

Statutory Issue Paper No. 45

Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements

STATUS

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Current Authoritative Guidance for Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements: SSAP No. 103R

This issue paper may not be directly related to the current authoritative statement.

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Type of Issue:

Common Area

SUMMARY OF ISSUE

1. The Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies contain guidance on accounting for bonds sold subject to reverse repurchase agreements and dollar repurchase agreements.
2. The purpose of this issue paper is to establish statutory accounting principles for repurchase and reverse repurchase agreements, including dollar repurchase and dollar reverse repurchase agreements, that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. Repurchase agreements, reverse repurchase agreements and dollar repurchase agreements meet the definition of assets as defined in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this issue paper.

Repurchase Agreements

4. Repurchase agreements shall be defined as agreements under which a reporting entity purchases securities and simultaneously agrees to resell the same or substantially the same securities at a stated price on a specified date within 12 months of the purchase. For securities to be substantially the same, the criteria set forth in paragraph 23 must be met, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.
5. Repurchase agreements shall be accounted for as collateralized lendings. The underlying securities shall not be accounted for as investments owned by the reporting entity. The amount paid for the securities shall be reported as a short-term investment, and the difference between the amount paid and the amount at which the securities will be subsequently resold shall be reported as interest income calculated on a straight-line basis or scientific interest (constant yield) basis over the term of the agreement.
6. Reporting entities generally take possession of the underlying collateral under repurchase agreements and in many cases may obtain additional collateral when the estimated fair value of such securities falls below their current contract value. However, to the extent that the current fair value of the

collateral is less than the recorded amount, the shortfall shall be used to reduce the admitted asset value of the repurchase agreement.

Reverse Repurchase Agreements

7. Reverse repurchase agreements shall be defined as agreements under which a reporting entity sells securities and simultaneously agrees to repurchase the same or substantially the same securities at a stated price on a specified date within 12 months of the sale date. For securities to be substantially the same, the criteria set forth in paragraph 23 must be met, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.

8. Reverse repurchase agreements shall be accounted for as collateralized borrowings (financing transactions). The underlying securities shall continue to be accounted for as an investment by the reporting entity. The proceeds from the sale of the securities shall be recorded as a liability, and the difference between the proceeds and the amount at which the securities will be subsequently reacquired shall be reported as interest expense on a straight-line basis or computed using the scientific (constant yield) interest method over the term of the agreement. Although recording these transactions gross tends to inflate assets and liabilities, it more closely reflects the financing nature of these transactions and their associated leverage impact to the financial statements.

Dollar Repurchase Agreements

9. Dollar repurchase and dollar reverse repurchase agreements shall be defined as repurchase and reverse repurchase agreements involving debt instruments that are pay-through securities collateralized with Government National Mortgage Association (GNMA), Federal Home Loan Mortgage Corporation (FHLMC) and Federal National Mortgage Association (FNMA) collateral, and pass-through certificates sponsored by GNMA, mortgage participation certificates issued by the FHLMC or similar securities issued by the FNMA. Dollar repurchase agreements are also commonly referred to as dollar roll transactions. To meet the definition of dollar repurchase and dollar reverse repurchase agreements, the securities underlying the agreements must meet the criteria set forth in paragraph 23, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.

10. For the seller in a dollar reverse repurchase agreement, a liability is recorded for the amount of proceeds of the sale and the sold mortgage-backed securities are not removed from the accounting records. During the period of the agreement, interest income is recorded as if the mortgage-backed security had been held during the term of the agreement. This is offset by an equal amount of interest expense related to the proceeds received from the sale. Additional interest expense is recorded representing the difference between the sales price and the repurchase price of the mortgage-backed securities sold.

11. When the mortgage-backed securities are repurchased under the agreement, the original mortgage-backed securities sold are removed from the accounting records and the purchased mortgage-backed securities are recorded. The principal amount of the mortgage-backed securities repurchased must be in good delivery form.

12. If the principal amount repurchased is greater than the amount sold, the cash paid is recorded as an additional investment in the newly acquired certificates. If the principal amount repurchased is less than the amount sold, a gain or loss relating to the original certificates held is recorded.

13. For the purchaser in a dollar repurchase agreement, an asset is recorded for the amount of the purchase. Since the term of the agreement is limited to twelve months, it is accounted for as a short-term investment. Upon completion of the reverse repurchase agreement, cash is received in exchange for a

“substantially the same” security. The difference between the purchase and reselling price represents interest income for the lending of short-term funds.

Separate Transactions

14. Agreements to repurchase and resell securities that do not meet the definitions in paragraph 4, 7, or 9 of this issue paper shall be accounted for as two separate transactions, that is, as a sale and purchase or as a purchase and sale, in accordance with the relevant statutory accounting guidance. For example, sales of bonds would result in recognition of realized gains or losses.

Offsetting

15. Reporting entities may operate on both sides of the repurchase agreement market resulting in recording of liabilities and assets representing repurchase and reverse repurchase agreements, respectively. Reporting entities shall offset such liabilities and assets only to the extent that one of the following occurs:

- a. A legal right of offset exists as defined in *Issue Paper No. 76—Offsetting and Netting of Assets and Liabilities* (Issue Paper No. 76), or
- b. The securities have the same settlement date, are executed with the same counterparty in accordance with a master netting arrangement, involve securities that exist in “book entry” form, and settle on securities transfer systems that have the same key elements and operating characteristics as the Fedwire Securities Transfer System (Fedwire system).

Otherwise, separate assets and liabilities shall be recognized.

Disclosures

16. The following disclosures shall be made in the notes to the financial statements.

- a. If the reporting entity has entered into repurchase agreements, its policy for requiring collateral or other security.
- b. A description of the securities underlying the agreements, including book values and fair values, maturities, and weighted average interest rates for the following categories: (a) securities subject to reverse repurchase agreements, (b) securities subject to repurchase agreements, (c) securities subject to dollar repurchase agreements, and (d) securities subject to reverse dollar repurchase agreements.
- c. A description of the terms of reverse repurchase agreements whose amounts are included in borrowed money.

DISCUSSION

17. The conclusion above adopts current statutory guidance for repurchase agreements, reverse repurchase agreements, and dollar repurchase and reverse repurchase agreements, with a modification to the definition of substantially the same security in the case of mortgage backed securities to be consistent with the “good delivery” standard in *AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position* (SOP 90-3). The disclosure requirements are consistent with information requested in the general interrogatories section of the annual statement and have been expanded to include disclosure of the reporting entity’s policy for requiring collateral or other security.

18. The conclusion above is consistent with GAAP, and, accordingly, adopts SOP 90-3 and *FASB Emerging Issues Task Force No. 84-20, GNMA Dollar Rolls*. Furthermore, the conclusion in this issue

paper is consistent with the *FASB Interpretation No. 39, Offsetting of Amounts Related to Certain Contracts—an interpretation of APB Opinion No. 10 and FASB Statement No. 105* (as it relates to reverse repurchase and repurchase agreements) and *FASB Interpretation No. 41, Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements—an interpretation of APB No. 10 and a modification of FASB Interpretation No. 39*. FIN 39 and FIN 41 are adopted in Issue Paper 76.

19. This issue paper also adopts paragraphs 9-13, 15-17, 23-25, 27-30 and 66-71 of FAS 125 as they relate to repurchase agreements, reverse repurchase agreements and dollar repurchase agreements. Paragraph 14 is rejected as it relates to the classifications of securities under FAS 115. FAS 115 was rejected in *Issue Paper No. 26—Bonds, Excluding Loan-Backed and Structured Securities*.

20. The statutory accounting principles outlined in the conclusion above are consistent with the conservatism concept in the Statement of Concepts in that repurchase agreements are reduced by the amounts of any collateral shortfalls. The guidance also prohibits the recognition of gains on sales of securities when there is an agreement to repurchase.

Drafting Notes/Comments

- AVR/IMR is addressed in *Issue Paper No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

21. Chapter 1 in the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies contain the following guidance relating to repurchase agreements and dollar repurchase agreements:

When a bond is sold and an equivalent security (a security of the same issuer having equal principal value, coupon rate, and maturity date) is to be repurchased pursuant to the terms of the reverse repurchase agreement, the transaction is accounted for as a financing (borrowing) transaction. A liability is recorded for the amount of the proceeds of the sale and the sold securities are not removed from the accounting records. The differential in the selling price and the repurchased price is recorded as interest expense and not netted against interest income. Amortization of original premium or accrual of original discount and interest income on the sold securities are recorded as though the securities had not been sold.

When a bond is sold and a security which is not an equivalent security is to be repurchased pursuant to a reverse repurchase agreement, the transaction is to be accounted for as two separate transactions. The sold security, including unamortized original premium for or unaccrued original discount, is to be removed from the accounting records and the resulting gain or loss recognized immediately. When the non-equivalent security is acquired pursuant to the reverse repurchase agreement, it is recorded at cost.

Dollar Repurchase Agreements

A dollar repurchase agreement is an agreement (contract) to sell and repurchase pass-through certificates sponsored by the Government National Mortgage Association (GNMA), mortgage participation certificates issued by the Federal Home Loan Mortgage Corporation (FHLMC) or similar securities issued by the Federal National Mortgage Association (FNMA). These instruments are generally referred to as mortgage-backed securities. These contracts do not fall under the definition of equivalent securities previously discussed under Loaned Bonds or Bonds Subject to Reverse Repurchase Agreements.

Where the law, rules, or regulations of the insurer's state of domicile permit such activity, mortgage-backed securities sold and reacquired under a dollar repurchase agreement or purchased and resold under a reverse dollar repurchase agreement should be accounted for as discussed below.

In dollar repurchase/dollar reverse repurchase agreements, the mortgage-backed securities involved may or may not be substantially the same. If the mortgage-backed securities are substantially the same, the dollar repurchase or dollar reverse repurchase agreement is treated as a financing. If the mortgage-backed securities are not substantially the same, the transactions are treated as a sale and purchase or purchase and sale of different securities.

For mortgage-backed securities to be substantially the same, all the following criteria must be met:

1. The mortgage-backed securities must have the same primary obligor, except for securities guaranteed by the United States or an agency thereof, in which case the guarantor must be the same.
2. The mortgage-backed securities must be identical in form and type. For example, the exchange of GNMA I securities for GNMA II securities would not meet the criterion.
3. The mortgage-backed securities must bear the identical contractual interest rate.
4. The mortgage-backed securities must be similar with respect to maturities (expected remaining lives) resulting in approximately the same market yield.
5. The mortgage-backed securities must be collateralized by a similar pool of mortgages, such as single-family residential mortgages.
6. The aggregate principal amounts of the mortgage-backed securities sold and repurchased must be substantially the same. For mortgage-backed securities to meet this criterion, the principal amount of the certificates repurchased must be within 2.5% (plus or minus) of the principal amount of the original certificates. For example, if the principal amount of mortgage-backed securities sold is \$1,000,000, the principal amount of mortgage-backed securities reacquired must be between \$1,025,000 and \$975,000 to qualify under this criterion.

If the mortgage-backed securities involved in a dollar repurchase agreement qualify under the above criteria, the transactions shall be treated as financing for statutory accounting purposes. A liability is recorded for the amount of proceeds of the sale and the sold mortgage-backed securities are not removed from the accounting records. During the period of the agreement, interest income is recorded as if the mortgage-backed security had been held during the term of the agreement. This is offset by an equal amount of interest expense related to the proceeds received from the sale. Additional interest expense is recorded representing the difference between the sales price and the repurchase price of the mortgage-backed securities.

When the mortgage-backed securities are repurchased under the agreement, the original mortgage-backed securities sold are removed from the accounting records and the purchased mortgage-backed securities are recorded. The principal amount of the mortgage-backed securities repurchased may be more or less than the book value of the mortgage-backed securities sold (within 2.5%).

If the principal amount repurchased is greater than the amount sold, the cash paid is recorded as an additional investment in the newly acquired certificates. If the principal amount repurchased is less than the amount sold, a gain or loss relating to the original certificates held is recorded. For example, assume that the certificates sold had a book value of \$1,000,000 and a market value of \$800,000 on the date of sale. This represents a fair market value 20% below the book value. On the date of repurchase, the new certificates have a principal amount of \$990,000 (within 2.5% of the book value at date of sale). A loss of \$2,000 ($\$1,000,000 - \$990,000 \times 20\%$) is recorded.

22. The NAIC Annual Statement Instructions for Life and Accident and Health Insurance Companies include the following in the general interrogatories related to repurchase and reverse repurchase agreements.

20. The information to be reported on all such transactions including securities involved in reverse repurchase agreements, loaned to others, and for any other securities that were made available for use by another person during the year covered by this statement must include, but not necessarily be limited to, the following items for each such transaction:

- (1) Dates of transaction-securities delivered on _____
securities returned on _____
- (2) Complete description of securities involved _____
- (3) Number of shares or amount of bond or other security _____
- (4) Market value on date securities were delivered \$ _____
- (5) Market value on date securities were returned \$ _____
- (6) Collateral value held \$ _____
- (7) Form of collateral _____
- (8) Collateral held by _____
(name and address)
- (9) Names and addresses of all other persons involved in
transaction _____

Assets owned at year-end which were not under the exclusive control of the company as shown in the General Interrogatories are to be identified in the asset schedules by placing the following symbols to the far right in the description column alongside each such asset:

- | | | |
|-----|---|--|
| LS | - | loaned or leased to others; |
| RR | - | subject to reverse repurchase agreement; |
| DR | - | dollar repurchase agreement; |
| DRR | - | dollar reverse repurchase agreement; |
| C | - | pledged as collateral; |
| DB | - | placed under option agreement; |
| DBP | - | placed under an option agreement involving "asset transfers with put options"; |
| R* | - | letter stock or otherwise restricted as to sale; |
| O | - | other. |

Companies that had reverse repurchase agreements for periods of two working days or less, with numerous transactions, should combine those transactions in a separate report or each federally insured financial institution and respond to items (4), (5), and (8) as shown in this interrogatory.

Companies should complete a full report for all other transactions, for everything owned at December 31 and respond to all nine items in this interrogatory.

* Private placements are not to be included unless specific restrictions as to sale are included as part of the security agreement.

Generally Accepted Accounting Principles

23. AICPA Statement of Position 90-3, *Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position (SOP 90-3)* provides the following guidance:

.13 To minimize diversity in practice, the AICPA Banking Committee, Savings and Loan Associations Committee, and Stockbrokerage and Investment Banking Committee believe the definition of substantially the same should be narrow. Therefore, the committees have concluded that for debt instruments, including mortgage-backed securities, to be substantially the same, all the following criteria must be met:

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

¹ The exchange of pools of single-family loans would not meet this criterion because the mortgages comprising the pool do not have the same primary obligor, and would therefore not be considered substantially the same.

- b. The debt instruments must be identical in form and type so as to give the same risks and rights to the holder.²

² For example, the following exchanges would not meet this criterion: GNMA I securities for GNMA II securities; loans to foreign debtors that are otherwise the same except for different U.S. foreign tax credit benefits (because such differences in the tax receipts associated with the loans result in instruments that vary “in form and type”); commercial paper for redeemable preferred stock.

- c. The debt instruments must bear the identical contractual interest rate.
- d. The debt instruments must have the same maturity except for mortgage-backed pass-through and pay-through securities for which the mortgages collateralizing the securities must have similar remaining weighted average maturities (WAMs) that result in approximately the same market yield.³

³ For example, the exchange of a “fast-pay” GNMA certificate (that is, a certificate with underlying mortgage loans that have a high prepayment record) for a “slow-pay” GNMA certificate would not meet this criterion because differences in the expected remaining lives of the certificates result in different market yields.

- e. Mortgage-backed pass-through and pay through securities must be collateralized by a similar pool of mortgages, such as single-family residential mortgages.
- f. The debt instruments must have the same aggregate unpaid principal amounts, except for mortgage-backed pass-through and pay-through securities, where the aggregate principal amounts of the mortgage-backed securities given up and the mortgage-backed securities reacquired must be within the accepted “good delivery” standard for the type of mortgage-backed security involved.⁴

⁴ Participants in the mortgage-backed securities market have established parameters for what is considered acceptable delivery. These specific standards are defined by the Public Securities Association (PSA) and can be found in Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities, which is published by PSA.

24. *FASB Interpretation No. 39, Offsetting of Amounts Related to Certain Contracts—an interpretation of APB Opinion No. 10 and FASB Statement No. 105* provides the following guidance:

5. Opinion 10, paragraph 7, states that “it is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists.” A right of setoff is a debtor’s legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the debtor.² A right of setoff exists when all of the following conditions are met:

² For purposes of this Interpretation, cash on deposit at a financial institution is to be considered by the depositor as cash rather than as an amount owed to the depositor.

- a. Each of two parties owes the other determinable amounts.
- b. The reporting party has the right to set off the amount owed with the amount owed by the other party.
- c. The reporting party intends to set off.
- d. The right of setoff is enforceable at law.

A debtor having a valid right of setoff may offset the related asset and liability and report the net amount.³

³ This Interpretation does not address derecognition or nonrecognition of assets and liabilities. Derecognition by sale of an asset or extinguishment of a liability results in removal of a recognized asset or liability and generally results in the recognition of gain or loss. Although conceptually different, offsetting that results in a net amount of zero and derecognition with no gain or loss are indistinguishable in their effects on the statement of financial position. Likewise, not recognizing assets and liabilities of the same amount in financial statements achieves similar reported results.

6. Generally, debts may be set off if they exist between mutual debtors each acting in its capacity as both debtor and creditor. In particular cases, however, state laws about the right of setoff may provide results different from those normally provided by contract or as a matter of common law. Similarly, the U.S. Bankruptcy Code imposes restrictions on or prohibitions against the right of setoff in bankruptcy under certain circumstances. Legal constraints should be considered to determine whether the right of setoff is enforceable.

25. *FASB Interpretation No. 41, Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements—an interpretation of APB Opinion No. 10 and a modification of FASB Interpretation No. 39 (FIN 41)* states the following:

INTRODUCTION

1. The Board has been asked to clarify the circumstances in which amounts recognized as payables under repurchase agreements¹ may be offset against amounts recognized as

receivables under reverse repurchase agreements² and reported as a net amount in the statement of financial position.

¹ For purposes of this Interpretation, a repurchase agreement (repo) refers to a transaction that is accounted for as a collateralized borrowing in which a seller-borrower of securities sells those securities to a buyer-lender with an agreement to repurchase them at a stated price plus interest at a specified date or in specified circumstances. The “payable” under a repurchase agreement refers to the amount of the seller-borrower’s obligation recognized for the future repurchase of the securities from the buyer-lender. In certain industries, the terminology is reversed; that is, entities in those industries refer to this type of agreement as a “reverse repo.”

² For purposes of this Interpretation, a reverse repurchase agreement (reverse repo) refers to a transaction that is accounted for as a collateralized lending in which a buyer-lender buys securities with an agreement to resell them to the seller-borrower at a stated price plus interest at a specified date or in specified circumstances. The “receivable” under a reverse repurchase agreement refers to the amount due from the seller-borrower for the repurchase of the securities from the buyer-lender. In certain industries, the terminology is reversed; that is, entities in those industries refer to this type of agreement as a “repo.”

INTERPRETATION

2. Paragraph 5 of *FASB Interpretation No. 39, Offsetting of Amounts Related to Certain Contracts*, sets forth the conditions necessary for a right of setoff to exist. Those conditions should be present to offset assets and liabilities in the statement of financial position unless offsetting is permitted by paragraph 10 of Interpretation 39 or by another accounting pronouncement listed in paragraph 7 of Interpretation 39.

3. Notwithstanding the condition in paragraph 5.c. of Interpretation 39, an enterprise may, but is not required to, offset amounts recognized as payables under repurchase agreements and amounts recognized as receivables under reverse repurchase agreements if all of the following conditions are met:

- a. The repurchase and reverse repurchase agreements are executed with the same counterparty.
- b. The repurchase and reverse repurchase agreements have the same explicit settlement date specified at the inception of the agreement.
- c. The repurchase and reverse repurchase agreements are executed in accordance with a master netting arrangement.³

³ The qualifications for a master netting arrangement are stated in paragraph 10 of Interpretation 39 and are discussed in paragraphs 21 and 30 of that Interpretation.

- d. The securities underlying the repurchase and reverse repurchase agreements exist in “book entry” form and can be transferred only by means of entries in the records of the transfer system operator or securities custodian.⁴

⁴ “Book entry” securities meeting the criterion in paragraph 3.d. exist only as items in accounting records maintained by a transfer system operator. This requirement does not preclude offsetting of securities held in “book entry” form solely because other securities of the same issue exist in other forms.

- e. The repurchase and reverse repurchase agreements will be settled on a securities transfer system that operates in the manner described in paragraph 4, and the enterprise must have associated banking arrangements in place as described in paragraph 4. Cash settlements for securities transferred are made under established banking arrangements that provide that the enterprise will need available cash on deposit only for any net amounts that are due at the end of the business day. It must be probable⁵ that the associated banking arrangements will provide sufficient daylight overdraft or other intraday credit⁶ at the settlement date for each of the parties.

⁵ The term probable is used in this Interpretation consistent with its use in paragraph 3.a. of FASB Statement No. 5, Accounting for Contingencies, to mean that a transaction or event is likely to occur.

⁶ Daylight overdraft or other intraday credit refers to the accommodation in the banking arrangements that allows transactions to be completed even if there is insufficient cash on deposit during the day provided there is sufficient cash to cover the net cash requirement at the end of the day. That accommodation may be through a credit facility, including a credit facility for which a fee is charged, or from a deposit of collateral.

- f. The enterprise intends to use the same account at the clearing bank or other financial institution at the settlement date in transacting both (1) the cash inflows resulting from the settlement of the reverse repurchase agreement and (2) the cash outflows in settlement of the offsetting repurchase agreement.

The enterprise's choice to offset or not must be applied consistently. Net receivables resulting from the application of this Interpretation should not be offset against net payables resulting from the application of this Interpretation in the statement of financial position.

4. In a securities transfer system for repurchase and reverse repurchase agreements that meets the requirements of paragraph e., cash transfers are initiated by notification from the owner of record of the securities to its securities custodian⁷ to transfer those securities to the counterparty to the agreement. Under associated banking arrangements, each party to a same-day settlement of both a repurchase agreement and a reverse repurchase agreement would be obligated to pay a gross amount of cash for the securities transferred from its counterparty but would be able to reduce that gross obligation by notifying its securities custodian to transfer other securities to that counterparty the same day. Thus, each party is responsible for maintaining available cash on deposit only for the amount of any net payable unless it fails to instruct its securities custodian to transfer securities to its counterparty.⁸ If both parties transfer the appropriate securities in settlement of the repurchase and reverse repurchase agreements, the party with a net receivable will not need any cash to facilitate the settlement, while the party with a net payable will need only to have available the required net amount due at the end of the business day.

⁷ The securities custodian for a securities transfer system may be the bank or financial institution that executes securities transfers over the securities transfer system, and "book entry" securities exist only in electronic form on the records of the transfer system operator for each entity that has a security account with the transfer system operator. "Book entry" securities exist only as items of account on the "controlling" records of the transfer system operator. Banks or other financial institutions may maintain "subsidiary" records of "book entry" securities. "Book entry" securities may be transferred on the subsidiary records of a bank or financial institution but, for entities that have a security account with the transfer system operator, may be transferred from the account of such an entity only through the transfer system operator.

⁸ Failure by either party to instruct its securities custodian to transfer securities owned of record would result in that party's failing to receive cash from the counterparty and, thereby, would require that party to have available cash on deposit for the gross payable due for securities transferred to it.

The failure also should be an event of default under the master netting arrangement required by paragraph 3.c. The event of default, in turn, should entitle the other party to terminate the arrangement and demand the immediate net settlement of all contracts.

26. *FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* provides the following guidance:

Accounting for Transfers and Servicing of Financial Assets

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

- a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership (paragraphs 23 and 24).
- b. Either (1) each transferee obtains the right—free of conditions that constrain it from taking advantage of that right (paragraph 25)—to pledge or exchange the transferred assets or (2) the transferee is a qualifying special-purpose entity (paragraph 26) and the holders of beneficial interests in that entity have the right—free of conditions that constrain them from taking advantage of that right (paragraph 25)—to pledge or exchange those interests.
- c. The transferor does not maintain effective control over the transferred assets through (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (paragraphs 27-29) or (2) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable (paragraph 30).

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

- a. Continue to carry in its statement of financial position any retained interest in the transferred assets, including, if applicable, servicing assets (paragraphs 35-41), beneficial interests in assets transferred to a qualifying special-purpose entity in a securitization (paragraphs 47-58), and retained undivided interests (paragraph 33).
- b. Allocate the previous carrying amount between the assets sold, if any, and the retained interests, if any, based on their relative fair values at the date of transfer (paragraphs 31-34).

11. Upon completion³ of a transfer of assets that satisfies the conditions to be accounted for as a sale (paragraph 9), the transferor (seller) shall:

- a. Derecognize all assets sold
- b. Recognize all assets obtained and liabilities incurred in consideration as proceeds of the sale, including cash, put or call options held or written (for example, guarantee or recourse obligations), forward commitments (for example, commitments to deliver additional receivables during the revolving periods of some securitizations), swaps (for example, provisions that convert interest rates from fixed to variable), and servicing liabilities, if applicable (paragraphs 31, 32, and 35-41)
- c. Initially measure at fair value assets obtained and liabilities incurred in a sale (paragraphs 42-44) or, if it is not practicable to estimate the fair value of an asset or a liability, apply alternative measures (paragraphs 45 and 46)

- d. Recognize in earnings any gain or loss on the sale. The transferee shall recognize all assets obtained and any liabilities incurred and initially measure them at fair value (in aggregate, presumptively the price paid).

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

12. If a transfer of financial assets in exchange for cash or other consideration (other than beneficial interests in the transferred assets) does not meet the criteria for a sale in paragraph 9, the transferor and transferee shall account for the transfer as a secured borrowing with pledge of collateral (paragraph 15).

Recognition and Measurement of Servicing Assets and Liabilities

13. Each time an entity undertakes an obligation to service financial assets it shall recognize either a servicing asset or a servicing liability for that servicing contract, unless it securitizes the assets, retains all of the resulting securities, and classifies them as debt securities held-to-maturity in accordance with *FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities*. If the servicing asset or liability was purchased or assumed rather than undertaken in a sale or securitization of the financial assets being serviced, it shall be measured initially at its fair value, presumptively the price paid. A servicing asset or liability shall be amortized in proportion to and over the period of estimated net servicing income (if servicing revenues exceed servicing costs) or net servicing loss (if servicing costs exceed servicing revenues). A servicing asset or liability shall be assessed for impairment or increased obligation based on its fair value (paragraphs 35-38).

Financial Assets Subject to Prepayment

Interest-only strips, loans, other receivables, or retained interests in securitizations that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment shall be subsequently measured like investments in debt securities classified as available-for-sale or trading under Statement 115, as amended by this Statement (paragraph 233).⁴

⁴ As a result of that amendment to Statement 115, securities that were previously classified as held-to-maturity may need to be reclassified. Reclassifications of interest-only strips or other securities from held-to-maturity to available-for-sale required to initially apply this Statement would not call into question an entity's intent to hold other debt securities to maturity in the future.

Secured Borrowings and Collateral

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

has taken control over the collateral and on the rights and obligations that result from the collateral arrangement:

- a. If (1) the secured party is permitted by contract or custom to sell or repledge the collateral and (2) the debtor does not have the right and ability to redeem the collateral on short notice, for example, by substituting other collateral or terminating the contract, then
 - (i) The debtor shall reclassify that asset and report that asset in its statement of financial position separately (for example, as securities receivable from broker) from other assets not so encumbered.
 - (ii) The secured party shall recognize that collateral as its asset, initially measure it at fair value, and also recognize its obligation to return it.
- b. If the secured party sells or repledges collateral on terms that do not give it the right and ability to repurchase or redeem the collateral from the transferee on short notice and thus may impair the debtor's right to redeem it, the secured party shall recognize the proceeds from the sale or the asset repledged and its obligation to return the asset to the extent that it has not already recognized them. The sale or repledging of the asset is a transfer subject to the provisions of this Statement.
- c. If the debtor defaults under the terms of the secured contract and is no longer entitled to redeem the collateral, it shall derecognize the collateral, and the secured party shall recognize the collateral as its asset to the extent it has not already recognized it and initially measure it at fair value.
- d. Otherwise, the debtor shall continue to carry the collateral as its asset, and the secured party shall not recognize the pledged asset.

Extinguishments of Liabilities

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

- a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes delivery of cash, other financial assets, goods, or services or reacquisition by the debtor of its outstanding debt securities whether the securities are canceled or held as so-called treasury bonds.
- b. The debtor is legally released⁵ from being the primary obligor under the liability, either judicially or by the creditor.

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

Disclosures

17. An entity shall disclose the following:

- a. If the entity has entered into repurchase agreements or securities lending transactions, its policy for requiring collateral or other security
- b. If debt was considered to be extinguished by in-substance defeasance under the provisions of *FASB Statement No. 76, Extinguishment of Debt*, prior to the effective date of this Statement, a general description of the transaction and the amount of debt that is considered extinguished at the end of the period so long as that debt remains outstanding
- c. If assets are set aside after the effective date of this Statement solely for satisfying scheduled payments of a specific obligation, a description of the nature of restrictions placed on those assets

- d. If it is not practicable to estimate the fair value of certain assets obtained or liabilities incurred in transfers of financial assets during the period, a description of those items and the reasons why it is not practicable to estimate their fair value
- e. For all servicing assets and servicing liabilities:
 - (1) The amounts of servicing assets or liabilities recognized and amortized during the period
 - (2) The fair value of recognized servicing assets and liabilities for which it is practicable to estimate that value and the method and significant assumptions used to estimate the fair value
 - (3) The risk characteristics of the underlying financial assets used to stratify recognized servicing assets for purposes of measuring impairment in accordance with paragraph 37
 - (4) The activity in any valuation allowance for impairment of recognized servicing assets—including beginning and ending balances, aggregate additions charged and reductions credited to operations, and aggregate direct write-downs charged against the allowances—for each period for which results of operations are presented.

23. The nature and extent of supporting evidence required for an assertion in financial statements that transferred financial assets have been isolated—put presumptively beyond the reach of the transferor and its creditors, either by a single transaction or a series of transactions taken as a whole—depend on the facts and circumstances. All available evidence that either supports or questions an assertion shall be considered. That consideration includes making judgments about whether the contract or circumstances permit the transferor to revoke the transfer. It also may include making judgments about the kind of bankruptcy or other receivership into which a transferor or special-purpose entity might be placed, whether a transfer of financial assets would likely be deemed a true sale at law, whether the transferor is affiliated with the transferee, and other factors pertinent under applicable law. Derecognition of transferred assets is appropriate only if the available evidence provides reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its affiliates, except for an affiliate that is a qualifying special-purpose entity designed to make remote the possibility that it would enter bankruptcy or other receivership (paragraph 57.c.).

24. Whether securitizations isolate transferred assets may depend on such factors as whether the securitization is accomplished in one step or two steps (paragraphs 54-58). Many common financial transactions, for example, typical repurchase agreements and securities lending transactions, isolate transferred assets from the transferor, although they may not meet the other criteria for surrender of control.

Conditions That Constrain a Transferee

25. Many transferor-imposed or other conditions on a transferee's contractual right to pledge or exchange a transferred asset constrain a transferee from taking advantage of that right. However, a transferor's right of first refusal on a bona fide offer from a third party, a requirement to obtain the transferor's permission to sell or pledge that shall not be unreasonably withheld, or a prohibition on sale to the transferor's competitor generally does not constrain a transferee from pledging or exchanging the asset and, therefore, presumptively does not preclude a transfer containing such a condition from being accounted for as a sale. For example, a prohibition on sale to the transferor's competitor would not constrain the transferee if it were able to sell the transferred assets to a number of other parties; however, it would be a constraint if that competitor were the only potential willing buyer.

Agreements That Maintain Effective Control over Transferred Assets

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

- a. The assets to be repurchased or redeemed are the same or substantially the same as those transferred (paragraph 28).
- b. The transferor is able to repurchase or redeem them on substantially the agreed terms, even in the event of default by the transferee (paragraph 29).
- c. The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price.
- d. The agreement is entered into concurrently with the transfer.

28. To be substantially the same,⁹ the asset that was transferred and the asset that is to be repurchased or redeemed need to have all of the following characteristics:

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

⁹In this Statement, the term substantially the same is used consistently with the usage of that term in the AICPA Statement of Position 90-3, *Definition of the Term Substantially the Same for Holders of Debt Instruments*, as Used in Certain Audit Guides and a Statement of Position.

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

30. A call option or forward contract that entitles the transferor to repurchase, prior to maturity, transferred assets not readily obtainable elsewhere maintains the transferor's effective control, because it would constrain the transferee from exchanging those assets, unless it is only a cleanup call.

Repurchase Agreements and "Wash Sales"

66. Government securities dealers, banks, other financial institutions, and corporate investors commonly use repurchase agreements to obtain or use short-term funds. Under those agreements, the transferor ("repo party") transfers a security to a transferee ("repo counterparty" or "reverse party") in exchange for cash¹² and concurrently agrees to reacquire that security at a future date for an amount equal to the cash exchanged plus a stipulated "interest factor".

¹² Other securities or letters of credit rarely are exchanged in repurchase agreements instead of cash.

67. Repurchase agreements can be effected in a variety of ways. Some repurchase agreements are similar to securities lending transactions in that the transferee has the right to sell or repledge the securities to a third party during the term of the repurchase agreement. In other repurchase agreements, the transferee does not have the right to sell or repledge the securities during the term of the repurchase agreement. For example, in a tri-party repurchase agreement, the transferor transfers securities to an independent third-party custodian that holds the securities during the term of the repurchase agreement. Also, many repurchase agreements are for short terms, often overnight, or have indefinite terms that allow either party to terminate the arrangement on short notice. However, other repurchase agreements are for longer terms, sometimes until the maturity of the transferred asset. Some repurchase agreements call for repurchase of securities that need not be identical to the securities transferred.

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

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

70. As with securities lending transactions, under many agreements to repurchase transferred assets before their maturity the transferor maintains effective control over those assets. Repurchase agreements that do not meet all the criteria in paragraph 9 shall be treated as secured borrowing. Fixed-coupon and dollar-roll repurchase agreements, and other contracts under which the securities to be repurchased need not be the same as securities sold, qualify as borrowing if the return of substantially the same (paragraph 28) securities as those concurrently transferred is assured. Therefore, those transactions shall be accounted for as secured borrowings by both parties to the transfer.

71. If a transferor has transferred securities to an independent third-party custodian, or to a transferee, under conditions that preclude the transferee from selling or repledging the assets during the terms of the repurchase agreement (as in most tri-party repurchase agreements), the transferor has not surrendered control over those assets. In those circumstances, the transferee does not acquire the right to sell or repledge the securities during the term of the repurchase agreement; therefore, it does not have access to the benefits embodied in those assets. The transferee shall not record those assets as its own, nor shall the transferor derecognize those assets.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 1, *Bonds and Loan Backed and Structured Securities*
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 1, *Bonds and Loan Backed and Structured Securities*
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 76—Offsetting and Netting of Assets and Liabilities*
- NAIC Annual Statement Instructions for Life and Accident and Health Insurance Companies

Generally Accepted Accounting Principles

- *AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as used In Certain Audit Guides and a Statement of Position*
- *FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
- *FASB Interpretation No. 39, Offsetting of Amounts Related to Certain Contracts—an interpretation of APB Opinion No. 10 and FASB Statement No. 105*
- *FASB Interpretation No. 41, Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements—an interpretation of APB Opinion No. 10 and a modification of FASB Interpretation No. 39*
- *FASB Emerging Issues Task Force No. 84-20, GNMA Dollar Rolls*

State Regulations

- No additional guidance obtained from state statutes or regulations.