settle the related obligation to the transferee. If the ROAP or contingent call is accounted for at fair value or is otherwise at-the-money, a gain or loss may not arise.</td>
</tr>
<tr>
<td>Issue</td>
<td>Guidance</td>
</tr>
<tr>
<td>----------------------------------------------------------------------</td>
<td>------------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>What impact does re-acquisition of a transferred financial asset have on a transferor’s accounting for any beneficial interests in the re-recognized asset?</td>
<td>It depends. If the beneficial interest consists entirely of an interest in the re-acquired financial asset, it should be re-combined with it. On the other hand, if the beneficial interest entitles the transferor to cash flows from assets that the transferee continues to hold, the beneficial interest should not be extinguished (recombined); rather, in that instance, the transferor should evaluate the impact that re-acquisition may have on the carrying amount of the beneficial interest and its estimated future cash flows.</td>
</tr>
<tr>
<td>How does re-reacquisition impact the accounting for any servicing asset or liability related to the re-acquired financial assets?</td>
<td>It depends. If re-acquisition results in cancellation of the servicing contract, the servicing asset or liability should be written off. On the other hand, if the servicing contract remains in effect, the transferor should continue to report and re-measure separately any servicing asset or liability. The impact that re-acquisition may have on estimated future servicing cash flows should also be evaluated when re-measuring the servicing asset or liability.</td>
</tr>
</tbody>
</table>

Question TS 4-3 discusses the accounting if the transferor buys back the asset.

**Question TS 4-3**

If, subsequent to a transfer when the sale criteria were considered satisfied, the transferor buys the transferred financial assets from the transferee or from a third party, should the initial sale be reversed?

**PwC response**

No, assuming the subsequent acquisition does not stem from an arrangement made contemporaneous with, or in contemplation of, the initial transfer. If so, the purchase may have been executed in accordance with a contract or understanding constituting a form of continuing involvement that should have been considered in connection with the transferor’s derecognition analysis, as required by ASC 860-10-40-4.

ASC 860-10-55-57 clarifies that these so-called wash sales should be accounted for as sales under ASC 860-10. The transferor is not considered to maintain effective control over transferred financial assets in the absence of a concurrent contract to repurchase or redeem the transferred financial assets, that is, in the absence of the transferor’s continuing involvement with the transferred financial assets that allows it to maintain effective control over them.
ASC 860-20-55- 83 through ASC 860-20-55-92 contains an example that illustrates the application of certain of the re-recognition provisions in ASC 860-20-25.

4.4 Derecognition accounting—transferee

As discussed in ASC 860-20-25-3 and ASC 860-20-30-2, a transferee should account for transfers that qualify for sale accounting by recording all assets obtained (including any participating interest) and liabilities incurred at fair value. However, if the asset is a purchased financial asset with credit deterioration (PCD asset), or if it meets the criteria in ASC 325-40-30-1A, then the transferee should apply the guidance in ASC 326 to determine the initial amortized cost basis (see LI 9).

ASC 860-20-40-3 provides guidance on a transferee’s accounting upon an event in which the transferor regains control over a transferred financial asset.

ASC 860’s derecognition model is intended to yield symmetrical financial reporting results; if the transfer of a financial asset satisfies the conditions for sale accounting, the transferor should derecognize the asset with corresponding recognition by the transferee. Similarly, if a transferor regains control over a transferred asset, the transferor should recognize the asset, with corresponding derecognition by the transferee. In these circumstances, until the transferor reacquires the transferred asset, the parties should each account for the previous transfer as a secured borrowing.
Chapter 5:
Accounting for transfers reported as secured borrowings
5.1 Accounting for transfers reported as secured borrowings overview

A transfer of financial assets qualifies for sale accounting if the transferor relinquishes control over the assets; that is, if the transfer meets the derecognition criteria in ASC 860, Transfers and Servicing. If the transferor does not surrender control, the transaction is reported as a secured borrowing. In that case, the transferor is considered to have borrowed cash (or other consideration) in exchange for granting the transferee a security interest in the transferred assets. See Figure TS 3-1 for a decision tree for applying ASC 860.

Transfers accounted for as secured borrowings can take many forms. They range from one-off transactions that do not meet all of the sale accounting requirements (sometimes referred to “failed sales”) to routine transfers of securities in the capital market governed by standardized contracts having terms that, by design, allow the transferor to maintain effective control over the securities. Three of the most common are:

- **Repurchase agreements.** The transferor sells a financial asset (usually a high-quality fixed-income security) to an entity (transferee) and simultaneously agrees to repurchase the security from the transferee at a future date. The repurchase price is typically the sales price plus an interest factor. For accounting purposes, the transferee is considered a secured lender (the transferred security serves as collateral) and the transferor is considered a borrower of cash.

- **Dollar rolls.** The transferor sells a mortgage-backed security (MBS) and simultaneously agrees to purchase an MBS from the transferee at a future date that is “substantially the same” as (but not necessarily identical to) the MBS sold. The repurchase price provides a return to the counterparty. For accounting purposes, the transferee is considered a secured lender (the transferred MBS serves as collateral) and the transferor is considered a borrower of cash.

- **Securities lending transactions.** An owner of securities (typically equities) lends its securities to a third party for a fee. The lender generally requires that the borrower provide collateral in the form of cash, standby letters of credit, or other securities. Many securities lending agreements are open-ended, with no explicit maturity date. Either party may unwind the agreement after first notifying the other, and shortly thereafter the parties re-exchange the borrowed securities and related collateral.

A transfer of financial assets can fail to qualify for derecognition accounting for a variety of reasons. If that happens, the exchange is reported as a secured borrowing. See TS 2 for information on the participating interest provisions in ASC 860 and TS 3 for the application of the sale accounting criteria in ASC 860-10-40-5. This chapter addresses only the application of the secured borrowing accounting guidance in ASC 860-30, Transfers – Secured Borrowings and Collateral, to a transfer of financial assets (or a portion of an asset) that fails to qualify for derecognition under the relevant provisions in ASC 860.

The chapter also provides detailed examples that illustrate the accounting for typical repurchase agreements and securities lending transactions.

Because it is written in the context of the secured borrowing accounting model, much of the guidance in ASC 860-30 uses terms commonly associated with financing transactions. For example:
A transferor of financial assets is considered an “obligor,” “debtor,” or “borrower”

The transferee is referred to as the “secured party”

Transferred financial assets are considered “noncash collateral”

To be consistent with the terms generally used elsewhere in ASC 860, we refer to the transacting parties as “transferor” and “transferee,” and similarly use the term “transferred financial assets,” with parenthetical references to the corresponding secured borrowing terminology in ASC 860-30.

5.2 The secured borrowing accounting framework

ASC 860-30-25-2 clarifies when a transfer of financial assets should be accounted for as a secured borrowing.

**ASC 860-30-25-2**

The transferor and transferee shall account for a transfer as a secured borrowing with pledge of collateral in either of the following circumstances:

a. If a transfer of an entire financial asset, a group of entire financial assets, or a participating interest in an entire financial asset does not meet the conditions for a sale in paragraph 860-10-40-5

b. If a transfer of a portion of an entire financial asset does not meet the definition of a participating interest.

The transferor shall continue to report the transferred financial asset in its statement of financial position with no change in the asset’s measurement (that is, basis of accounting).

Even though financial assets may be legally sold to a transferee, if the transfer does not qualify for sale accounting, the exchange must be reported as a borrowing accompanied by a pledge of collateral. At a high level, under the secured borrowing accounting model, the transferor:

- Recognizes any cash received from the transferee (and any other assets obtained from the transferee that the transferor can pledge or exchange, other than beneficial interests in the transferred assets)

- Records an obligation (liability) to return the cash to the transferee (and any other recognized assets obtained from the transferee)

- Continues to apply the appropriate US GAAP to the financial assets transferred, which the transferor continues to recognize on its balance sheet

Under the secured borrowing accounting model, the transferee:

- Derecognizes any cash paid to the transferor

- Records a receivable, representing its entitlement to receive at a later date the cash paid to the transferor
The secured borrowing model maintains financial reporting “symmetry” between the two parties. The transferred assets remain on the books of the transferor, with no corresponding recognition of those assets by the transferee. Similarly, cash exchanged between the parties is recognized and derecognized by its recipient and payer, respectively, along with a corresponding payable and receivable.

The collateral recognition provisions in ASC 860-30 are discussed in TS 5.3. See FSP 22 for information on the presentation and disclosure requirements of ASC 860, including those dealing with collateral.

### 5.3 Recognition of collateral

When a transfer of financial assets is accounted for as a secured borrowing, the transferor continues to report the transferred assets on its balance sheet. ASC 860-30 prescribes how the transferred financial assets (the “noncash collateral”) should be reported by each party.

Because the characterization of the exchanges between a transferor and transferee under the secured borrowing model in ASC 860-30 sometimes differs from its legal form, applying the collateral recognition provisions in ASC 860-30 can be challenging. This is particularly true regarding repurchase agreements and securities lending agreements customarily used in the US. Figure TS 5-1 highlights these differences.

#### Figure TS 5-1

**Collateral recognition**

<table>
<thead>
<tr>
<th>Repurchase agreement</th>
<th>Transferred securities</th>
<th>Legal characterization</th>
<th>Accounting characterization</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Legal purchase and sale. Transferee acquires legal ownership of each security, but is obligated to sell the security back to the transferor</td>
<td>Noncash collateral pledged to secure transferor’s obligation to repay “borrowed” cash</td>
</tr>
<tr>
<td></td>
<td>Cash received by transferor of securities</td>
<td>Proceeds from a legal sale</td>
<td>Proceeds from a borrowing</td>
</tr>
</tbody>
</table>

| Securities lending agreement | Securities transferred (“loaned securities”) | Transferee acquires ownership of the loaned securities, including the right to transfer them to others | Noncash collateral pledged to secure the cash and/or securities “borrowed” by the transferor |
Cash and/or securities received by the securities lender | Collateral in which the securities lender is granted a security interest | Proceeds from a borrowing. Noncash collateral transferred by the securities borrower continues to be reported on transferor’s balance sheet.

5.3.1 Cash collateral

ASC 860-30 provides guidance on the recognition of cash collateral.

ASC 860-30-25-3

Transfers of financial assets in exchange for cash collateral cannot be distinguished from borrowing cash. Further, because cash is fungible, it is impossible to determine whether it has been used by the secured party. Accordingly, all cash collateral shall be recorded as an asset by the party receiving it (the secured party), together with a liability for the obligation to return it to the payer (obligor), whose asset is a receivable.

Excerpt from ASC 860-30-25-4

Cash collateral used, for example, in securities lending transactions (see paragraphs 860-10-05-16 through 05-18) shall be derecognized by the obligor and recognized by the secured party, not as collateral but rather as proceeds of either a sale or a borrowing.

For financial reporting purposes, cash exchanged in connection with a transfer of financial assets accounted for as a secured borrowing is always recognized by its recipient (the transferor of the financial asset), with a corresponding obligation to return that cash. The counterparty (transferee) derecognizes the cash disbursed, and records a corresponding receivable from the recipient (transferor). This reporting model is applied irrespective of whether the underlying legal agreement characterizes the cash received as proceeds from a sale or a borrowing.

5.3.2 Noncash collateral

ASC 860-30-25-5 prescribes the accounting by the transferor and the transferee for transferred financial assets.

- Securities or other noncash financial assets received by the transferee (noncash collateral) should continue to be recognized on the transferor’s balance sheet (subject to reclassification if the transferee has the right to sell or repledge the collateral).

- If the transferee sells the noncash collateral, it should recognize the proceeds it receives from the transaction and record a liability for its obligation to return the collateral. Prior to any such sale, the transferred financial asset should not be recognized on the transferee’s balance sheet unless the transferor has defaulted under the related agreement.

- If the transferor defaults and is no longer entitled to redeem the transferred financial assets (collateral), it should derecognize the collateral and the transferee should either (1) recognize the
collateral as its own asset at fair value or (2) derecognize any obligation to return the collateral (if an obligation was previously recognized).

When transferred financial assets are considered noncash collateral subject to the collateral recognition provisions in ASC 860-30, the transferor and transferee should consider the reporting guidance illustrated in the Figure TS 5-2.

**Figure TS 5-2**
Decision tree for recognition of noncash collateral

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**5.3.3 Consideration received by a securities lender (transferor)**

In a typical securities lending transaction, the securities borrower (transferee) provides the lender with cash and/or securities that are contractually characterized as collateral in which the securities lender (transferor) obtains a security interest. Upon the underlying agreement’s termination, the securities lender (transferor) is obligated to return the collateral.

Despite the legal characterization of the consideration received by a securities lender (transferor) as collateral, ASC 860-30-25-7 clarifies that, under the secured borrowing accounting model, the cash
and/or securities received are considered the proceeds of a borrowing. See TS 5.7 for information on when the transferor should recognize these proceeds on its balance sheet.

Question TS 5-1, Question TS 5-2, Question TS 5-3, Question TS 5-4, and Question TS 5-5 discuss aspects of this guidance.

**Question TS 5-1**

What is the scope of collateral accounting and reporting requirements in ASC 860-30? Does it matter whether, as a legal matter, the transferee (secured party) is granted a security interest in the underlying asset or, alternatively, obtains an ownership (equitable) interest in the asset?

**PwC response**

The guidance in ASC 860-30 applies to all transfers of financial assets that do not meet the conditions for derecognition in ASC 860-10-40-5. In these circumstances, whether the transferor conveys an ownership interest in underlying asset to the transferee, or only a security interest, is irrelevant. If the transferor has not surrendered control over the financial asset, the exchange is accounted for as a secured borrowing, regardless of the legal form of the conveyance.

ASC 860-10-20 defines collateral as personal or real property in which a security interest has been given. However, ASC 860-30 uses the term “collateral” more broadly than that definition would suggest. That is, if an exchange is accounted for as a secured borrowing, the transferred financial asset is considered collateral for financial accounting purposes even when, as a legal matter, the transferee acquires an ownership interest (as opposed to a security interest) in the transferred asset.

The collateral accounting provisions in ASC 860-30-25 do not apply to cash, or securities that can be sold or pledged for cash, that a transferor has received in exchange for noncash financial assets (e.g., in a securities lending transaction). As discussed in ASC 860-30-25-9, cash or securities that can be sold or pledged for cash are deemed to be proceeds of either a sale or a borrowing.

**Question TS 5-2**

As noted above, in a securities lending transaction, the securities lender (transferor) recognizes on its balance sheet securities received as collateral that it can sell or repledge. From the lender’s perspective, the securities received are considered proceeds of a sale or borrowing under ASC 860, despite their characterization as collateral in the typical securities lending agreement.

In these circumstances, how should the securities borrower (transferee) report the securities posted as collateral?

**PwC response**

The securities borrower should continue to report the pledged securities on its balance sheet, as it has not surrendered control over them. Posting securities as collateral constitutes a transfer of financial assets. Accordingly, although ASC 860-30 is silent in this regard, we believe that the securities borrower should evaluate its accounting for these transactions based on applying the derecognition guidance in ASC 860-10-40-5. Under the standard securities lending agreement, the securities borrower may have the right to substitute collateral while the agreement is in effect, and the securities lender is obligated to return the collateral upon the agreement’s termination (which either party can
Accounting for transfers reported as secured borrowings

initiate). Given these provisions, the securities borrower maintains effective control over the pledged securities. Derecognition would be inappropriate in these circumstances.

This is one instance under GAAP when the same securities may be reported on the balance sheet of two entities simultaneously. This stems from the fact that, from the perspective of the securities lender, the collateral received is considered the proceeds of a borrowing and is required to be recognized if it can be repledged or sold. ASC 860-30-25-8 is clear in this regard.

The borrower of securities (transferee) is required to provide the disclosures about the pledged collateral in accordance with ASC 860-30-50-1A.

**Question TS 5-3**

How should a transferor measure transferred collateral that must be reclassified (e.g., securities pledged to creditors)?

**PwC response**

ASC 860-30-25-5(a) requires transferred collateral that the secured party can sell or repledge to be reclassified and reported separately by the transferor. That guidance does not change the transferor's measurement of the collateral. Because the transferor continues to effectively control the collateral, it should not be derecognized, and should be subject to the same measurement principles in effect prior to the transfer. For example, securities reclassified from the available-for-sale category to securities pledged to creditors should continue to be measured at fair value, with changes in fair value reported in other comprehensive income. Similarly, debt securities reclassified from the held-to-maturity category to securities pledged to creditors should continue to be measured at amortized cost.

**Question TS 5-4**

If a transferee (secured party) recognizes noncash collateral stemming from the transferor’s (debtor’s) default (see ASC 860-30-25-5(c)), how should that collateral be measured?

**PwC response**

ASC 860-30-30-1 indicates that the transferee (secured party) should initially measure the collateral at fair value. However, ASC 860 does not address how the assets should be subsequently measured. We believe that collateral recognized by a transferee should be subsequently measured consistent with its existing accounting policies for similar assets.

**Question TS 5-5**

How should a transferee (secured party) account for its obligation to return transferred collateral that has sold?

**PwC response**

If a transferee (secured party) sells collateral pledged to it, it should recognize the proceeds received and a corresponding obligation to return the collateral, as discussed in ASC 860-30-25-5(b). However, ASC 860 itself provides little guidance regarding the transferee's accounting for the obligation in subsequent periods. In lieu of such guidance, ASC 860-30-35-3 states that the liability to return such
collateral should be measured in accordance with other relevant accounting pronouncements. For example, a transferee bank or savings institution that has sold collateral is required to subsequently measure the related liability like a short sale at fair value. ASC 942-405-25-1 and ASC 942-405-35-1 indicate that obligations incurred in short sales should be reported as liabilities and remeasured to fair value through the income statement at each reporting date.

5.4 “Failed sale” accounting

ASC 860-30 provides only high-level guidance to assist reporting entities in applying its secured borrowing accounting model. As ASC 860-30-25-2 indicates, the transferred financial assets continue to be reported on the transferor’s books and measured as if the transfer never took place. The transferee does not record the financial assets obtained, barring subsequent default by the transferor. Any cash exchanged is recognized by its recipient (typically, the transferor of the financial assets) with a corresponding liability to return the cash. The payer derecognizes the cash and books a corresponding receivable from the payee.

The following sections discuss how a transfer of financial assets deemed a “failed sale” should be reported by the transferor under ASC 860-30’s secured borrowing accounting model. Transfers involving repurchase agreements or securities lending transactions are discussed in TS 5.5 and TS 5.7, respectively.

5.4.1 Initial measurement of a “failed sale” liability

Under the secured borrowing accounting model, the transferor of the financial assets (obligor) records any cash received and a corresponding obligation to return (repay) those funds. However, in certain “failed sale” transactions, the transferor receives not only cash but also a beneficial interest in the assets “sold.” In these instances, it is not clear whether, in addition to recognizing the cash received, the transferor should also record the beneficial interest at the transaction date.

Question TS 5-6 provides our views on this matter.

**Question TS 5-6**

Transferor Corp sells a pool of receivables to Bank Co for $50 million cash and a subordinated seller’s interest with a fair value of $10 million. The transfer is required to be reported as a secured borrowing. At the transaction date, should Transferor Corp recognize only the cash received with a corresponding “failed sale” obligation of $50 million or, alternatively, should Transferor Corp recognize both the cash and the seller’s interest, and a corresponding liability of $60 million?

**PwC response**

For the following reasons, we believe a transferor should record only the cash received:

- Under ASC 860-30’s secured borrowing model, the transferred financial assets are considered “collateral” pledged to the transferee (lender). In this context, it appears anomalous for the transferor to record an interest in assets conveyed to a transferee (lender) that, from ASC 860-30’s perspective, secure the transferor’s obligation to repay cash “borrowed” from the transferee.
Recognition of a beneficial interest in transferred assets that remain on the transferor’s balance sheet results in a “double-counting” of sorts – as the source of the beneficial interest’s cash inflows are cash collections on the underlying financial assets that the transferor continues to recognize.

This view aligns with the guidance in ASC 815-10-15-64, which states that a derivative instrument is not subject to the guidance in ASC 815-10 if recognizing both the derivative and a transferred asset accounted for as a financing under ASC 860 would result in counting the same item twice on the transferor’s balance sheet.

5.4.2 Subsequent measurement of a “failed sale” liability

ASC 860-30 is silent regarding how a transferor should subsequently account for the liability recognized in connection with a failed sale transaction. However, consistent with the secured borrowing accounting model, we believe that the transferor should apply the same measurement principles that govern an obligor’s accounting for a debt instrument, including the attribution of interest expense. That is, although the liability results from a transfer of financial assets that does not qualify for derecognition, the obligation should be considered a unit of account separate from those assets. Example TS 5-1 and Example TS 5-2 illustrate the application of this decision principle.

Most transferors report a failed sale liability at amortized cost; however, a transferor may elect to apply the fair value option in ASC 825, Financial Instruments, to a failed sale obligation. Question TS 5-7 provides an illustration for this guidance.

Question TS 5-7

In accordance with a pooling and servicing agreement, Transferor Corp sells a pool of loans to a non-consolidated securitization trust in exchange for $95 million cash and certain of the trust’s beneficial interests. The transfer is required to be reported as a secured borrowing. May Transferor Corp elect to apply the fair value option to the resulting $95 million obligation?

PwC response

Yes, we believe a transferor may apply the fair value option (FVO) to a liability arising from a failed sale transaction. The FVO may be elected for a financial liability other than those listed in ASC 825-10-15-5. Those exceptions do not include a liability arising from a transfer of financial assets accounted for as a secured borrowing.

According to the ASC Master Glossary definition, a financial liability arises from the existence of a contract that, among other things, imposes on one entity an obligation to deliver cash to a second entity. In this example, no loan agreement exists that contractually obligates Transferor Corp to pay principal and interest to the securitization trust. Rather, the liability stems entirely from characterizing (reporting) a transfer of financial assets as a secured borrowing for financial reporting purposes. Under a literal interpretation of the definition of a financial liability, one might conclude that a failed sale obligation is not eligible for the FVO election. However, we believe this applies the definition of a financial liability too narrowly.

The failed sale obligation arises from a transfer of financial assets governed by a contract (the pooling and servicing agreement) that conveyed legal title to a pool of loans to the securitization trust. The trust legally owns the loans and is entitled to receive all of their economics post-transfer. However, for financial reporting purposes, Transferor Corp continues to report the transferred loans on its balance
The failed sale liability gives accounting recognition to Transferor Corp’s obligation to “pass on” or remit to the securitization trust the cash inflows from those loans, in accordance with a contract -- the pooling and servicing agreement. Accordingly, we believe that the failed sale liability recorded by Transferor Corp should be eligible for the FVO election.

Failed sale transactions can encompass a wide array of fact patterns and contractual arrangements. As such, no prescriptive “one-size-fits all” model exists to assist a transferor in determining how a failed sale liability should be accounted for post-recognition. This is particularly true regarding the method used to attribute interest expense to the liability. In all cases, however, the transferor should apply an approach that aligns as closely as possible with the contractual arrangements of the underlying transaction (and reflects the economics that legally inure to the transferor) while also adhering to the secured borrowing framework prescribed by ASC 860.

Example TS 5-1 and Example TS 5-2 illustrate what we believe would be the appropriate accounting for a “failed sale” liability subsequent to initial measurement, given the facts presented.

**EXAMPLE TS 5-1**

Transfer of a subordinated interest in a loan accounted for as a secured borrowing

On January 1, 20X1, Transferor Corp originates a commercial loan to Obligor Co with a balloon payment due at maturity. The loan is issued at par and has the following terms:

<table>
<thead>
<tr>
<th>Principal amount</th>
<th>$1,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual coupon rate</td>
<td>6%</td>
</tr>
<tr>
<td>Payment terms</td>
<td>Interest-only loan payable annually; principal repaid at maturity</td>
</tr>
<tr>
<td>Maturity date</td>
<td>December 31, 20X4</td>
</tr>
</tbody>
</table>

Upon origination, Transferor Corp estimates the expected credit losses on the loan based on ASC 326-20 to be $10,000. Transferor Corp records the following entries.

Dr. Loan $1,000,000

Dr. Provision expense – credit loss $10,000

Cr. Cash $1,000,000

Cr. Allowance for credit losses $10,000

To record the loan and the allowance for credit losses at origination.

On December 31, 20X1, Obligor Co makes a payment to Transferor Corp for the annual interest due. Transferor Corp records the following entry (for purposes of this example, all accrued interest entries have been excluded).
On January 1, 20X2, Transferor Corp sells a 50% subordinated ownership interest in the loan to SI Corp for proceeds of $470,000. The terms of the transferred interest are:

Right to interest payments  Entitled to 50% of the loan’s 6% annual interest collections. However, interest is payable to SI Corp only after Transferor Corp has first received its 50% interest in such collections.

Right to principal payments  Entitled to 50% of the loan’s principal collections. However, the full amount ($500,000) is payable to SI Corp only if Transferor Corp has first received its 50% interest in all interest and principal collections.

Because the participation sold to SI Corp is subordinated to Transferor Corp’s ownership interest in the loan, the transfer does not satisfy all of the participating interest criteria in ASC 860-10-40-6A. Accordingly, Transferor Corp accounts for the transaction as a secured borrowing and records the following entry.

Dr. Cash  $470,000
Cr. Failed sale liability  $470,000

To record initial receipt of cash for the transfer of the subordinated ownership interest

On December 31, 20X2, Obligor Co makes a payment to Transferor Corp for the annual interest due. Transferor Corp records the following entries.

Dr. Cash  $60,000
Cr. Interest Income  $60,000

To record interest income for the year from Obligor Co.

Dr. Interest expense  $39,210
Cr. Cash  $30,000
Cr. Accretion of failed sale liability discount  $9,210

To record Transferor Corp’s annual interest expense due to the failed sale liability for the year, using the effective interest rate of the obligation.
The effective interest rate would include (1) the contractual interest payments on the loan from Obligor Corp that Transferor Corp is obligated to pass on to SI Corp and (2) the accretion of the failed sale liability discount.

On March 31, 20X3, Transferor Corp determines that there has been a degradation in the credit of the loan to Obligor Co and estimates the allowance for credit losses to be $100,000. Transferor Corp records the following entry.

Dr. Provision expense – credit loss $90,000
Cr. Allowance for credit losses $90,000

To record an increase in the allowance for credit losses to $100,000 from $10,000.

On December 31, 20X3, Obligor Co makes a payment to Transferor Corp for the annual interest due. Transferor Corp records the following entries.

Dr. Cash $60,000
Cr. Interest Income $60,000

To record interest income for the year from Obligor Co.

Dr. Interest Expense $39,979
Cr. Cash $30,000
Cr. Accretion of failed sale liability discount $9,979

To record Transferor Corp’s annual interest expense for the year due to the failed sale liability.

On June 30, 20X4, Transferor Corp becomes increasingly concerned about the credit risk of the loan to Obligor Co and estimates the allowance for credit losses to be $200,000. Transferor Corp records the following entry.

Dr. Provision expense – credit loss $100,000
Cr. Allowance for credit losses $100,000

To record an increase in the allowance for credit losses to $200,000 from $100,000.

On December 31, 20X4, the loan’s maturity date, Obligor Co is unable to pay any amount due to Transferor Corp. Through discussions with Obligor Co, it is agreed that Obligor Co will pay Transferor Corp $800,000 on March 31, 20X5 to settle the loan amount. Transferor Corp determines the principal reduction of $200,000 is uncollectible and recognizes a corresponding write-off of the loan’s amortized cost basis. Transferor Corp records the following entries (for simplicity we have ignored any interest that might be due to Transferor Corp).
Dr. Allowance for credit losses $200,000

Cr. Loan $200,000

*To record a charge-off of the loan’s amortized cost basis of $200,000 due to a reduction in the principal balance being deemed uncollectible.*

With respect to the failed sale liability and related interest expense, Transferor Corp would accrue an amount due to SI Corp at December 31, 20X4 consistent with the prior years.

Dr. Interest expense $40,811

Cr. Failed sale liability $30,000

Cr. Accretion of failed sale liability discount $10,811

*To record the interest expense due to SI Corp.*

Because SI Corp’s ownership interest is subordinate, SI Corp ultimately will absorb first any credit losses on Obligor Co’s loan. However, those legal arrangements do not affect Transferor Corp’s accounting for the failed sale liability (and recognition of related interest expense) until any such losses on the underlying loan are realized. Under ASC 860-30’s secured borrowing accounting framework, Transferor Corp’s failed sale liability is a separate unit of account from its loan to Obligor Co. Since Transferor Corp accounts for the failed sale obligation at amortized cost, to adjust (write down) the carrying value of the liability (or to cease recognition of periodic interest expense at the participation’s contractual rate) in response to an anticipated loss on the underlying loan would be inconsistent with the liability extinguishment provisions in ASC 405-20-40-1.

On March 31, 20X5, Obligor Co makes a payment of $800,000 to Transferor Corp to settle the outstanding loan amount. The relevant balances on Transferor Corp’s books immediately prior to extinguishment of the loan are as follows:

<table>
<thead>
<tr>
<th>Amortized cost basis of loan</th>
<th>$800,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allowance for credit losses</td>
<td>0</td>
</tr>
<tr>
<td>Net carrying value of loan</td>
<td>$800,000</td>
</tr>
<tr>
<td>Failed sale liability</td>
<td>$530,000</td>
</tr>
</tbody>
</table>

The failed sale liability represents the initial balance of $470,000, plus (1) $30,000 of cumulative accretion of discount and (2) $30,000 relating to SI Corp’s share of the interest on the loan from Obligor Corp that was not paid to SI Corp.

Transferor Corp. would record the following entries to extinguish the loan and settle the failed sale liability.

Dr. Cash $800,000

Cr. Loan $800,000

*To record the cash received and extinguishment of the loan.*
Accounting for transfers reported as secured borrowings

Dr. Failed sale liability $530,000

Cr. Cash (payment to SI Corp) $270,000

Cr. Gain on extinguishment of failed sale liability $260,000

To record cash paid to SI Corp and extinguishment of the failed sale liability

The following tables illustrate how the loan settlement payment was allocated between Transferor Corp and SI Corp, and the components of the extinguishment gain.

<table>
<thead>
<tr>
<th>Loan settlement amount</th>
<th>$800,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amounts payable first to Transferor Corp (senior ownership interest in loan):</td>
<td></td>
</tr>
<tr>
<td>Principal amount</td>
<td>$500,000</td>
</tr>
<tr>
<td>Interest for 20X4 never paid by Obligor Co</td>
<td>30,000 (530,000)</td>
</tr>
<tr>
<td>Remaining amount payable to SI Corp</td>
<td>$270,000</td>
</tr>
</tbody>
</table>

**EXAMPLE TS 5-2**

Transfer of a pool of loans, in exchange for cash and a subordinated seller's interest, accounted for as a secured borrowing

On January 1, 20X1, Transferor Corp sells a static pool of interest-bearing consumer loans having an aggregate face amount of $100 million to Big Bank in exchange for a cash payment of $90 million and a subordinated seller’s interest (deferred purchase price) for the difference. Transferor Corp continues to service the loans. Under the transfer and servicing agreement, Big Bank is entitled to receive all cash collections on the transferred loans until the bank has recouped its $90 million investment and related interest. Interest is calculated daily, based on a floating cost-of-funds formula and the then-current balance of the bank’s investment in the loan pool.

Transferor Corp accounts for the exchange as a secured borrowing transaction because it has retained a call option on the transferred loans, subject to a cap, that allows it to maintain effective control over the entire transferred portfolio.

How should Transferor Corp account for the transaction?

**Analysis**

At the transfer date, Transferor Corp would recognize Big Bank’s cash purchase price payment and a corresponding failed sale liability.

Dr. Cash $90,000,000

Cr. Failed sale liability $90,000,000
The transferred loans would be considered an asset of Transferor Corp, as it has not surrendered control over them. Transferor Corp would continue to reflect the transferred loans on its balance sheet, and account for them in subsequent periods as if the transaction with Big Bank had not occurred.

Transferor Corp would account for the failed sale liability in subsequent periods as if the obligation were a conventional loan. As such, it would recognize related periodic interest expense based on the floating rate charged by Big Bank. In accordance with cash collection and remittance provisions in the transfer and servicing agreement, Transferor Corp would reduce the carrying value of the liability (including accrued interest) as collections on the related receivables are remitted to Big Bank or deposited into a collections account beneficially owned by Big Bank. Because the liability is a unit of account separate from the transferred loans, it would be inappropriate for Transferor Corp to attribute anticipated or realized losses arising from the underlying loans to the carrying value of the obligation.

As a consequence of the failed sale, Transferor Corp would not recognize its seller’s interest in the transferred loans. Also, since the call option prevents sale accounting, it is scoped out of ASC 815-10-15-63 and is not recognized separately from the financing (see DH 3.2). However, the secured borrowing accounting model nonetheless captures the economics of this subordinated interest. In its financial statements, Transferor Corp would continue to measure and report the loans as if the transfer had never occurred. Treating Big Bank’s interest in the loans as a secured borrowing allocates to the bank its entitlement to the loans’ economics. The difference between the return on the loans reported in Transferor Corp’s income statement and the interest expense attributed to Big Bank represents the spread income that inures to Transferor Corp through its subordinated -- albeit unrecognized -- interest in the transferred loan portfolio.

As observed in these examples, a failed sale liability should be considered an obligation (unit of account) distinct from the underlying transferred financial asset. Accordingly, as a general rule, we believe that the measurement and recognition of periodic interest cost attributable to a failed sale liability should not be predicated upon, or linked to, the transferor’s recognition of the contractual rate of interest on the related transferred financial asset. However, we recognize that it may be appropriate in certain circumstances to attribute interest cost to a failed sale liability that takes into account the anticipated return on the underlying transferred financial assets, irrespective of their contractual terms. Example TS 5-3 illustrates when this approach may be acceptable.

**EXAMPLE TS 5-3**

**Transfer of an interest in a group of purchased financial assets with credit deterioration accounted for as a secured borrowing**

Bad Debt Collector periodically purchases from various originators, at a significant discount, portfolios of unsecured consumer loans that have experienced a more-than-insignificant deterioration in credit quality since origination and are deemed to be PCD. It carries the acquired groups of loans at amortized cost and, in accordance with ASC 310-10-35-53B and ASC 310-10-35-53C, accretes as interest income the non-credit-related discount.

Bad Debt Collector sometimes sells participations (ownership interests) in these portfolios to external investors. Although the interests sold are pari passu and proportionate, the transfers frequently do not satisfy all of the conditions for sale accounting, and thus are reported as secured borrowings on Bad Debt Collector’s balance sheet.
What rate of interest should Bad Debt Collector use to measure the interest expense to attribute to the failed-sale liabilities reported at amortized cost?

*Analysis*

There is no implementation guidance in ASC 860 that prescribes the rate at which interest should be accreted on the failed-sale liability of PCD assets, and hence determining the accretion rate may require judgment. Different approaches could be used, such as accreting to expected cash flows or (in the case of failed sale of equity securities) an immediate increase of the liability to the current value of the securities.

However, to measure interest expense based on the contractual rate of the underlying loans or based on their effective interest rate (which only includes the non-credit discount/premium) would not be representationally faithful in this case, as the loans are credit impaired (i.e., PCD) when acquired by Bad Debt Collector (unlike the fact pattern in Example TS 5-1).

In any case, Bad Debt Collector should not write down the carrying value of any failed-sale liability prior to extinguishment (final settlement) of the related participation, since doing so would be inconsistent with the liability extinguishment provisions in ASC 405-20-40-1. Such write down would not be appropriate even in instances when Bad Debt Collector increases the allowance for credit losses on the underlying loan pool. In other words, the accretion rate on the failed sale liability can never be negative.

### 5.5 Repurchase agreements

Repurchase agreements (often referred to as “repos”) are transactions in which a transferor transfers a financial asset (typically a high-quality debt security) to a transferee in exchange for cash. Simultaneously, the transferor enters into an agreement to reacquire the security on a specified future date for an amount equal to the cash received plus interest.

Banks, dealers, other financial institutions, and corporate investors commonly use repos to finance their securities inventories, obtain short-term funding and/or meet regulatory requirements. The term of a repo is relatively flexible (i.e., can be shorter or longer as needed) compared to other short-term financing arrangements, such as commercial paper or certificates of deposit.

Parties to repo transactions are referred to in a variety of ways. Figure TS 5-3 lists the terms commonly used to identify them.
Figure TS 5-3
Parties to repos

repos can be structured in different ways. Common arrangements include:

- **Term repos**, which have specified maturity dates that can range from overnight to several months. Repos with a specified maturity date can generally be rolled over or extended by mutual agreement of the parties.

- **Open repos**, which do not have maturity dates and can be terminated by the transferee or transferor at any time, on short notice.

- **Tri-party repos**, in which the securities are not delivered to the transferee. The securities are held by a custodian (usually a clearing bank), subject to an agreement signed by all three parties to the transaction. The transferor cannot obtain the collateral until it pays the transferee the amount owed under the contract (the collateral's repurchase price), thus providing security to the transferee in the event of default by the transferor.

Repurchase agreements are designed to minimize counterparty credit risk during their term. Accordingly, the market value of the securities subject to repurchase is determined daily. Changes in the market value of these positions can give rise to a “margin deficit” or a “margin excess” that, in turn, may require the transferor to transfer consideration (cash or securities) to the transferee (secured party) or obligate the transferee to transfer cash or certain of the purchased securities back to the transferor, respectively. Margin calls may be on a transaction-by-transaction basis, or may be determined considering all transferred securities and related collateral in the aggregate.

5.5.1 **Accounting for repurchase agreements**

The accounting for repos depends on whether (1) it is a repurchase-to-maturity transaction and (2) the transfer of the underlying financial asset qualifies for sale accounting under ASC 860-10-40-5. All repurchase-to-maturity transactions, as defined, should be accounted for as secured borrowings, as mandated by ASC 860-10-40-24A.
Most other repos are also accounted for as secured borrowings, because the terms of the underlying repurchase agreement satisfy (by design) the “effective control” requirements in ASC 860-10-40-24. Specifically, they obligate the transferor to repurchase a financial asset at a fixed or determinable price, and the financial asset is the same or substantially the same as the one transferred.

When the transferee to a repurchase agreement can satisfy its resale obligation by delivering a similar (but not identical) financial asset, additional analysis is necessary to determine whether the transferor has, in fact, maintained effective control over the transferred asset. If so, consistent with the secured borrowing accounting model, the transferor should recognize the cash received, record the obligation to repurchase the transferred financial asset, and apply the collateral-related accounting and reporting provisions in ASC 860-30-25-5.

Although rare, a repo transaction may qualify for sale accounting. For example, a repurchase agreement may not obligate the transferee to return to the transferor a financial asset that meets all of ASC 860-10-40-24’s “substantially the same” conditions. In these circumstances, the transferor is not considered to have retained effective control over the transferred asset. As discussed in ASC 860-10-55-51, in these instances, the repo transaction may qualify for derecognition, but only if the exchange meets the two remaining sale accounting criteria in ASC 860-10-40-5. If these conditions are satisfied, sale accounting is appropriate, in which case the transferred financial assets should be derecognized, accompanied by the recognition of proceeds received and liabilities assumed, including the forward purchase contract, at their current fair value. The forward purchase contract may be subject to derivative accounting under ASC 815, Derivatives and Hedging.

Figure TS 5-4 illustrates the general sequence of decisions applicable to transferors of financial assets subject to repurchase arrangements, exclusive of repurchase-to-maturity agreements, which are required to be reported as secured borrowings in all cases.
Figure TS 5-4
Transferor’s accounting for repurchase agreements (excluding repurchase-to-maturity agreements)

In a custodial or tri-party arrangement, control over the assets is not surrendered and a reclassification entry from securities to securities pledged to creditors is not required, as the secured party (transferee) does not have the right to pledge or sell the collateral held in the account.

Question TS 5-8 and Question TS 5-9 clarify different aspects of this guidance.

Question TS 5-8
Can a repo party and a reverse-repo party to the same transaction account for that transaction differently? For instance, can the transferor account for the transaction as a financing, while the transferee accounts for it as a buy/sell arrangement?

PwC response
No. A transferor and transferee should account for the transfer of a financial asset transfer in a consistent and symmetrical manner. Therefore, if a transferor concludes that a transfer should be reported as a secured borrowing transaction, the transferee should apply the same accounting in its financial statements, consistent with the guidance in ASC 860-30-25-2.

Despite ASC 860’s symmetrical accounting model, it is possible that certain transfers may be reported differently by the transferor and transferee. This may stem from the two parties reaching different judgments when evaluating whether a condition for derecognition has been satisfied. For example, the counterparties may conclude differently about the sufficiency of evidence obtained in connection with
the legal isolation assertion in ASC 860-10-40-5(a). However, we would expect instances of such asymmetrical accounting to be rare.

**Question TS 5-9**

Would it be appropriate for a reporting entity to include gains and losses arising from repurchase agreements reported as sales in the same line item as interest cost attributable to other repurchase agreements reported as secured borrowings?

**PwC response**

ASC 860-20-50-1B mandates that any gain or loss arising from a transfer reported as a sale be included in earnings. However, ASC 860 does not address how a transferor should present those gains or losses in its income statement. As a general rule, we believe that the classification of such amounts should conform to the characterization of the underlying transfer under ASC 860. For example, the cost associated with a repurchase agreement accounted for as a financing (i.e., the difference between the cash proceeds received at inception and the amount paid to repurchase the transferred security upon the agreement’s maturity) should be characterized as interest expense in the transferor’s income statement.

On the other hand, in practice, most companies that sell non-interest bearing trade accounts receivable to a bank or commercial paper conduit characterize the resulting loss as a loss on sale in its entirety – even though, arguably, a component of that loss is attributable to the investor’s imputation of a financing cost into the purchase price paid. ASC 860-20-50-5 requires that the aggregate amount of gains or losses on sales of loans or trade receivables (including related lower of cost or market and fair value adjustments) be presented separately in the financial statements or be disclosed in a note.

Example TS 5-4, Example TS 5-5, and Example TS 5-6 illustrate the accounting for various repurchase agreements reported as secured borrowings. See FSP 22.6 for a discussion of the disclosure requirements for transfers of financial assets reported as secured borrowings, including those pertaining to collateral.

**EXAMPLE TS 5-4**

Standard repo — transferee does not sell or repledge the transferred security

Transferor Corp and Transferee Corp enter into a repurchase agreement accounted for as a secured borrowing. The terms of the agreement and other relevant facts are as follows:

- Transferor Corp transfers (sells) a security carried at its fair value of $1,000 to Transferee Corp in exchange for $980 in cash.

- Transferor Corp agrees to repurchase the security in 35 days. The fair value of the security remains unchanged over the agreement’s term; as such, no margin payments are exchanged. The repurchase price is $984, which includes an implied interest cost of $4.

- Transferor Corp’s return from investing the cash received is $5.

Although Transferee Corp may sell or repledge the security, it does not do so over the repo’s term.

How should Transferor Corp and Transferee Corp account for this repurchase transaction?
Analysis

The following journal entries illustrate the accounting treatment for this arrangement. For the sake of simplicity, the example does not include journal entries to recognize and update the allowance for credit losses for the reverse repo receivable. Also, interest income and expense are recorded at the conclusion of the transaction. In practice, these amounts are accrued over the term of the repurchase transaction.

<table>
<thead>
<tr>
<th>Transferor Corp</th>
<th>Transferee Corp</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>At inception:</strong></td>
<td><strong>At inception:</strong></td>
</tr>
<tr>
<td>Dr. Cash $980</td>
<td>Dr. Reverse repo agreements $980</td>
</tr>
<tr>
<td>Cr. Obligation under repo agreements $980</td>
<td>Cr. Cash $980</td>
</tr>
<tr>
<td><strong>To record the receipt of cash and obligation under repo agreement</strong></td>
<td><strong>To record transfer of cash to Transferor Corp in exchange for security (noncash collateral)</strong></td>
</tr>
<tr>
<td>Dr. Securities pledged to Transferee Corp $1,000</td>
<td>Transferee Corp does not recognize the security (noncash collateral) on its balance sheet. An obligation to return the security is recorded only if Transferee Corp on-sells it.</td>
</tr>
<tr>
<td>Cr. Securities $1,000</td>
<td></td>
</tr>
<tr>
<td><strong>To reclassify pledged security that Transferee Corp has the right to sell or repledge</strong></td>
<td></td>
</tr>
<tr>
<td>Dr. Money market instrument $980</td>
<td></td>
</tr>
<tr>
<td>Cr. Cash $980</td>
<td></td>
</tr>
<tr>
<td><strong>To record investment of cash collateral</strong></td>
<td></td>
</tr>
<tr>
<td><strong>At conclusion:</strong></td>
<td><strong>At conclusion:</strong></td>
</tr>
<tr>
<td>Dr. Cash $985</td>
<td>Dr. Cash $984</td>
</tr>
<tr>
<td>Cr. Interest income $5</td>
<td>Cr. Reverse repo agreements $980</td>
</tr>
<tr>
<td>Cr. Money market instrument $980</td>
<td>Cr. Interest income $4</td>
</tr>
<tr>
<td><strong>To record results of short-term cash investment</strong></td>
<td><strong>To record receipt of cash upon maturity of reverse repo agreement and related interest income</strong></td>
</tr>
<tr>
<td>Dr. Obligation under repo agreements $980</td>
<td></td>
</tr>
<tr>
<td>Dr. Interest expense $4</td>
<td></td>
</tr>
<tr>
<td>Cr. Cash $984</td>
<td></td>
</tr>
<tr>
<td><strong>To record repayment of repo obligation and related interest (security’s repurchase price)</strong></td>
<td></td>
</tr>
<tr>
<td>Dr. Securities $1,000</td>
<td></td>
</tr>
<tr>
<td>Cr. Securities pledged to Transferee Corp $1,000</td>
<td></td>
</tr>
<tr>
<td><strong>To reclassify security no longer pledged</strong></td>
<td></td>
</tr>
</tbody>
</table>
EXAMPLE TS 5-5

Standard repo — transforee sells or repledges the transferred security

Transferor Corp and Transferee Corp enter into a repurchase agreement accounted for as a secured borrowing. The terms of the agreement and other relevant facts are as follows:

- Transferor Corp transfers (sells) a security carried at its fair value of $1,000 to Transferee Corp in exchange for $980 in cash.
- Transferor Corp agrees to repurchase the security in 35 days. The fair value of the security remains unchanged over the agreement’s term; as such, no margin payments are exchanged. The repurchase price is $984, which includes an implied interest cost of $4.
- Transferor Corp’s return from investing the cash received is $5.

Transferee Corp has the right to sell or repledge the security. It sells the security upon receipt and later returns the same security to Transferor Corp. Transferee Corp’s return from investing the cash collateral is $2.

How should Transferor Corp and Transferee Corp account for this repurchase transaction?

Analysis

The following journal entries illustrate the accounting treatment for this arrangement. For the sake of simplicity, the example does not include journal entries to recognize and update the allowance for credit losses. Also, interest income and expense are recorded at the conclusion of the transaction. In practice, these amounts are accrued over the term of the repurchase transaction.

<table>
<thead>
<tr>
<th>Transferor Corp</th>
<th>Transferee Corp</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>At inception:</strong></td>
<td><strong>At inception:</strong></td>
</tr>
<tr>
<td>Dr. Cash $980</td>
<td>Dr. Reverse repo agreements $980</td>
</tr>
<tr>
<td>Cr. Obligation under repo agreements $980</td>
<td>Cr. Cash $980</td>
</tr>
<tr>
<td><strong>To record the receipt of cash and obligation under repo agreement</strong></td>
<td><strong>To record transfer of cash to Transferor Corp in exchange for security (noncash collateral)</strong></td>
</tr>
<tr>
<td>Dr. Securities pledged to Transferee Corp $1,000</td>
<td></td>
</tr>
<tr>
<td>Cr. Securities $1,000</td>
<td></td>
</tr>
<tr>
<td><strong>To reclassify pledged security that Transferee Corp has the right to sell or repledge</strong></td>
<td><strong>Transferee Corp does not recognize the security (noncash collateral) on its balance sheet. An obligation to return the security is only recorded when Transferee Corp sells the security.</strong></td>
</tr>
<tr>
<td>Dr. Money market instrument $980</td>
<td></td>
</tr>
<tr>
<td>Cr. Cash $980</td>
<td></td>
</tr>
<tr>
<td><strong>To record investment of cash collateral</strong></td>
<td></td>
</tr>
</tbody>
</table>

5-23
### EXAMPLE TS 5-6

**Tri-party repo agreement**

Transferor Corp and Transferee Corp enter into a repurchase agreement accounted for as a secured borrowing. The terms of the agreement and other relevant facts are as follows:

- Transferor Corp transfers (sells) a security carried at its fair value of $1,000 to Transferee Corp in exchange for $980 in cash.
- Transferor Corp agrees to repurchase the security in 35 days. The fair value of the security remains unchanged over the agreement’s term; as such, no margin payments are exchanged. The repurchase price is $984, which includes an implied interest cost of $4.
Transferor Corp’s return from investing the cash received is $5.

Transferee Corp cannot sell or repledge the security because it is held by a custodian.

How should Transferor Corp and Transferee Corp account for this repurchase transaction?

**Analysis**

The following journal entries show the accounting treatment for this arrangement. For the sake of simplicity, the example does not include journal entries to recognize and update the allowance for credit losses. Also, interest income and expense are recorded at the conclusion of the transaction. In practice, interest income and expense should be accrued over the term of the repurchase transaction.

<table>
<thead>
<tr>
<th>Transferor Corp</th>
<th>Transferee Corp</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>At inception:</strong></td>
<td><strong>At inception:</strong></td>
</tr>
<tr>
<td>Dr. Cash $980</td>
<td>Dr. Reverse repo agreements $980</td>
</tr>
<tr>
<td>Cr. Obligation under repo agreements $980</td>
<td>Cr. Cash $980</td>
</tr>
<tr>
<td><strong>To record the receipt of cash and obligation under the repo agreement</strong></td>
<td><strong>To record transfer of cash to the repo counterparty in exchange for pledged security</strong></td>
</tr>
</tbody>
</table>

Transferor Corp does not reclassify the pledged security because Transferee Corp does not have the right to sell or repledge it.

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr. Money market instrument $980</td>
<td></td>
</tr>
<tr>
<td>Cr. Cash $980</td>
<td></td>
</tr>
<tr>
<td><strong>To record investment of cash collateral</strong></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>At conclusion:</strong></th>
<th><strong>At conclusion:</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr. Cash $985</td>
<td>Dr. Cash $984</td>
</tr>
<tr>
<td>Cr. Interest income $5</td>
<td>Cr. Reverse repo agreements $980</td>
</tr>
<tr>
<td>Cr. Money market instrument $980</td>
<td>Cr. Interest income $4</td>
</tr>
<tr>
<td><strong>To record results of short-term cash investment</strong></td>
<td><strong>To record the receipt of cash upon maturity (unwind) of reverse repo agreement</strong></td>
</tr>
</tbody>
</table>

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr. Obligation under repo agreements $980</td>
<td>Dr. Cash $984</td>
</tr>
<tr>
<td>Cr. Interest expense $4</td>
<td>Cr. Reverse repo agreements $980</td>
</tr>
<tr>
<td>Cr. Cash $984</td>
<td>Cr. Interest income $4</td>
</tr>
<tr>
<td><strong>To record the repayment of repo principal and interest</strong></td>
<td><strong>To record the receipt of cash upon maturity (unwind) of reverse repo agreement</strong></td>
</tr>
</tbody>
</table>
5.6 *Dollar rolls*

Various transactions or sets of transactions are commonly referred to as “dollar rolls.” Depending upon the facts and circumstances, certain dollar rolls are reported as repurchase agreements, while others are considered to involve derivative contracts. In certain instances, the transfer of the underlying securities may qualify for sale accounting, accompanied by the recognition of a derivative. By definition, dollar rolls involve a sale of securities accompanied by a commitment on the part of the transferor to subsequently purchase securities from the counterparty that are similar – but not identical – to the securities sold. The securities transferred and required to be repurchased are typically mortgage-backed securities (MBS) issued and/or guaranteed by the Government National Mortgage Association or government-sponsored enterprises (Freddie Mac and Fannie Mae).

The accounting for dollar rolls depends upon various factors, including the form of the transaction, judgments regarding whether securities to be repurchased will be substantially the same as those initially transferred, and whether the securities to be repurchased exist at the initial exchange date, or instead consist of securities to-be-announced (“TBA securities”) before settlement of the transaction.

The ASC Master Glossary defines dollar rolls.

**Definition from ASC Master Glossary**

Dollar-Roll Repurchase Agreement: An agreement to sell and repurchase similar but not identical securities. The securities sold and repurchased are usually of the same issuer. Dollar rolls differ from regular repurchase agreements in that the securities sold and repurchased have all of the following characteristics:

a. They are represented by different certificates.

b. They are collateralized by different but similar mortgage pools (for example, conforming single-family residential mortgages).

c. They generally have different principal amounts.

Fixed coupon and yield maintenance dollar agreements comprise the most common agreement variations. In a fixed coupon agreement, the seller and buyer agree that delivery will be made with securities having the same stated interest rate as the interest rate stated on the securities sold. In a yield maintenance agreement, the parties agree that delivery will be made with securities that will provide the seller a yield that is specified in the agreement.

ASC 860-10-20 also categorizes (as “types”) various dollar rolls that involve mortgage-backed securities typically issued (or to be issued) by the Government National Mortgage Association.

**Definition from ASC Master Glossary**

Government National Mortgage Association Rolls: The term Government National Mortgage Association (GNMA) rolls has been used broadly to refer to a variety of transactions involving mortgage-backed securities, frequently those issued by the GNMA. There are four basic types of transactions:
a. Type 1. Reverse repurchase agreements for which the exact same security is received at the end of the repurchase period (vanilla repo)

b. Type 2. Fixed coupon dollar reverse repurchase agreements (dollar repo)

c. Type 3. Fixed coupon dollar reverse repurchase agreements that are rolled at their maturities, that is, renewed in lieu of taking delivery of an underlying security (GNMA roll)

d. Type 4. Forward commitment dollar rolls (also referred to as to-be-announced GNMA forward contracts or to-be-announced GNMA rolls), for which the underlying security does not yet exist.

5.6.1 Accounting for dollar rolls

The Master Glossary’s enumeration of GNMA dollar rolls provides a useful framework when determining the appropriate accounting for these transactions more generally. Type 1 is simply a repurchase agreement entailing a GNMA MBS. Although it may be referred to as a dollar roll, the transaction involves a conventional repurchase agreement. Accordingly, the transfer of the MBS will not meet the criteria for sale accounting in ASC 860-10-40-5.

A Type 2 dollar roll arises when a reporting entity transfers an existing MBS from its inventory and simultaneously agrees to repurchase a similar (but not identical) security in the future. As with any repurchase agreement, the transferor should evaluate first whether it has maintained effective control over the underlying security. For this condition to be met, the security to be repurchased or redeemed must be “substantially the same” as the transferred security, based on the criteria in ASC 860-10-40-24. Because the security sold and required to be repurchased in a Type 2 dollar roll may be similar but not identical, careful analysis of the terms of the repurchase agreement is necessary to determine whether the transferor has, in fact, maintained effective control over the MBS sold. If it is determined that the securities involved are not substantially the same, derecognition of the transferred MBS is appropriate only if the remaining two conditions in ASC 860-10-40-5 are satisfied. Assuming the transaction qualifies for sale accounting, the commitment to repurchase the not-substantially-the-same MBS typically will meet the definition of a derivative.

A Type 3 dollar roll is essentially the same as Type 2, with one noteworthy exception; namely, as the contractual repurchase date nears, it is anticipated that the parties will, by mutual consent, extend this date, thus “rolling” the repurchase date to a future point in time. To achieve this, the parties enter into a commitment that offsets the current commitment to repurchase a security, and contemporaneously execute a new commitment that specifies a new (extended) repurchase date.

Although the “rolled” commitment to repurchase an MBS does not involve a transfer, the parties should ensure that new contract’s terms continue to support the assertion that the security to be repurchased is (or is not) substantially the same as the MBS initially sold. If not, additional analysis is warranted to determine whether the dollar roll’s initial accounting characterization remains appropriate.

A Type 4 dollar roll involves contracts requiring delivery of to-be-announced (TBA) MBS. The distinguishing feature of these contracts is that the identity of the MBS to be delivered at settlement is not specified at the trade date. Rather, the parties agree only on six characteristics of the MBS to be delivered: the issuer, par amount, maturity date, coupon rate, and price.1 In certain instances, a TBA

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1 In accordance with industry practice, two business days prior to settlement, a seller of the TBA MBS communicates to the buyer the details of the MBS pools that it intends to deliver.
forward contract may cite additional characteristics ("stipulations"), for example, the geographical composition of the underlying loan collateral. In addition, participants in the TBA market generally observe market-practice standards (commonly referred to as “good-delivery guidelines”) established and maintained by the Securities Industry and Financial Markets Association. These conventions and contractual terms narrow the securities eligible to be delivered at settlement, and facilitate determining whether MBS to be delivered in future are likely to be substantially the same as the MBS securities sold.

Typically, two contracts having TBA MBS as an underlying are executed simultaneously. One contract will obligate the reporting entity to deliver (sell) a TBA MBS to a counterparty at a future date. At the same time, the reporting entity will contract with the same counterparty to acquire from it a TBA MBS, albeit at a different future date. The interaction between the two contracts’ settlement dates will depend on the reporting entity’s trading strategies, hedging objectives, and other commercial considerations.

A Type 4 dollar roll may not involve a financial asset recognized on the transferor’s balance sheet, as the underlying MBS obligated to be delivered at settlement may not yet exist or, if the securities do exist, the transferor does not necessarily own them at the trade date. Furthermore, the transferor may intend to offset its obligation to deliver MBS by subsequently entering into another TBA contract to purchase equivalent securities having the same settlement date. Indeed, in many instances, participants that utilize TBA MBS dollar rolls do so for hedging and financing purposes, and intend to net settle their positions using offsetting contracts. Accordingly, in these cases, the guidance in ASC 860 does not apply. These transactions should be accounted for consistent with the guidance in ASC 815, Derivatives and Hedging.

Other transactions involving the sale of MBS and a contemporaneous commitment to purchase MBS may be considered to constitute a dollar roll. For example, a reporting entity may transfer (sell) an existing MBS and simultaneously enter into a long forward contract involving TBA MBS with the same counterparty. As noted above, forward TBA contracts do not identify the specific securities required to be delivered. Accordingly, the TBA feature may complicate the transferor’s determination whether it will be acquiring MBS that will be substantially the same as the securities sold. Thus, similar to Type 2 dollar rolls, careful analysis and judgment is warranted.

In many cases, MBS TBA contracts are executed on an exchange that net settles transactions, such as the Mortgage Backed Securities Division of the Fixed Income Clearing Corporation. As such, a reporting entity’s settlement with an exchange may represent only the net impacts of a wide array of contracts settled that day. Securities delivered or received may represent only the incremental difference between long and short positions having the same underlying that were entered into at various points in time. Certain contracts may stem from speculative trading strategies; others may have arisen from any of the dollar roll transactions described above. Accordingly, net settlement protocols may introduce operational complexities that complicate a reporting entity’s assertion that MBS received are, in fact, substantially the same as those initially transferred.

### 5.7 Securities lending transactions

Owners of securities sometimes lend them to third parties for a fee. The borrower of securities frequently uses them to make delivery on a short position or to settle a customer sale transaction that has failed. If a dealer sells a security that it does not own, it may borrow the security temporarily to

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2 See ASC 860-10-40-24(a)(6) for these guidelines.
settle the transaction. Securities under these agreements may be lent for a prescribed term or for an indefinite period. Securities lending programs are often managed by custodians to earn additional income for clients.

The securities lender generally requires the borrower to provide collateral, which can be cash, standby letters of credit, or other securities. The collateral typically has a value higher than that of the borrowed securities (i.e., there is overcollateralization). If the collateral is cash, the transferor typically earns a return by investing it at a rate higher than the rate paid or rebated to the transferee. To the extent the collateral is other than cash (e.g., standby letters of credit or other securities), the transferor typically receives a fee for lending the securities. Distributions (e.g., dividends) received on the securities lent and on the collateral, if applicable, during the term of the agreement inure to the transferor and securities borrower, respectively.

Much like repurchase agreements, securities lending transactions are structured to minimize counterparty credit risk. Accordingly, the market value of the securities borrowed and corresponding collateral is determined daily. Changes in the relative market value of these positions may give rise to a “margin deficit” or a “margin excess” that, in turn, requires the securities borrower to post additional collateral or obligates the securities lender to return a portion of the collateral if requested by the securities borrower. Margin calls may be on a loan-by-loan basis, or may be determined considering all loans and related collateral in the aggregate.

### 5.7.1 Accounting for securities lending

Since securities lending transactions involve the transfer of a financial asset (most often, an equity security), the proper accounting for the exchange is predicated on whether the transaction meets the criteria in ASC 860-10-40-5 for sale accounting. If these conditions are satisfied, ASC 860-10-55-55A provides further guidance regarding the derecognition accounting for securities lending transactions.

#### ASC 860-10-55-55A

If the conditions in paragraph 860-10-40-5 are met, a securities lending transaction should be accounted for as follows:

a. By the transferor as a sale of the loaned securities for proceeds consisting of the cash collateral and a forward repurchase commitment. If the collateral in a transaction that meets the conditions in paragraph 860-10-40-5 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.

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 circumstance, creditors of the transferor have a claim only to the collateral and the forward repurchase commitment.

If the transfer meets the criteria for a sale in ASC 860-10-40-5, the lender should derecognize the transferred securities, recognize the collateral received (cash and/or other securities, provided that the
lender can sell or repledge the latter) as an asset, and record a forward repurchase commitment. Depending on the economics of the transaction and the carrying value of securities sold, a gain or loss may be recorded.

The vast majority of securities lending transactions do not meet the conditions for sale accounting because the transferor maintains effective control over the transferred securities. ASC 860-30-25-7 provides guidance on the accounting treatment of securities lending transactions required to be reported as secured borrowings.

**ASC 860-30-25-7**

Many securities lending transactions are accompanied by an agreement that both entitles and obligates the transferor to repurchase or redeem the transferred financial assets before their maturity. Paragraph 860-10-40-24 states that an agreement that both entitles and obligates the transferor to repurchase or redeem transferred financial assets from the transferee maintains the transferor’s effective control over those assets as described in paragraph 860-10-40-5(c)(1), if all of the conditions in paragraph 860-10-40-24 are met. Those transactions shall be accounted for as secured borrowings, in which either cash or securities that the holder is permitted by contract or custom to sell or repledge received as collateral are considered the amount borrowed, the securities loaned are considered pledged as collateral against the cash borrowed and reclassified as set forth in paragraph 860-30-25-5(a), and any rebate paid to the transferee of securities is interest on the cash the transferor is considered to have borrowed.

To summarize, the transferor’s reporting for securities lending transactions under the secured borrowing accounting model is as follows:

- Any cash, standby letters of credit, or other securities received as collateral should be considered the amount borrowed by the transferor and recognized as an asset on its financial statements (provided that any such non-cash collateral can be sold or repledged by the transferor).

- The securities loaned are considered pledged as collateral against the amount borrowed and may require reclassification under the collateral provision of ASC 860-30-25.

- Any rebate paid to the transferee should be considered interest expense on the cash borrowed by the transferor, recognized over the life of the contract.

ASC 860-30-25-8 further clarifies that cash or securities received as collateral for securities loaned (and any investments made with that cash) should be recognized as an asset by the lender (provided that the securities received can be sold or repledged), regardless of whether the transaction is accounted for as a sale or secured borrowing. In the latter case, the securities lender should also recognize a liability for the obligation to return the collateral.

Example TS 5-7, Example TS 5-8, and Example TS 5-9 illustrate the accounting for various securities lending transactions reported as secured borrowings.
EXAMPLE TS 5-7
Securities lending transaction — cash received in exchange for transferred (borrowed) security

Transferor Corp and Transferee Corp enter into a securities lending agreement accounted for as a secured borrowing. The terms of the agreement and other relevant facts are as follows:

- Transferor Corp lends an equity security carried at its fair value of $1,000 to Transferee Corp for 35 days. The security’s fair value remains unchanged over the agreement’s term.
- Transferee Corp pledges $1,020 as cash collateral to Transferor Corp.
- Transferor Corp’s return from investing the collateral is $5. Transferor Corp has agreed to rebate $4 to Transferee Corp.

Transferee Corp sells the security upon receipt and later buys an identical security to return to Transferor Corp.

How should Transferor Corp and Transferee Corp account for this securities lending transaction?

**Analysis**

The following journal entries illustrate the accounting for this example. For simplicity, the example does not include journal entries to recognize and update the allowance for credit losses. Also, interest income and expense relating to the cash invested by Transferor Corp is assumed to be recognized only at the conclusion of the transaction. In addition, Transferee Corp’s investment of the proceeds from the sale of the borrowed security is omitted from this example.

<table>
<thead>
<tr>
<th>Transferor Corp</th>
<th>Transferee Corp</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>At inception:</strong></td>
<td><strong>At inception:</strong></td>
</tr>
<tr>
<td>Dr. Cash $1,020</td>
<td>Dr. Receivable under securities borrowing agreements $1,020</td>
</tr>
<tr>
<td>Cr. Payable under securities lending agreements $1,020</td>
<td>Cr. Cash $1,020</td>
</tr>
<tr>
<td><strong>To record the receipt of cash in exchange for loaned security, and related obligation</strong></td>
<td><strong>To record transfer of cash to Transferor Corp in exchange for borrowed security</strong></td>
</tr>
<tr>
<td>Dr. Securities pledged to Transferee Corp $1,000</td>
<td>Dr. Cash $1,000</td>
</tr>
<tr>
<td>Cr. Securities $1,000</td>
<td>Cr. Obligation to return borrowed securities $1,000</td>
</tr>
<tr>
<td><strong>To reclassify loaned security that Transferee Corp has the right to sell or pledge</strong></td>
<td><strong>To record sale of borrowed security to third party and obligation to return</strong></td>
</tr>
<tr>
<td>Dr. Money market instrument $1,020</td>
<td></td>
</tr>
<tr>
<td>Cr. Cash $1,020</td>
<td></td>
</tr>
<tr>
<td><strong>To record investment of cash collateral</strong></td>
<td></td>
</tr>
</tbody>
</table>
Transferor Corp | Transferee Corp
---|---
**At conclusion:** | **At conclusion:**
Dr. Cash | Dr. Cash $1,024
Cr. Interest income | Cr. Receivable under securities borrowing agreements $1,020
Cr. Money market instrument | Cr. Interest income (rebate) $4

*To record results of short-term cash investment* | *To record the receipt of cash collateral and rebate interest upon return of borrowed security*

Dr. Securities | Dr. Obligation to return borrowed securities $1,000
Cr. Securities pledged to Transferee Corp | $1,000

*To reclassify security no longer pledged (received from Transferee Corp)* | *To record the purchase of security borrowed and delivery of security to Transferor Corp*

Dr. Payable under securities lending agreements | $1,020
Dr. Interest expense (rebate) | $4
Cr. Cash | $1,024

*To record repayment of cash collateral and interest to Transferee Corp*

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**EXAMPLE TS 5-8**

Securities lending transaction—Treasury securities received in exchange for transferred (borrowed) equity securities; borrower does not sell the securities

Transferor Corp and Transferee Corp enter into a securities lending agreement accounted for as a secured borrowing. The terms of the agreement and other relevant facts are as follows:

- Transferor Corp lends shares of ABC Corp common stock carried at their fair value of $1,010 to Transferee Corp for 35 days. The fair value of the stock remains unchanged over the agreement’s term.
- Transferee Corp pledges Treasury securities with a fair value of $1,020 as collateral to Transferor Corp. The fair value of the securities remains unchanged over the agreement’s term.
- Transferee Corp pays a securities lending fee of $1 to Transferor Corp.

Transferee Corp does not sell the borrowed stock.

How should Transferor Corp and Transferee Corp account for this securities lending transaction?

*Analysis*

The following journal entries show the accounting treatment for this arrangement. For simplicity, interest accruals relating to the Treasury securities held by Transferor Corp and the corresponding payable to Transferee Corp are omitted.
<table>
<thead>
<tr>
<th><strong>Transferor Corp</strong></th>
<th><strong>Transferee Corp</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>At inception:</strong></td>
<td><strong>At inception:</strong></td>
</tr>
<tr>
<td>Dr. Treasury securities</td>
<td>$1,020</td>
</tr>
<tr>
<td>Cr. Payable under securities lending agreements</td>
<td>$1,020</td>
</tr>
<tr>
<td><strong>To record the receipt of Treasury securities (in lieu of cash collateral) that Transferor Corp can sell or pledge, in exchange for loaned ABC Corp common shares</strong></td>
<td></td>
</tr>
<tr>
<td>Cash or securities collateral that the transferor can sell or repledge is considered the amount borrowed under a secured borrowing.</td>
<td>Transferee Corp does not recognize the borrowed ABC Corp common stock on its balance sheet. It records an obligation to return the stock only upon the stock's subsequent sale or if Transferor Corp defaults.</td>
</tr>
<tr>
<td>Dr. Securities pledged to Transferee Corp</td>
<td>$1,010</td>
</tr>
<tr>
<td>Cr. ABC Corp common stock</td>
<td>$1,010</td>
</tr>
<tr>
<td><strong>To reclassify loaned ABC Corp common stock that Transferee Corp has the right to sell or repledge</strong></td>
<td></td>
</tr>
<tr>
<td><strong>At conclusion:</strong></td>
<td><strong>At conclusion:</strong></td>
</tr>
<tr>
<td>Dr. ABC Corp common stock</td>
<td>$1,010</td>
</tr>
<tr>
<td>Cr. Securities borrowing fee</td>
<td>$1</td>
</tr>
<tr>
<td><strong>To reclassify ABC Corp common stock no longer pledged (returned by Transferee Corp)</strong></td>
<td></td>
</tr>
<tr>
<td>Dr. Payable under securities loan agreements</td>
<td>$1,020</td>
</tr>
<tr>
<td>Cr. Treasury securities</td>
<td>$1,020</td>
</tr>
<tr>
<td><strong>To record return of Treasury securities</strong></td>
<td></td>
</tr>
<tr>
<td>Dr. Cash</td>
<td>$1</td>
</tr>
<tr>
<td>Cr. Securities lending fee</td>
<td>$1</td>
</tr>
<tr>
<td><strong>To record fee received from Transferee Corp</strong></td>
<td></td>
</tr>
</tbody>
</table>

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5-33
EXAMPLE TS 5-9

Securities lending transaction — Treasury securities received in exchange for transferred (borrowed) equity securities; borrower sells the securities

Transferor Corp and Transferee Corp enter into a securities lending agreement accounted for as a secured borrowing. The terms of the agreement and other relevant facts are as follows:

- Transferor Corp lends shares of ABC Corp common stock carried at their fair value of $1,010 to Transferee Corp for 35 days. The fair value of the stock remains unchanged over the agreement’s term.

- Transferee Corp pledges Treasury securities with a fair value of $1,020 as collateral to Transferor Corp. The fair value of the securities remains unchanged over the agreement’s term.

- Transferee Corp pays a securities lending fee of $1 to Transferor Corp.

To settle a previously-existing short position, Transferee Corp delivers the borrowed ABC Corp common stock immediately upon receipt. It subsequently buys shares of the same stock to satisfy its obligation to return them to Transferor Corp.

How should Transferor Corp and Transferee Corp account for this securities lending transaction?

Analysis

The following journal entries show the accounting treatment for this arrangement. For simplicity, interest accruals relating to the Treasury securities held by Transferor Corp and the corresponding payable to Transferee Corp are omitted.

<table>
<thead>
<tr>
<th>Transferor Corp</th>
<th>Transferee Corp</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>At inception:</strong></td>
<td><strong>At inception:</strong></td>
</tr>
<tr>
<td>Dr. Treasury securities $1,020</td>
<td>No entry is required by Transferee Corp. See Question TS 5-2.</td>
</tr>
<tr>
<td>Cr. Payable under securities loan agreements $1,020</td>
<td></td>
</tr>
<tr>
<td><em>To record the receipt of Treasury securities (in lieu of cash collateral) that Transferor Corp can sell or repledge, in exchange for loaned ABC Corp common stock</em></td>
<td></td>
</tr>
<tr>
<td>Dr. Securities pledged to Transferee Corp $1,010</td>
<td>Dr. Short position in ABC Corp common stock $1,010</td>
</tr>
<tr>
<td>Cr. ABC Corp common stock $1,010</td>
<td>Cr. Obligation to return borrowed securities $1,010</td>
</tr>
<tr>
<td><em>To reclassify loaned ABC Corp common stock that the secured party has the right to sell or repledge</em></td>
<td><em>To record settlement of short position with borrowed ABC Corp common stock, and corresponding obligation to return</em></td>
</tr>
</tbody>
</table>
## Accounting for transfers reported as secured borrowings

<table>
<thead>
<tr>
<th>Dr. ABC Corp common stock</th>
<th>$1,010</th>
<th>Dr. Obligation to return borrowed securities</th>
<th>$1,010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cr. Securities pledged to Transferee Corp</td>
<td>$1,010</td>
<td>Cr. Cash</td>
<td>$1,010</td>
</tr>
</tbody>
</table>

*To reclassify ABC Corp common stock no longer pledged (returned by Transferee Corp)*

<table>
<thead>
<tr>
<th>Dr. Payable under securities lending agreements</th>
<th>$1,020</th>
<th>Dr. Securities borrowing fee</th>
<th>$1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cr. Treasury securities</td>
<td>$1,020</td>
<td>Cr. Cash</td>
<td>$1</td>
</tr>
</tbody>
</table>

*To record return of Treasury securities*

<table>
<thead>
<tr>
<th>Dr. Cash</th>
<th>$1</th>
<th>Dr. Securities borrowing fee</th>
<th>$1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cr. Securities lending fee</td>
<td>$1</td>
<td>Cr. Cash</td>
<td>$1</td>
</tr>
</tbody>
</table>

*To record fee received from Transferee Corp*
Chapter 6: Servicing of financial assets
6.1 Chapter overview

This chapter discusses the accounting for servicing rights. Servicing is the contractual right to service or administer many of the functions associated with a financial asset.

ASC 860 requires all servicing assets and liabilities to be initially measured at fair value but allows either fair value accounting or an amortization method on day two. If fair value accounting is elected, ASC 860 accomplishes symmetric accounting at fair value for both servicing assets and liabilities and any financial instruments used to mitigate or hedge their risk.

6.2 Servicing overview

Servicing is inherent in all financial assets. Servicing rights are most often associated with assets such as mortgage loans, credit card receivables, automobile loans, and trade receivables. The contractual right to service financial assets that are held by a third party can be developed or acquired through a variety of means, including explicitly through a contract or implicitly through the origination of a financial asset.

Many activities fall under the umbrella of servicing, including:

- Collecting principal, interest, and escrow payments from borrowers
- Paying taxes and insurance from escrowed funds
- Monitoring delinquencies
- Completing workouts/restructurings
- Executing foreclosures
- Remitting fees to guarantors, trustees, and others providing services
- Accounting for and remitting principal and interest payments to the holders of beneficial interests or participating interests in the financial assets

The benefits of servicing contracts are typically made up of several components, including contractually specified servicing fees and the right to collect other ancillary sources of income, such as float and late charges. In some cases (e.g., mortgage servicing contracts), the contractually specified servicing fees are set at a level above what is necessary to generate enough cash flow to maintain profitable servicing operations. The incremental future cash flows are intended to align the interests of the servicer with that of the mortgage-backed security (MBS) holders and borrowers. If a servicer is entitled to cash flows in excess of an amount that would adequately compensate the servicer for performing the required servicing duties, it should recognize a servicing asset provided the requirements of ASC 860 have been met. See TS 6.3.1 for information on when a servicing right should be separately recognized.

Servicing rights come with related risks. The fair value of a servicing right is subject to interest rate and prepayment risks. Prepayments are driven (in part) by a consumer’s sensitivity to changing interest rates, which are difficult to predict. Additionally, servicers of mortgage loans and other asset-
backed securities may be subject to specific servicing standards. As a result, they may also face operational, regulatory, and reputational risks.

Companies often manage, or protect against, the financial risks of servicing (the unexpected change in fair value) associated with early prepayment by using derivative financial instruments and investment securities. Typical risk management products include interest rate floors, caps, swaps and swaptions, agency MBS, forward contracts, Treasury and Eurodollar futures contracts, and options on futures contracts.

6.3 **Recognition and measurement of servicing rights**

Servicing rights become distinct assets or liabilities that require separate accounting treatment when they are contractually separated from the underlying financial assets and provide compensation to the servicer that is either:

- More than adequate (resulting in a net servicing asset)
- Less than adequate (resulting in a net servicing liability)

ASC 860 prescribes a uniform approach to the accounting for servicing of all types of financial assets under which a net servicing asset or liability is recognized for each servicing contract. ASC 860 permits fair value accounting or an amortization method, under which servicing rights are accounted for at the lower of amortized cost or fair value.

There is diversity in practice concerning the applicable GAAP guidance for servicing and subservicing contracts deemed to have just adequate compensation. See Question TS 6-2 for additional information.

6.3.1 **Separate recognition of servicing rights**

ASC 860 describes when a servicing right should be accounted for separately.

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**Excerpt from ASC 860-50-25-1**

An entity shall recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in any of the following situations:

a. A servicer’s transfer of any of the following, if that transfer meets the requirements for sale accounting:
   1. An entire financial asset
   2. A group of entire financial assets
   3. A participating interest in an entire financial asset, in which circumstance the transferor shall recognize a servicing asset or a servicing liability only related to the participating interest sold.

b. Subparagraph superseded by Accounting Standards Update No. 2009-16

c. An acquisition or assumption of a servicing obligation that does not relate to financial assets of the servicer or its consolidated affiliates included in the financial statements being presented.
Example 1 (see paragraph 860-50-55-20) illustrates accounting for a sale of receivables with servicing obtained by the transferor.

**Excerpt from ASC 860-50-25-2**

A servicer that transfers or securitizes financial assets in a transaction that does not meet the requirements for sale accounting and is accounted for as a secured borrowing with the underlying financial assets remaining on the transferor’s balance sheet shall not recognize a servicing asset or a servicing liability.

**Excerpt from ASC 860-50-25-3**

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

**Excerpt from ASC 860-50-25-4**

An entity that transfers its financial assets to an unconsolidated entity in a transfer that qualifies as a sale in which the transferor obtains the resulting securities and classifies them as debt securities held to maturity in accordance with Topic 320 may either separately recognize its servicing assets or servicing liabilities or report those servicing assets or servicing liabilities together with the asset being serviced.

A servicing asset or servicing liability should be recognized when a company undertakes an obligation to service financial assets (i.e., the acquisition or assumption of the right to service a financial asset from a third party). Servicing rights related to failed sales (i.e., secured borrowings) or transfers to SPEs that are consolidated under ASC 810, would not qualify for separate recognition under ASC 860.

In accordance with ASC 860-50-55-4, if an entity transfers a participating interest in a financial asset that qualifies for sale accounting, the entity should record a servicing asset for the portion of the loan it sold. The assumption that the entity would service the loan because it retains part of the participated loan does not affect the requirement to recognize a servicing asset.

Recognition of servicing assets or servicing liabilities for revolving-period receivables shall be limited to the servicing for the receivables that exist and have been transferred. As new receivables are transferred into the revolving-period structure, rights to service those receivables should be recognized, to the extent the transfers to the structure meet the conditions for sale accounting.

Question TS 6-1 further clarifies the scope of transactions that are subject to ASC 860.

**Question TS 6-1**

Would ASC 860 apply if a broker were to bring a bank and a borrower together in a brokered loan transaction and simultaneously enter into a servicing contract with the bank upon origination of the loan?

**PwC response**

Yes. ASC 860 applies to any separate purchase or assumption of a servicing contract, regardless of whether a transfer of financial assets is connected to it, as outlined in ASC 860-50-30-1.
6.3.2 Initial measurement of servicing assets and liabilities

ASC 860-50-30 discusses some of the critical considerations when determining the initial measurement of a servicing asset or a servicing liability that qualifies for separate recognition. The guidance establishes that servicing contracts for which the servicer’s benefits of servicing are expected to more than adequately compensate the servicer will result in a servicing asset and contracts for which the benefits of servicing are not expected to adequately compensate the servicer will result in a servicing liability. The determination of adequate compensation considers the margin that would be demanded in the marketplace based on expected costs to serve; it does not vary based on the servicer’s own specific servicing costs. Servicing contracts that entitle the servicer to benefits equal to adequate compensation do not result in the recognition of a servicing asset or liability.

ASC 860 requires that separately recognized servicing rights be measured initially at fair value. ASC 820 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Measurements of the fair value of servicing rights may consider the present value of expected cash flows, including both future inflows of servicing revenues and outflows of costs related to servicing. See TS 6.3.5 for a discussion of fair value measurements of servicing rights.

6.3.2.1 Determining whether a servicer is adequately compensated

A servicer of financial assets receives revenues from contractually specified servicing fees and other ancillary sources of income, including float and late charges. This income represents the benefits of servicing. In most cases, servicing contracts are structured such that the benefits of servicing are expected to more than adequately compensate the servicer for performing the servicing. The ASC Master Glossary defines benefits of servicing and adequate compensation. The determination of the adequacy of compensation is done on a contract by contract basis with no aggregation of contracts.

Definitions from ASC Master Glossary

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

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. It is the amount demanded by the marketplace to perform the specific type of servicing. Adequate compensation is determined by the marketplace; it does not vary according to the specific servicing costs of the servicer.

Adequate compensation is a market concept and should be made independent of the servicer’s internal cost structure. A servicer’s level of compensation should be compared to the level of compensation demanded by current market prices (i.e., the cost to service that servicers of similar assets would assume when buying the servicing in the marketplace, plus the profit margin they would demand).

Because the determination of a servicing asset or liability is based on the compensation demanded by the marketplace to perform the servicing, a company’s actual costs to service are irrelevant in determining whether a servicing asset or liability should be recorded. An efficient servicer could end up recording a liability, even if it can profitably perform the servicing below the contractually specified fee or “adequate compensation.” Likewise, an inefficient servicer may be able to establish an asset, even though its actual cost to service may be higher.
The types of assets being serviced will impact the amount required to adequately compensate the servicer. ASC 860-50-30-7 provides an example that addresses these differences by distinguishing between the amount of effort that would be required to service a home equity loan from a credit card receivable or a small business administration loan. Some entities look to proxies, such as subservicing contracts, to help determine what adequate compensation, including a reasonable profit margin, would be for different assets being serviced.

The actual servicing costs and fees are recorded in the income statement as they are incurred or earned. Changes in the fair value of the servicing asset/liability are recorded in the income statement as they occur or through amortization. As a result, the income statement reflects the servicing contracts’ actual yield, including any efficiencies/inefficiencies in the entity’s own operations.

If a servicer is not adequately compensated by marketplace standards, a servicing liability should be recorded at fair value, even though the contractually specified fee may cover the servicing costs of that particular servicer. A contractual provision establishing the amount to be paid to a replacement servicer should not be utilized as the sole basis for determining fair value of servicing in the marketplace. However, that contractual provision would be a relevant provision for evaluating the overall fair value of the servicing contract.

If a servicer’s internal servicing costs exceed its compensation, a servicing liability should not be recorded as long as (1) the compensation represents what a substitute servicer would demand in the market, and/or (2) the servicer has the ability to sell its servicing rights to a substitute servicer, or to subcontract the servicing without incurring a loss. In these cases, the servicer’s internal servicing costs in excess of its servicing revenues should be recognized as a period cost during the term of the servicing contract. If, however, a servicer is contractually precluded from transferring its servicing rights or unable to subcontract the servicing without incurring a loss, a liability (at the time the servicing contract is entered into or assumed) equal to the unfavorable commitment for the contract’s remaining term should be recorded using a market-based cost assumption.

Question TS 6-2 discusses which standard should be applied when measuring revenue from a servicing contract.

**Question TS 6-2**

Does the recognition and measurement of revenue attributable to a servicing contract (relating to financial assets, such as residential mortgage loans) fall within the scope of ASC 606 or ASC 860?

**PwC response**

ASC 860-50 addresses when a servicer of financial assets should record a servicing asset (or obligation), and directs how a servicer should account for the asset (or liability) in subsequent periods. However, other than requiring a servicer to disclose certain information about fees earned during the reporting period that relate to servicing assets or liabilities, the guidance is silent regarding the accounting for those fees by the servicer. Similarly, the guidance does not explicitly address subservicing fees; ASC 860-50 refers only to servicing contracts and related assets/liabilities.

There is diversity in practice concerning the applicable GAAP guidance for servicing and subservicing contracts deemed to have just adequate compensation. Servicing and subservicing contracts with more or less than adequate consideration fall within the scope of ASC 860 and are thus exempted from ASC 606, *Revenue for Contracts with Customers*. Although there is diversity in practice concerning
servicing contracts with adequate compensation, revenue recognition patterns are likely similar under both standards and both standards require similar disclosures concerning amounts and significant assumptions. Entities with servicing contracts that contain incentive features and other unique revenue patterns should carefully consider the appropriate revenue recognition model.

**6.3.3 Subsequent measurement of recognized servicing rights**

ASC 860-50-35 provides guidance on the measurement attribute for servicing assets and servicing liabilities subsequent to initial recognition.

**Excerpt from ASC 860-50-35-1**

An entity shall subsequently measure each class of servicing assets and servicing liabilities using either of the following methods:

a. Amortization method. Amortize servicing assets or servicing liabilities 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), and assess servicing assets or servicing liabilities for impairment or increased obligation based on fair value at each reporting date.

b. Fair value measurement method. Measure servicing assets or servicing liabilities at fair value at each reporting date and report changes in fair value of servicing assets and servicing liabilities in earnings in the period in which the changes occur.

**Excerpt from ASC 860-50-35-1A**

A servicing asset may become a servicing liability, or vice versa, if circumstances change.

The guidance allows entities to account for servicing assets and servicing liabilities subsequent to initial measurement and recognition at either amortized cost subject to an impairment test or fair value. See TS 6.3.5 and TS 6.3.6 for additional information.

**6.3.4 Classes of servicing assets and servicing liabilities**

Different elections for subsequent measurement can be made for different classes of servicing assets or servicing liabilities. Entities must elect and apply one of the methods for each “class” of servicing assets and servicing liabilities.

ASC 860-50-35-5 requires that classes of servicing assets and servicing liabilities be identified based on one or both of the following: (a) the availability of market inputs used to determine the fair value of servicing assets or servicing liabilities and/or (b) an entity’s method for managing the risks of its servicing assets or servicing liabilities. The number of classes will affect a company’s disclosures because a number of the disclosures are required by class of servicing assets and servicing liabilities. See FSP 22.7 for information on the disclosure of servicing assets and servicing liabilities.

There is not a uniform approach mandated by GAAP for identifying classes of servicing assets or servicing liabilities. An entity may consider grouping them by the nature of the assumptions underlying the fair value of the servicing assets or servicing liabilities (e.g., prepayment and default rates). The fair value of servicing assets or servicing liabilities is generally determined using valuation models that incorporate a number of different assumptions because quoted market prices for servicing rights are generally not available.
In other cases, a company may find it more appropriate to base the grouping on its risk management strategies. The risks of servicing assets and servicing liabilities will often differ among asset types, and companies may manage those risks separately. A company may use derivative financial instruments or available-for-sale (AFS) securities to economically hedge the risks, or may not hedge the risks at all. As a result, a company’s method for defining classes may differ depending on the complexity of its risk management strategies. Factors such as the nature of the collateral, fixed or floating interest rates, commercial or consumer loans, credit quality, and tenor (which all impact customer prepayment rates) may influence how an entity manages its risk exposure and, ultimately, how it defines its classes.

If the right to service a new class of financial assets is contractually undertaken, the election of a subsequent measurement method for the new class should be documented on the date on which the company acquires that right.

6.3.5 **Fair value measurement method**

The fair value election is irrevocable and can be made at the beginning of any fiscal year. For example, if a calendar year-end company elects to subsequently account for Class A servicing assets at fair value on January 1, 20X1, the company cannot change to the amortization method in any subsequent period. However, this does not prevent the company from electing to subsequently value its Class B servicing assets at amortized cost. If the fair value election is made, changes in the fair value of servicing rights should be recognized in earnings at each reporting date.

When the fair value measurement method is elected, it is beneficial for that election to be supported by concurrent documentation or a pre-existing documented policy for automatic election. As the fair value method can be elected at the beginning of any fiscal year, “concurrent” would mean that a company documents its election at the beginning of the fiscal year in which it applies the fair value method to that specific class of servicing assets or servicing liabilities.

The fair value measurement method requires an entity to measure classes of servicing assets or servicing liabilities at fair value at each reporting date, with changes in fair value recorded in earnings in the period during which they occur. ASC 860 does not define how fair value must be measured. An entity should look to ASC 820 for guidance on how to measure the fair value of servicing assets and liabilities.

Under ASC 820, fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The basis for a fair value measurement is the market price at which a company would sell or otherwise dispose of assets or transfer liabilities (i.e., an exit price), not the market price that an entity pays to acquire assets or assume liabilities (i.e., not an entry price). ASC 820 further requires that the price used be based on the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. Refer to FV 4 for additional information.

ASC 820 requires that an entity maximize the use of observable inputs and minimize the use of unobservable inputs. Observable inputs that reflect quoted prices in active markets for identical assets or liabilities are the best evidence of fair value. Markets that provide quoted prices may include exchange, dealer, and principal-to-principal markets. Quotation and pricing services may also provide observable price quotations. However, there is no exchange market that provides both price quotations and an active market in servicing rights.
Care should be exercised when evaluating quoted prices to ensure that the prices used are representative of the servicing rights being valued. Prices can vary significantly based on the underlying characteristics of the loans. Quoted prices for newly-originated individual servicing rights on agency-conforming mortgage loans may be more readily available than quoted prices for other types of mortgage loans, which may require the use of alternative valuation methods.

The fair value of the servicing assets or liabilities should represent the difference between the benefits of servicing and adequate compensation. The initial measure for servicing may be zero if the benefits of servicing are just adequate to compensate the servicer for its responsibilities.

If quoted prices are not available, the estimate of fair value should be based on the best information available, given the circumstances. Often, in these cases, the prices of similar assets and liabilities represent the best information. If neither quoted market prices for the servicing assets or liabilities nor quoted market prices for similar servicing assets or liabilities are available, fair value should be estimated using other valuation techniques. These may include a present value of estimated future cash flows, option-pricing models, matrix pricing, option-adjusted spread models, or fundamental analysis. Regardless of the valuation technique used, the fair value of servicing assets or liabilities should represent the present value of a stream of cash flows, composed primarily of the servicing fees collected by the servicer, net of cash outflows that would be used by a market participant for performing the administrative tasks of servicing (e.g., collecting cash from borrowers, paying real estate taxes and hazard insurance, and remitting cash to third parties) and a market profit margin. It should also include all fees contractually due to the servicer (e.g., late payment fees). In determining the exact stream of cash flows that will be collected by the servicer (and, therefore, the fair value of the servicing rights), the amount and timing of cash flows are forecasted based on a number of assumptions.

The assumptions used in the model should be reasonable and supportable. All available evidence should be considered when estimating expected future cash flows. When servicing rights are valued using discounted cash flow analyses, the assumptions used in the valuation (primarily prepayment speeds, discount rate, delinquency and default rates, escrow earnings rates and the cost to service) should be consistent with the assumptions that would be used by a market participant independently evaluating the same portfolio of servicing for purchase.

In many situations, assumptions that market participants would use in computing the fair value of servicing rights are not available due to a limited number of market participants, imperfect information, or other conditions. In such cases, companies will likely need to estimate expected cash flows related to servicing activities using their own historical cash flow experience as a basis for formulating assumptions. ASC 820 allows this approach only to the extent that an entity can demonstrate that its own assumptions provide a reasonable proxy for market participant assumptions. It is also important to evaluate the nature of the cash flows that are included in the computation to ensure that they are consistent with the types of cash flows that a market participant would use to determine fair value.

For mortgage servicing rights, information regarding assumptions used can be obtained from independent servicing brokers in the market and from other sources, such as peer and industry group surveys. In addition, many mortgage servicers engage external third-party appraisers to provide estimates of fair value of their mortgage servicing rights.

Estimated future net servicing income includes estimated future cash inflows and outflows related to servicing. Estimates of cash inflows or servicing revenues should include servicing fees and other
ancillary revenue, including float and late charges. Estimates of cash outflows or servicing costs should include direct costs associated with performing the servicing function and appropriate allocations of other costs. Estimated future servicing costs should be determined on a market value basis.

Critical assumptions used to determine estimated fair value generally include servicing fee to be earned, prepayment and default rates, discount rate, cost of servicing, float income, ancillary fees, default estimates, interest income on escrow and principal and interest balances, inflation factors, and interest paid on escrows.

### 6.3.5.1 Servicing fee to be earned

The servicing fee to be earned is equal to the contractual servicing fee retained after the financial asset is sold.

The ASC Master Glossary defines contractually specified servicing fee.

**Definition from ASC Master Glossary**

Contractually Specified Servicing Fee: 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 financial asset being serviced and the rate to be paid to the beneficial owners of those financial assets.

### 6.3.5.2 Prepayment and default rates

Prepayment and default rates are used to estimate the length of the life of the servicing right and timing of the estimated cash flows. Because many factors impact prepayment activity, predicting the actual cash flows of a financial instrument can be complex. Therefore, the factors outlined in Figure TS 6-1 are typically considered when determining or assessing prepayment assumptions for mortgage loans.

**Figure TS 6-1**

Factors to consider when determining or assessing prepayment assumptions

<table>
<thead>
<tr>
<th>Consideration</th>
<th>Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current interest rates</td>
<td>Lower interest rates provide borrowers incentive to refinance.</td>
</tr>
<tr>
<td>Loan to value ratio</td>
<td>Some homeowners may, despite low interest rates, be unable to refinance their loans because they have little or no equity in their homes due to declining property values.</td>
</tr>
<tr>
<td>Regional demographics</td>
<td>Certain areas of the country have historically experienced higher prepayment rates than others. This partly stems from local demographics. For instance, a particular area may be more transient than other parts of the country.</td>
</tr>
</tbody>
</table>
In the mortgage servicing industry, two measurements of prepayment activity are commonly used: (1) the Securities Industry and Financial Markets Association’s Prepayment Speed Assumption (PSA) model and (2) Constant Prepayment Rate (CPR).

Prepayment estimates such as PSA and CPR are available from a wide variety of services, including several investment banks and information services.

Third-party prepayment models are also used to estimate prepayments. These models often provide prepayment speeds that better approximate actual prepayment activity than the static PSA or CPR prepayment rates. Entities may also use internally-developed prepayment speeds that are simply client-specific estimates of the timing of prepayments for a loan pool. More often than not, these vectors are derivatives of a standard CPR rate with either a ramp-up or ramp-down period of prepayments designed to reflect unique expected prepayment performance in a newly originated loan pool or to reflect unique current market conditions.

The objective should always be to use prepayment estimates that accurately reflect the loans that are underlying the servicing rights being evaluated, and that are representative of market participant assumptions. In cases involving pools of geographically dispersed mortgages, this measure may be based on national prepayment estimates. Estimates other than national prepayment estimates might be used in cases when an entity can demonstrate that loans differ from a geographically dispersed pool of mortgages.

6.3.5.3  **Float income**

Income is earned on balances held in trust by servicers from the date a loan payment is received from the borrower to the date funds are forwarded to investors. The benefit of this float accrues to the servicer through interest earned or a reduced cost of funds.

6.3.5.4  **Ancillary fees**

Ancillary fees are those fees that a mortgage servicer receives in addition to the contractual servicing fee. These fees typically consist of late fees, but may also include telephone payment fees, third-party promotional fees, charges for lost coupon books, as well as other fees.

6.3.5.5  **Costs of servicing**

Servicing costs represent the expenses borne by the servicer for performing functions outlined in the servicing agreement and include the costs associated with processing payments, managing delinquent and defaulting loans, and monitoring and administering escrow accounts. The costs represent the servicer’s legal obligations under the contractual agreement.

6.3.5.6  **Income/expense on escrow and trust balances**

Many mortgage bankers use escrow and principal and interest balances as compensating balances for borrowings. These balances provide interest savings and are typically considered a benefit of servicing.
In addition, several states in the US require mortgage servicers to pay interest to borrowers on amounts escrowed throughout the life of the loan, and this cost is typically considered a cost related to servicing.

### 6.3.5.7 Inflation factors and discount rate

Given the longer-dated life of typical servicing contracts, an inflation or similar factor is typically used in calculating estimated future costs of servicing.

A discount rate is a rate at which the expected cash flows are discounted to arrive at the present value of net servicing cash flows. This rate should reflect the risk profile of the servicing cash flows, consider relevant market conditions and be consistent with discount rates used by market participants in fair valuing servicing rights.

### 6.3.6 Amortization method

If an entity elects the amortization method for subsequent measurement of the servicing rights, the initial carrying value (i.e., the Day 1 fair value) is amortized over the expected period of estimated net servicing income or loss and assessed for impairment or increased obligation at each reporting date.

Servicing assets are to be amortized in proportion to, and over the period of, estimated net servicing income. Servicing liabilities are to be amortized in proportion to, and over the period of, estimated net servicing loss.

Companies often determine the amount of the servicing asset (liability) to be amortized during a given period by calculating the undiscounted net servicing income (loss) for the period, divided by the total estimated undiscounted net servicing income (loss). The resulting percentage represents the amount of the originally recorded servicing asset (liability) to be amortized during the period. This is sometimes referred to as the “expected over expected cash flow” or “proportionate to income” methodology when a given period’s amortization rate is equal to the ratio of that period’s expected net cash flow over the total expected net cash flow for the life of the servicing asset or liability. For this purpose, the same estimated undiscounted cash flows used in the fair value calculation should be used. This expected over expected cash flow methodology is only one example of an amortization method. Other methods may be appropriate.

Example TS 6-1 demonstrates the application of the amortization requirement.

**EXAMPLE TS 6-1**

**Amortization of servicing assets or servicing liabilities**

A servicer of residential mortgages has the following specifications for a portion of a loan portfolio:

- Total undiscounted net servicing income (contractual revenues less the servicer’s internal servicing costs) is estimated to be $290,000.

- The initial fair value recorded for the servicing asset is $160,000.

The undiscounted net servicing income to be received in years one through five is estimated at $23,200, $22,475, $21,750, $21,025, and $20,300, respectively. (For simplicity, only the first five
years are shown here; the total net undiscounted income of $290,000 includes all years comprising the weighted-average term of the loan pool.)

What amortization amounts should be recorded in years one through five?

Analysis

The following table shows the amortization amounts the servicer should record in years one through five.

<table>
<thead>
<tr>
<th>Year</th>
<th>Servicing asset carrying value</th>
<th>Cumulative amortization percentage (A) = (D) / $290K</th>
<th>Cumulative amortization expense (B) = (A) * $160K</th>
<th>Current period amortization expense (C) = current year (B) – prior year (B)</th>
<th>Net servicing income per year* (D)</th>
<th>Cumulative net servicing income* (E)</th>
<th>Total estimated net servicing income* (F)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$160,000</td>
<td>8.00%</td>
<td>$12,800</td>
<td>$12,800</td>
<td>$23,200</td>
<td>$23,200</td>
<td>$290,000</td>
</tr>
<tr>
<td>2</td>
<td>147,200</td>
<td>15.75%</td>
<td>25,200</td>
<td>12,400</td>
<td>22,475</td>
<td>45,675</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>122,800</td>
<td>23.25%</td>
<td>37,200</td>
<td>12,000</td>
<td>21,750</td>
<td>67,425</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>111,200</td>
<td>30.50%</td>
<td>48,800</td>
<td>11,600</td>
<td>21,025</td>
<td>88,450</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>100,000</td>
<td>37.50%</td>
<td>60,000</td>
<td>11,200</td>
<td>20,300</td>
<td>108,750</td>
<td></td>
</tr>
</tbody>
</table>

* Amounts are undiscounted

The estimates of undiscounted cash flows should be updated for actual experience at each valuation date.

6.3.6.1 Assessing servicing assets and liabilities for impairment

If an entity elects the amortization method, it must evaluate and measure impairment for each class of recognized servicing assets. Similarly, an entity must evaluate each class of recognized servicing liabilities for an increase in the servicing obligation.

Stratification of classes of servicing assets and liabilities

ASC 860 requires that servicing assets subsequently measured using the amortization method be evaluated for impairment based on a stratification of the predominant risk characteristics of the underlying financial assets, which may include interest rates, type of asset, term, origination date, and geographic location. ASC 860 does not require that the most predominant risk characteristic or more than one predominant risk characteristic be used to stratify the servicing assets for purposes of evaluating and measuring impairment.

A servicer must exercise judgment when determining how to stratify servicing assets (i.e., when selecting the most appropriate characteristic(s) for stratification). While the guidance is not prescriptive, historically, servicers have often used interest rates as a predominant risk characteristic to stratify servicing assets and liabilities.
In addition, as discussed in ASC 860-50-35-14, once an entity determines the predominant risk characteristics it will use in identifying strataums, that decision should be applied consistently unless significant changes in economic facts and circumstances clearly indicate a change is warranted. Any change should be accounted for prospectively as a change in accounting estimate under ASC 250, Accounting Changes and Error Corrections.

An entity may use different stratification criteria for the purposes of ASC 860 impairment testing and for the purposes of grouping similar assets to be designated as a hedged portfolio in a fair value hedge under ASC 815.

**Measurement of impairment or increased obligation**

Impairment should be recognized through the use of a valuation allowance for each individual stratum for the amount by which the amortized cost of the servicing asset exceeds fair value for that stratum. The fair value of servicing assets that have not been recognized are not used in the evaluation of impairment. Subsequent increases in fair value can be recorded by reducing the valuation allowance up to an amount that results in the servicing asset being carried at its remaining amortized cost. Therefore, although subsequent increases in fair value can be recognized by reducing the valuation allowance, such adjustments are limited to the remaining amortized cost of the asset.

The carrying value of a servicing liability should be evaluated subsequently for increases in the fair value of the servicing liability. If there is an increase in the fair value of a stratum of servicing liabilities, the servicer should revise its earlier estimates and recognize the increased obligation and a charge to earnings. Subsequently, reductions in the fair value of the servicing liability can be recognized in earnings to the extent of previously recorded charges to earnings.

Example TS 6-2 demonstrates the application of the impairment requirement when applying the amortization method for subsequent measurement.

**EXAMPLE TS 6-2**

**Analysis of measurement of servicing assets**

Servicer Corp elected the amortization method to subsequently measure its Class A servicing assets. Servicer Corp determined that the Class A servicing assets contained two strataums with the following characteristics as of 12/31/x9.

- Stratum A has an amortized carrying value of $22,019,877 and a fair value of $21,641,291.
- Stratum B has an amortized carrying value of $18,038,444 and a fair value of $18,987,622.

What is the impairment amount that Servicer Corp should record as of 12/31/x9?

**Analysis**

Servicer Corp should record an impairment on Stratum A of $378,586 (the excess of the fair value over the amortized carrying value). No impairment should be recorded on Stratum B as the fair value exceeded the carrying value as of 12/31/x9. An entity is not permitted to net stratum with a fair value in excess of amortized carrying value against stratum with a fair value that is below the amortized carrying value.
6.3.7 Distinguishing servicing assets from interest-only strips

ASC 860 requires separate accounting for rights to future income that exceed contractually specified servicing fees. These rights are not considered servicing assets; they are interest-only (IO) strips. Interest spreads in addition to a contractual servicing fee should be evaluated to determine whether a separate IO strip should be recorded.

An IO strip should be assessed to determine whether it should be accounted for as a derivative in its entirety or contains an embedded derivative under the guidance in ASC 815 (see DH 3.2.12 for additional information). If not, ASC 860-20-35-2 specifies that such assets should be measured like investments in debt securities classified as available-for-sale or trading under ASC 320. Given the prepayment exposure, an investor typically would not recover substantially all of its recorded investment and therefore the impairment and income recognition provisions of ASC 325-40 would apply.

Absent a contractually specified servicing fee, if the servicer would lose the entire difference between the rate received and the rate passed through to the investor upon termination or transfer of the servicing contract, the entire interest spread represents the contractually specified servicing fee. Otherwise, the contractually specified servicing fee represents only the fee that would be forfeit by the servicer if the servicing contract were terminated.

If the servicer were to determine that it has no servicing fee (i.e., that no interest spread would be lost upon termination or transfer of the servicing contract, and that there is no contractually specified servicing fee), then the right to receive the interest spread should be treated as an IO strip and the obligation to service should be evaluated as a servicing liability. Question TS 6-3 and Question TS 6-4 address how this guidance should be applied.

Question TS 6-3

Can an entity bifurcate the servicing fee it receives under a servicing contract into a base servicing fee and interest only strip?

PwC response

It depends. An entity should account separately for rights to future interest income from the serviced assets that exceed the contractually specified servicing fees. Under ASC 860-50-25-7, whether a right to future interest income from serviced assets should be accounted for as an interest only strip, a servicing asset, or a combination thereof, depends on whether a servicer would continue to receive that amount if a substitute servicer began to service the assets.

Therefore, an entity will need to determine whether it would continue to receive a portion of the right to future interest income from the serviced assets if servicing was shifted to another servicer. This will often require a legal interpretation of the servicing contract and how the contractually specified servicing fee is defined.

If it is determined that the entire right to future interest income from serviced assets would shift to another servicer, then the total amount received would be considered the contractually specified servicing fee and the entity would not be able to bifurcate the fees received into a servicing asset and an interest only strip.
Question TS 6-4

Bank Corp originated a portfolio of mortgage loans and transferred them in their entirety to a third party in a transfer that is accounted for as a sale. As part of the transaction, Bank Corp undertakes an obligation to service the loans. After the transfer, Bank Corp enters into a subservicing agreement with a third party.

Bank Corp's benefit from servicing exceeds its obligation under the servicing contract. Can Bank Corp account for the difference between the servicing fees it is receiving and the subservicing fees it is paying to the subservicer as an interest only strip?

PwC response

No. ASC 860-50-55-11 is explicit that in such cases, the transferor should account for the two transactions separately. Although theoretically the difference between the contractual fees to be received and to be paid might equal a fixed percentage of principal, the transactions are with different parties and should be accounted for separately. First, the transferor should account for the transfer of mortgage loans in accordance with the guidance in ASC 860-20 on transfers that qualify for sale accounting. The obligation to service the loans should be initially recognized and measured at fair value. Second, the transferor should account for the subcontract with the subservicer by recognizing the expenses as the services are provided.

For agency loan sales (e.g., FNMA, FHLMC, GNMA), the interest spread exceeding contractually specified servicing fees (excess servicing), should be treated as part of the mortgage servicing right. The seller can generally control the amount of excess servicing created in agency loan sales by buying up or down the standard guarantee fee and as a result, this excess servicing fee is part of the contractual arrangement with the agencies and is specifically related to the servicing function. An agency excess IO market has developed where the excess is split and becomes a separately traded CUSIP instrument. For non-agency loan sales and securitizations, the servicing fee to be earned is limited to the amount contractually stated in the loan sale contract (i.e., the seller cannot control the amount of excess by buying up or down the guarantee fee). Any cash flows retained in excess of the contractual servicing fee specifically stated in the loan sale contract are considered part of the transferor’s interests and must be accounted for in accordance with the guidance in ASC 860-20-35-2.

Example TS 6-3 illustrates the application of ASC 860 to servicing obtained on transferred financial assets.

EXAMPLE TS 6-3

Application of ASC 860 to servicing obtained on transferred financial assets

Bank Corp is in the business of originating, securitizing, and selling residential mortgages. From time to time, depending on market conditions and its investment strategy, Bank Corp will sell certain loans it originated.

Bank Corp is evaluating several securitization structures for a $100 million pool of residential mortgages for sale in the secondary market as shown in the following table.
1 No servicing asset or liability is recorded as the servicer is just adequately compensated.
2 A servicing liability is recorded as the contract’s fair value is negative due to contractually specified servicing fee of zero.
3 The gain in Scenario 3 is lower as the servicing contract with just adequate compensation is not separately recorded. The revenue from this contract would be reflected over time.

Assuming the requirements for sale accounting are met, how would Bank Corp record its (1) sale of the securitized mortgage loans, (2) servicing asset or liability, (3) interest only strip, and (4) recourse and put obligations under each scenario?

**Analysis**

**Scenario 1**

Bank Corp would record the following entry under scenario 1.

- **Dr. Cash** $100,000
- **Dr. Servicing asset** $2,700
- **Cr. Loans** $100,000
- **Cr. Recourse obligation** $65
- **Cr. Put option** $35
- **Cr. Gain on sale of loans** $2,600

---

**Terms of securitization:**

<table>
<thead>
<tr>
<th></th>
<th>Scenario 1</th>
<th>Scenario 2</th>
<th>Scenario 3</th>
<th>Scenario 4</th>
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</thead>
<tbody>
<tr>
<td>Securitized loan balance</td>
<td>$100,000</td>
<td>$100,000</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Weighted average fixed coupon</td>
<td>4.00%</td>
<td>4.00%</td>
<td>4.00%</td>
<td>4.00%</td>
</tr>
<tr>
<td>Securitization-related interests</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Contractually specified servicing fee</td>
<td>1.00%</td>
<td>0.50%</td>
<td>0.15%</td>
<td>-</td>
</tr>
<tr>
<td>Interest-only strip</td>
<td>-</td>
<td>0.50%</td>
<td>0.85%</td>
<td>0.50%</td>
</tr>
<tr>
<td>Interest rate to Investor Corp</td>
<td>3.00%</td>
<td>3.00%</td>
<td>3.00%</td>
<td>3.50%</td>
</tr>
<tr>
<td>Total interest spread</td>
<td>4.00%</td>
<td>4.00%</td>
<td>4.00%</td>
<td>4.00%</td>
</tr>
<tr>
<td>Market compensation to service</td>
<td>0.15%</td>
<td>0.15%</td>
<td>0.15%</td>
<td>0.15%</td>
</tr>
</tbody>
</table>

**Produce:**

<table>
<thead>
<tr>
<th></th>
<th>Scenario 1</th>
<th>Scenario 2</th>
<th>Scenario 3</th>
<th>Scenario 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash proceeds</td>
<td>$100,000</td>
<td>$100,000</td>
<td>$100,000</td>
<td>$101,500</td>
</tr>
<tr>
<td>Servicing asset/(liability) - at fair value</td>
<td>2,700</td>
<td>1,200</td>
<td>-</td>
<td>(300)2</td>
</tr>
<tr>
<td>Interest-only strip - at fair value</td>
<td>-</td>
<td>1,500</td>
<td>2,550</td>
<td>1,500</td>
</tr>
<tr>
<td>Total proceeds</td>
<td>$102,700</td>
<td>$102,700</td>
<td>$102,550</td>
<td>$102,700</td>
</tr>
</tbody>
</table>

**Analysis of gain on transfer:**

<table>
<thead>
<tr>
<th></th>
<th>Scenario 1</th>
<th>Scenario 2</th>
<th>Scenario 3</th>
<th>Scenario 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total proceeds received</td>
<td>$102,700</td>
<td>$102,700</td>
<td>$102,550</td>
<td>$102,700</td>
</tr>
<tr>
<td>Carrying amount of loans transferred</td>
<td>(100,000)</td>
<td>(100,000)</td>
<td>(100,000)</td>
<td>(100,000)</td>
</tr>
<tr>
<td>Recourse obligation - at fair value</td>
<td>(65)</td>
<td>(65)</td>
<td>(65)</td>
<td>(65)</td>
</tr>
<tr>
<td>Put obligation - at fair value</td>
<td>(35)</td>
<td>(35)</td>
<td>(35)</td>
<td>(35)</td>
</tr>
<tr>
<td>Total gain/(loss)</td>
<td>$(2,600)</td>
<td>$(2,600)</td>
<td>$(2,450)2</td>
<td>$(2,600)</td>
</tr>
</tbody>
</table>
**Scenario 2**

Bank Corp would record the following entry under scenario 2.

- Dr. Cash $100,000
- Dr. Servicing asset $1,200
- Dr. Interest only strip $1,500
- Cr. Loans $100,000
- Cr. Recourse obligation $65
- Cr. Put option $35
- Cr. Gain on sale of loans $2,600

**Scenario 3**

Bank Corp would record the following entry under scenario 3.

- Dr. Cash $100,000
- Dr. Interest only strip $2,550
- Cr. Loans $100,000
- Cr. Recourse obligation $65
- Cr. Put option $35
- Cr. Gain on sale of loans $2,450

**Scenario 4**

Bank Corp would record the following entry under scenario 4.

- Dr. Cash $101,500
- Dr. Interest only strip $1,500
- Cr. Loans $100,000
- Cr. Recourse obligation $65
- Cr. Put option $35
- Cr. Servicing liability $300
- Cr. Gain on sale of loans $2,600

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**6.3.8 Hedging considerations**

Companies may hedge the interest rate and prepayment risks associated with servicing rights using derivative financial instruments and investment securities. Instruments typically used to hedge
Servicing of financial assets

Servicing rights include interest rate floors, caps, swaps and swaptions, agency mortgage-backed securities forward contracts, Treasury and Eurodollar futures contracts, and options on futures contracts.

ASC 815 requires that all derivatives be recognized as assets or liabilities on the statement of financial position and measured at fair value. Under the amortization method, the related servicing assets and liabilities need to be recognized at the lower of amortized cost and market value. Income statement volatility exists when the fair value changes in the derivatives are recognized in earnings while only adverse changes in the fair value of the servicing assets or servicing liabilities are recognized.

As a result, entities might consider applying ASC 815 hedge accounting provisions to hedge the fair value of their servicing rights accounted for under the amortization method. However, the application of hedge accounting under ASC 815 is complex. That is why ASC 860 allows servicing assets and liabilities to be subsequently recognized at fair value under the fair value measurement method. This method reduces income statement volatility and the difficulty of achieving hedge accounting for such transactions.

6.4 Accounting for the sale of servicing rights

Since servicing assets and liabilities are not considered financial assets and liabilities (see FV 6.4), their derecognition model differs from the model applied to financial assets and liabilities. In accordance with the guidance in ASC 860-50-40, a transfer of servicing rights related to loans previously sold and to transfers of servicing rights relating to loans that are retained by the transferor qualifies as a sale at the date on which title passes, if the following two conditions are met:

- Substantially all risks and rewards of ownership have irrevocably passed to the transferee
- Any protection provisions retained by the transferor are minor and can be reasonably estimated

If a sale is recognized and minor protection provisions exist, a liability should be accrued for the estimated obligation associated with those provisions.

The transferor retains only minor protection provisions if (a) the obligation associated with those provisions is estimated to be no more than 10% of the sales price and (b) risk of prepayment is retained by the transferor for no more than 120 days. ASC 860-50-40 also notes that a temporary subservicing agreement in which the transferor subservices the loans for a short period of time (generally found in sales of servicing rights) would not necessarily preclude recognition of a sale at the closing date.

Additionally, ASC 860-50-40 establishes certain other criteria that should be considered when determining whether the transfer of servicing rights qualifies as a sale:

- Whether the transferor has received written approval from the investor, if required
- Whether the transferee is a currently approved seller/servicer and is not at risk of losing approved status
- For a sale in which the transferor finances a portion of the sale price, whether an adequate non-refundable down payment has been received (necessary to demonstrate the buyer’s commitment to pay the remaining sales price) and whether the note receivable from the transferee provides full
recourse to the buyer. Nonrecourse notes or notes with limited recourse do not satisfy this criterion.

- Whether temporary servicing performed by the transferor for a short time are compensated in accordance with a subservicing agreement that provides adequate compensation

In general, three to six months may elapse between the time a company enters into a contract to sell servicing rights and the time the loan portfolio to be serviced is actually delivered. These delays may result from the purchaser’s inability to accept immediate delivery, the seller’s inability to immediately transfer the servicing records and loan files, difficulties in obtaining necessary investor approval, requirements to give advance notification to mortgagors, or other planning considerations. Question TS 6-5 discusses the unit of account for the derecognition assessment.

**Question TS 6-5**
What unit of account should be considered when applying the derecognition guidance in ASC 860-50-40?

**PwC response**
ASC 860-50-20 defines servicing assets and servicing liabilities as contracts to service financial assets. Therefore, we believe the derecognition guidance outlined in ASC 860-50-40 should be applied at the servicing contract level. A servicing asset is created when the benefits of servicing, under a contract to service financial assets, is expected to more than adequately compensate the servicer for performing the servicing. Similarly, a servicing liability is created when the estimated future revenues from contractually specified servicing fees, late charges, and other ancillary revenues, under a contract to service financial assets, are not expected to adequately compensate the servicer. Since servicing assets and liabilities are created at the contract level, they should be analyzed for derecognition at the servicing contract level.

**6.4.1 Sale of mortgage servicing rights with a subservicing agreement**

ASC 860-50-40 provides guidance on accounting for the transfer of mortgage servicing rights to an unrelated entity at a gain and the parties also enter into an agreement that requires the transferor to continue to perform the loan servicing for a fixed-dollar amount per loan (a subservicing agreement). The guidance provides that if the significant risks and rewards of ownership related to the mortgage servicing rights are transferred to the transferee, the servicing rights have been sold and should be derecognized, but the gain on the transaction should be deferred. Refer to ASC 860-50-40-8 and ASC 860-50-40-9 for factors that should be considered in determining if all the risks and rewards have been transferred. If the servicing of mortgage loans is expected to result in a loss, that loss should be recognized currently.

**6.4.2 Sales of mortgage servicing rights for an income stream**

ASC 860-50-40 states that gain recognition on the sale of the right to service mortgage loans owned by other parties is appropriate at the sale date. If the sales price is based on a participation in future payments, calculation of the gain on sale can be difficult given the uncertainty associated with the future payments and the impact on the sale price. In these fact patterns, the amount of the gain recognized should be based on all available information, including the amount of gain that would be recognized if the servicing rights were sold outright for a fixed cash price.