Transfers and servicing of financial assets

Executive Summary

US GAAP

August 2024

frv.kpmg.us

An established model and evolving transactions

In the decades since the FASB first developed its guidance on transfers of financial assets, the capital markets – and the types of transfers that take place in them – have continued to evolve.

The accounting guidance has evolved as well, although the core principles have remained intact: a transaction is recognized as a sale when a financial asset has been transferred and control has been surrendered; and following a sale, a company measures both the benefits it controls and the resulting obligations.

This model is well-established, but the continuing evolution of transactions involving transfers of financial assets often pushes the profession to make critical judgments about the application of the guidance.

We want to help you make those critical judgments.

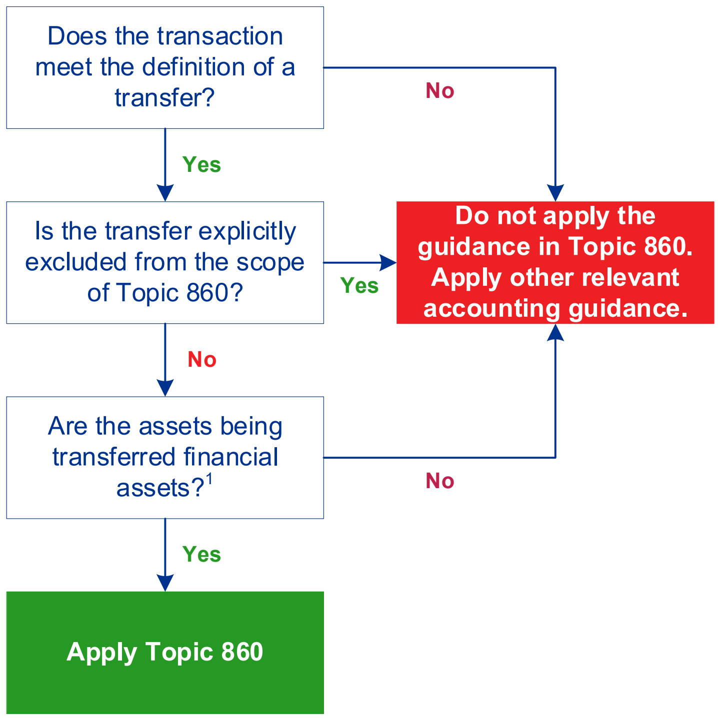
In this Executive Summary, we summarize the scope of Topic 860 on transfers and servicing, introduce the sale criteria, and highlight the accounting for both sales and secured borrowings. We also touch on the accounting for servicing assets and liabilities.

In addition, in our in-depth Handbook, Transfers and servicing of financial assets, we seek to demystify securitization transactions and how to analyze repurchase agreements and securities lending. The accounting for servicing assets and liabilities is also covered in detail.

We hope you find this Executive Summary and the related Handbook useful in understanding and applying the guidance on transfers and servicing of financial assets to the types of transactions most relevant to you.

Scope

Topic 860 applies to transfers of financial assets by all entities (including not-for-profit entities), except for transfers specifically excluded from its scope. The following decision tree summarizes the steps in determining whether a transaction is in the scope of Topic 860.



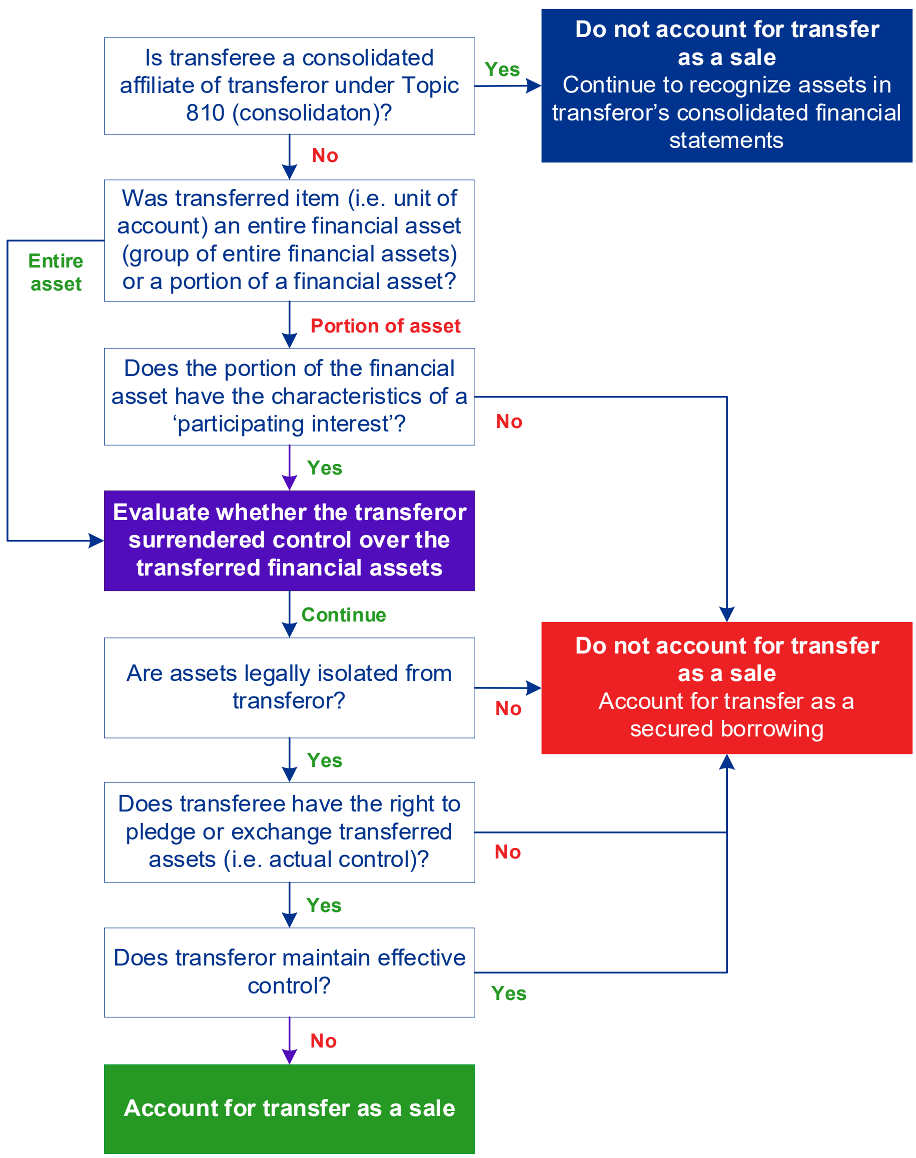
Note:

1. Transfers of certain other derivative instruments are also within the scope of Topic 860.

Subtopic 860-50 applies to servicing assets and servicing liabilities. It has a scope that is separate and distinct from the rest of Topic 860.

Determining whether to account for a transfer of financial assets as a sale or secured borrowing

The following decision tree summarizes the steps in determining whether to account for a transfer of financial assets as a sale (or a secured borrowing).



Sale criteria

Overview

An entity evaluates whether to account for a transfer of financial assets as a sale (or a secured borrowing) throughout the life of the transferred assets.

The first step in determining whether a transfer of financial assets is accounted for as a sale or secured borrowing is to evaluate whether the transferee is a consolidated affiliate of the transferor. Topic 810 (consolidation) is used to determine whether the transferee is a consolidated affiliate. A transfer to a consolidated affiliate is not accounted for as a sale.

When a transfer is not to a consolidated affiliate, the next step is to evaluate whether the transferred item (i.e. unit of account) is eligible for sale accounting. To be eligible for sale accounting, a transferred item must be one of the following:

- an entire financial asset;
- a group of entire financial assets; or
- a participating interest in an entire financial asset (or a group of such participating interests). To be eligible for sale accounting, a transferred interest that is less than an entire financial asset (a component of a financial asset) must meet all of the characteristics of a participating interest that are specified in Topic 860.

If the transferred item is eligible for sale accounting, the next step is to evaluate whether the transferor surrendered control over the transferred financial assets based on the control criteria: legal isolation, actual control and effective control. There is no requirement to evaluate these criteria in any particular sequence.

Legal isolation

To achieve sale accounting, the transferred financial assets are required to be legally isolated from the transferor and its consolidated affiliates. This requirement is commonly referred to as the legal isolation criterion, and the determination is largely a legal analysis.

Actual control

To achieve sale accounting, the transferee is required to have the ability to pledge or exchange the transferred financial assets. If this criterion is met, the transferor has surrendered actual control of the transferred financial assets.

The criterion is met if:

- the transferor, its consolidated affiliates and its agents have no continuing involvement with the transferred financial assets; or
- the transferor, its consolidated affiliates or its agents have continuing involvement, but:
  - the transferee is not constrained in its ability to pledge or exchange the transferred assets; or
  - if the transferee is so constrained, the constraint does not provide a more-than-trivial benefit to the transferor.

For this criterion, the references to 'transferee' and 'financial assets' also apply to third-party beneficial interest holders and beneficial interests, respectively, if the transferee's sole purpose is to engage in securitizations or asset-backed financing arrangements.

Effective control

A transferor does not account for a transfer of financial assets as a sale when it has maintained effective control over them (or over third-party beneficial interests related to them). A transferor maintains effective control through any of the following types of agreements.

Type 1	An agreement that both entitles and obligates the transferor to repurchase or redeem the transferred financial assets before their maturity.
Type 2	An agreement that provides the transferor with the following (other than through a cleanup call): • the unilateral ability to cause the holder to return specific financial assets; and • a more-than-trivial benefit attributable to that ability.

Type 3	An agreement that permits the transferee to require the transferor to repurchase the transferred financial assets (i.e. a put option) at a price that is so favorable to the transferee that it is probable the transferee will exercise its right.

As an exception to the effective control criterion, Topic 860 requires all repurchase-to-maturity transactions to be accounted for as secured borrowings as if the transferor had maintained effective control.

For this criterion:

- references to a transferred financial asset include beneficial interests issued by a transferee whose sole purpose is to engage in securitizations or asset-backed financing activities; and
- references to transferees include third-party holders of those beneficial interests.

Accounting for sales

The accounting by both the transferor and transferee for a transfer to which sale accounting applies is as follows.

Transferor	• Derecognizes an entire financial asset or group of entire financial assets. • For a participating interest: – allocates the carrying amount of the entire financial asset between the participating interest sold and participating interest retained based on their relative fair values at the date of transfer and recognizes any participating interest(s) retained based on its allocated carrying amount (i.e. the retained participating interest is not remeasured to its fair value); and – derecognizes the carrying amount of the participating interest sold. • Recognizes all assets obtained and liabilities incurred in the sale at fair value. • Recognizes a gain or loss on sale.
Transferee	• Generally, recognizes all assets acquired and liabilities incurred at fair value.

Subsequent measurement of assets obtained and liabilities incurred is generally prescribed by other applicable US GAAP. However, Topic 860 provides subsequent measurement guidance for certain assets obtained and liabilities incurred. Some of that guidance in Topic 860 is incremental to other applicable US GAAP.

Additional accounting considerations apply when a transfer initially qualifies as a sale but subsequently no longer qualifies as a sale. This occurs if:

- the transferor regains control of the transferred financial asset; or
- the transferred financial asset was a participating interest at the time of the transfer but no longer qualifies as one.

Accounting for secured borrowings

If the transfer does not qualify to be accounted for as a sale, both the transferor and transferee account for it as a secured borrowing with a pledge of collateral. The accounting by both the transferor and transferee for a transfer accounted for as a secured borrowing is generally as follows.

Transferor	• Continues to recognize the transferred assets – i.e. does not derecognize them or recognize a gain or loss. • Identifies the transferred assets as pledged/ encumbered on the balance sheet if the transferee has the right to pledge or exchange them. • Recognizes any cash received along with an obligation (liability) to return it to the transferee. • Subsequently recognizes interest expense on the obligation.
Transferee	• Derecognizes the cash paid. • Recognizes a receivable from the transferor. • Subsequently recognizes interest income on the receivable.

However, the subsequent accounting for noncash collateral (i.e. the transferred financial asset) for both the transferor and transferee is affected by whether the transferor (as the obligor) has defaulted and is no longer entitled to redeem the pledged asset. As a result, the transferor may subsequently be required to derecognize the transferred asset and the transferee may be required to recognize it.

Special topics

The following table describes several types of transactions involving transfers of financial assets that are common in practice.

Transaction type	Description
Securitizations	The process of pooling financial assets into a group, and selling interests in that group of assets to investors.
Securities lending	The practice of loaning financial assets to others in exchange for a fee.
Repurchase agreements	A transaction involving the sale of securities with a corresponding agreement to repurchase the securities at a future date.
Dollar rolls	A variation of a repurchase agreement in which the repurchased securities are similar, but not identical, to the originally transferred securities.
Banker's acceptances	A short-term financing arrangement in which an accepting bank agrees to pay a customer's liability to its vendor. The customer repays the bank at a later date.
Risk participations	A risk participation is a contract between two banks in which the participating bank agrees to reimburse the accepting bank if the accepting bank's customer defaults on its liability under a banker's acceptance.
Wash sales	A transaction in which a transferor sells securities with the intent to repurchase the same (or substantially the same) securities to obtain income tax or other benefits.

The criteria for sale accounting are applied to these transaction types to determine the appropriate accounting. It is common for securities lending and repurchase agreements to be accounted for as secured borrowings because they frequently do not meet the actual or effective control criteria.

Servicing assets and liabilities

Servicing financial assets includes a variety of activities, including collecting payments from borrowers, monitoring delinquencies and remitting fees to service providers (e.g. trustees, guarantors).

While servicing is inherent in financial assets, servicing assets and liabilities are not themselves financial instruments. Instead, they represent executory contracts. Servicing is not accounted for separately as a distinct asset (or liability) until:

- the entity transfers the financial asset in a transaction accounted for as a sale under Topic 860 while retaining the servicing rights to that asset; or
- the entity acquires or assumes a servicing right but does not own the related financial asset.

Accounting for a servicing asset or liability includes evaluating:

- whether and how to recognize a servicing asset or liability;
- how to initially measure a servicing asset or liability;
- how to subsequently measure a servicing asset or liability under one of two available methods; and
- whether the transfer of a servicing asset or liability by the servicer qualifies as a sale.

If an entity determines a servicing right qualifies for recognition separate from the financial asset being serviced, it must determine if the servicing right represents an asset, liability or neither. If it represents neither, no amount is recognized regarding the servicing right. An entity initially measures the servicing asset or liability at fair value.

An entity may elect to subsequently measure servicing assets and liabilities using either the amortization method or fair value measurement method. Such election is made separately for each class of servicing assets and liabilities, including a new class of servicing assets and liabilities when an entity had not previously recognized a servicing asset or liability that would belong to that class.

Disclosures

The principal objectives of Topic 860's disclosure requirements are to provide financial statement users with an understanding of:

- a transferor's continuing involvement (if any) with transferred financial assets;
- the nature of restrictions on assets on a transferor's balance sheet;
- how servicing assets and liabilities are reported; and
- how a transfer of financial assets affects a transferor's balance sheet, income statement and statement of cash flows.

The specific disclosures in Topic 860 include those related to:

- sales of financial assets;
- secured borrowings and collateral; and
- servicing assets and liabilities.

These disclosures represent the minimum requirements, and an entity may need to supplement them to achieve Topic 860's disclosure objectives.

Topic 860 permits disclosures for similar transfers to be aggregated if separate reporting would not provide more useful information to financial statement users. If a transferor chooses to aggregate disclosures, it discloses how transfers are aggregated. However, an entity cannot aggregate transfers accounted for as sales with those accounted for as secured borrowings.

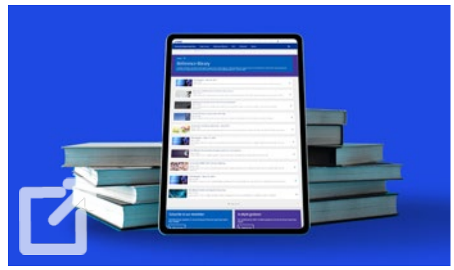
Certain types of transactions (or forms of continuing involvement) may also require specific disclosures, including disclosures required by Topics other than Topic 860. Those disclosures are considered when determining whether Topic 860's disclosure objectives have been met.

KPMG Financial Reporting View

Delivering guidance and insights, KPMG Financial Reporting View is ready to inform your decision making. Stay up to date with us.

Defining Issues

Our collection of newsletters with insights and news about financial reporting and regulatory developments, including Quarterly Outlook and FRV Weekly.



Handbooks and Hot Topics

Our discussion and analysis of accounting topics – from short Hot Topics that deal with a topical issue, to our in-depth guides covering a broad area of accounting.

CPE opportunities

Register for live discussions of topical accounting and financial reporting issues. CPE-eligible replays also available.

Financial Reporting Podcasts

Tune in to hear KPMG professionals discuss major accounting and financial reporting developments.

Access our in-depth handbook on transfers and servicing of financial assets on Financial Reporting View, and sign up for news and insights

Learn about us: **kpmg.com**