



FINANCIAL INSTITUTIONS

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ACCOUNTING FOR TRANSFERS OF FINANCIAL ASSETS

FAS No. 166, *Accounting for Transfers of Financial Assets*, is effective for transfers of financial assets (e.g., loans) that occur after the beginning of an entity's first annual reporting period beginning after November 15, 2009 (transfers on or after January 1, 2010, for calendar-year entities). FAS No. 166 can be found in its entirety at www.fasb.org under "Pre-Codification Standards" in the Standards menu.

In June 2009, the Financial Accounting Standards Board (FASB) issued a new accounting standard (Financial Accounting Standard No. 166) that amends previous guidance on accounting for transfers of financial assets. This standard is effective as of the beginning of an entity's first annual reporting period beginning after November 15, 2009 (for calendar-year entities, it will be effective January 1, 2010).

This new standard will change current accounting practices in two very significant ways:

- The concept of a qualifying special-purpose entity (QSPE) and the exception from applying the accounting guidance on consolidation of variable interest entities to QSPEs is now removed from accounting standards.
- If an entity transfers a portion of a financial asset rather than the entire financial asset, the standard will limit when the transfer will qualify as a sale and consequently when the institution will be able to remove the asset from its financial statements and recognize any gain or loss on sale.

ELIMINATION OF THE QUALIFYING SPECIAL-PURPOSE ENTITY

Prior to this new guidance, institutions could set up a QSPE, transfer assets to this entity, and automatically disregard this entity when preparing consolidated financial statements, thereby removing the assets from the institution's balance sheet. A common example of this occurs when loans are securitized. The institution will transfer the loans to a QSPE and issue securities that are collateralized by the loans in the QSPE. Since the loans are removed from the institution's balance sheet, the institution has renewed capacity to originate or purchase additional loans.

After adoption of this new standard, such institutions will have to consider the consolidation requirements of variable interest entities to determine whether a QSPE can be disregarded or must be included in the institution's consolidated financial statements.

While there are several important issues that will impact institutions with QSPEs, this Accounting Insight will not address these issues. Instead, this Accounting Insight focuses on the impact to institutions that transfer a portion of a financial asset through loan participations sold.

PARTICIPATIONS SOLD

When an institution transfers an entire financial asset (for example, the sale of a fixed-rate mortgage loan to the secondary market), the institution can treat this transfer as a sale and remove the asset from its own balance sheet if and only if the following conditions are met (ASC 860-10-40-5, as amended):

- The transferred financial asset is isolated from the selling institution – that is, put presumptively beyond the reach of the selling institution and its creditors, even in bankruptcy or other receivership.
- Each transferee has the right to pledge or exchange the assets it received.
- The selling institution does not maintain effective control over the transferred financial asset.

These requirements remain largely unchanged from previous accounting guidance.

However, the new accounting guidance may significantly impact institutions that transfer a portion of a financial asset. A common example of this occurs when an institution sells a participation in a loan (“participation sold”). Participations sold may include a variety of terms, but in its simplest form, an institution will sell a specific percent of a loan originated by the institution to a third party. As the borrower makes payments on the original loan, the institution remits a pro rata amount of each payment less a servicing fee to the third party.

When an institution does not sell an entire financial asset, as is the case with a participation sold, it must meet the above requirements and the additional criteria of a “participating interest” to be treated as a sale. A participating interest has all of the following characteristics:

- From the date of the transfer, the sold portion represents a proportionate (pro rata) ownership interest in an entire financial asset.
- From the date of the transfer, all cash flows received from the entire financial asset are divided proportionately among the participating interest holders in an amount equal to their share of ownership.
- The rights of each participating interest holder (including the selling institution in its role as a participating interest holder) have the same priority, and no participating interest holder’s interest is subordinated to the interest of another participating interest holder.
 - As part of this requirement, participating interest holders have no recourse to the selling institution or to each other (normal servicing arrangements do not violate this requirement).
- 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.

SALES VERSUS SECURED BORROWING TRANSACTIONS

If sale treatment is permitted for a transfer of financial assets, such as a participation sold, the institution benefits by being able to reduce its loans for the portion of the loan sold and to recognize any applicable gain on sale at the time of the transfer.

If a transfer of a financial asset does not qualify for sale treatment, the transferring institution continues to recognize the asset on its own balance sheet, records a secured borrowing (liability) with a pledge of collateral, and is not permitted to recognize any gain on sale. Accounting Standards Codification (ASC) 860-30 includes accounting guidance on how the transferor and transferee should account for a secured borrowing.

A secured borrowing transaction has less favorable regulatory treatment than a sale, too. If sale treatment is allowed, the participation sold is removed from the loan portfolio, which has the effect of improving regulatory capital ratios. Since the institution continues to recognize the entire loan as an asset in a secured borrowing transaction, such transactions do not improve regulatory capital ratios. In addition, if sale treatment is not allowed for a participation sold and the loan balance is not reduced, the institution cannot use the participation sold to reduce large loan balances below the institution's legal lending limit.

PROBLEM TERMS IN PARTICIPATION SOLD AGREEMENTS

The new guidance will be effective for participations sold and other transfers of financial assets that occur after the institution is required to adopt the guidance. Thus, institutions will not have to evaluate participations sold currently in effect, although they will have to evaluate the arrangements if they are renewed or modified after the effective date of the accounting standard.

Although not a complete list, the following are some common scenarios that will likely disqualify an institution from using sale treatment:

- **Line of credit participation** – Some institutions have participated interests in lines of credit or other loans whereby the selling institution funds draws up to a certain dollar amount (often their legal lending limit) and participates the remaining draws as they are made. Wipfli believes this is permitted under the standard as long as the selling institution and participants can express their ownership interest as a percent of the entire loan and any cash flows received from the borrower are distributed to all of the participants (including the selling institution) in a pro rata manner according to each institution's ownership interest. The ownership percent held by each institution can change over time as new draws are made by the borrower or new transfers are made to participants. However, with each new draw or transfer, the percentage of ownership interest held by each institution must be appropriately updated, and cash flows received from the borrower must continue to be remitted proportionately based on each participant's new ownership percent. If, for example, the arrangement calls for principal payments to be paid to the participants first without regard to their ownership percent, this would disqualify the participation sold from sale treatment.

Important Considerations: Based on discussions Wipfli has had with the FDIC, it does not appear they believe this arrangement will qualify for sale treatment unless all of the draws are also funded in a pro rata manner by all of the participants. If there is a question about whether a loan participation will qualify as a sale, the institution should discuss the arrangement with its primary regulator.

The OCC and some state regulators (including the Wisconsin Department of Financial Institutions) may be revisiting legal lending rules to permit institutions with traditional loan participations to reduce loan balances for legal lending purposes even though they do not qualify as sales for accounting purposes.

PROBLEM TERMS IN PARTICIPATION SOLD AGREEMENTS (CONTINUED)

- **Last in, first out and similar arrangements** – In some participation sold agreements, all of the first payments from the borrower are passed along to the participating interest holders, and the selling institution receives the remaining payments after the participants have been paid off. This results in disproportionate cash flows and disallows the use of sale treatment. The arrangement could qualify for sale treatment if, instead, it required all payments received by the selling institution to be divided equally among the participating interest holders, including the selling institution.
- **Excessive servicing fees** – Some institutions retain a fee for servicing the loan that is significantly higher than the fee that would fairly compensate the institution for its servicing obligation. This also results in a disproportionate division of cash flows among the participating interest holders. To qualify as a sale, the selling institution could modify the arrangement so that it retains a servicing fee that fairly compensates it for servicing the loan.
- **Interest-only strips** – In some cases, the contractual interest rate of the loan exceeds the market rate at the time of transfer. This is especially common with sales of the guaranteed portion of SBA loans. The agreement generally allows the selling institution to pass along the market interest rate to the participating interest holders and retain the excess interest, which usually results in the recognition of an interest-only strip and disqualifies sale treatment. The institution may qualify for sale treatment if it charged a premium to the participating interest holders at the transfer date to compensate for the above-market interest and then remitted the full contractual interest amounts (less applicable servicing fees) to the participants as they are received from the borrower.
- **Recourse obligations** – Most recourse provisions will disqualify the use of sale treatment for participations sold. Examples of recourse obligations include an agreement that the selling institution will repurchase loans that default within 90 days of sale or refund any premium paid by the participating interest holder if the loan is prepaid within a defined time frame. If the recourse provision expires, the institution can reevaluate the participation agreement to determine if it subsequently meets the participating interest criteria.

CONCLUDING THOUGHTS

This guidance applies to all transfers that occur on or after the beginning of an entity's first annual reporting period beginning after November 15, 2009 (January 1, 2010, for calendar-year entities). The standard does not impact loan participations sold prior to this date where the only activity related to the participation is the remittance of payments. However, this standard will affect new draws on lines of credit that are participated out since these are considered new transfers. In addition, it appears this standard will affect loan participation renewals and extensions occurring after the effective date. We recommend management become familiar with this new guidance and train those that work directly with loan participations sold to identify terms of participation agreements that could disqualify the institution from using sale treatment.

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