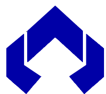

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Guideline

Subject: Transfers of Financial Assets with Recourse

Category: Accounting

No : D-4 **Date: July 1994**
October 2002 (Revised)

Status

In 2001, the Accounting Standards Board of the Canadian Institute of Chartered Accountants (CICA) issued an Accounting Guideline, AcG-12, "Transfers of Receivables." AcG-12 took effect on or after July 1, 2001 but applied at a transferor's option to transfers occurring on or after April 1, 2001. It superseded this OSFI Guideline for all but certain transactions for which the accounting was grandfathered.

The implementation of AcG-12 does not affect the application of the section of this Guideline on "Repurchase Agreements and Reverse Repurchase Agreements" (see page 6), since the accounting for such agreements is not within the scope of AcG-12. However, the wording of this section has been amended in consideration of the new criteria for sale treatment set out in paragraph 9 of AcG-12. The Office of the Superintendent of Financial Institutions (OSFI) has issued a new guideline, D-8, "Transfers of Receivables Including Securitizations," that addresses the application of AcG-12.

Scope

Guideline D-4 applies to financial assets (receivables) transferred before the date AcG-12 was first applied and to certain receivables transferred on or after that date as required by commitments made by the transferor before that date. Such commitments are to transferees or beneficial interest holders (BIHs) in qualifying special purpose entities (QSPEs) other than the transferor, its affiliates, or its agents. As a result, in the case of securitization structures existing prior to the effective date of AcG-12:

> *The accounting for transfers, on or after the effective date, that increase the overall balance in a structure will not be grandfathered, unless specifically committed to prior to the effective date; and*
>
> *Transfers contractually required to maintain the balance in a QSPE revolving structure that is periodically refinanced through the issuance of new securities to investors (e.g.,*

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most commercial paper structures) will be grandfathered only up to the first refinancing following the effective date.

In the latter circumstances, refinancing of an existing structure does not affect the transferor's accounting for past transfers into that structure, but would preclude grandfathering for subsequent transfers because the commitment at that point is to the new beneficial interest holders. The refinancing of an SPE that is not a QSPE does not affect the accounting for any transfer into that SPE.

Guideline D-4 continues to apply to each servicing contract related to a transfer of financial assets (receivables) in existence before the implementation of AcG-12.

Introduction

This guideline sets out OSFI's accounting treatment to be adopted by federally regulated financial institutions transferring financial assets with recourse (receivables). It applies to the transfer of all financial assets including (a) receivables transferred under asset securitization arrangements, and (b) securities transferred under repurchase and reverse repurchase agreements. The guideline supplements the guidance for the accounting of a transfer of receivables set out in the CICA Handbook; it does not apply to the accounting for the transfer of NHA mortgage-backed securities which is dealt with under Guideline D-3.

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Financial Assets other than Repurchase and Reverse Repurchase Agreements

Transfers of financial assets, including those done as part of asset securitization transactions, raise a number of important accounting issues, including whether they should be accounted for as sales or financings by the transferor and, if accounted for as sales, how and when a gain on sale should be recorded.

In Canada, these issues were first addressed in November 1989 in an Abstract (EIC 9), Transfers of Receivables, released by the Emerging Issues Committee (EIC) of the CICA. This guideline sets out certain clarifications and interpretations regarding the application of EIC 9 by FRFIs. In June 1994, the EIC issued a related Abstract, EIC-54, Transfers of Receivables – Definition of Recourse, providing a definition of recourse that was omitted in EIC-9. In that definition, EIC-54 describes the relationship between a transferor and a transferee that is a special purpose vehicle (SPV) when there is a transfer of receivables that are securitized.

Accounting Treatment

Subject to certain clarifications and interpretations discussed below, OSFI accepts the consensus opinions noted in EIC 9, including the conditions for sale treatment which read in part:

> *For a transaction involving a transfer of receivables to be recognized as a sale, both of the following conditions should exist:*
>
> *i. the transferor has transferred the significant risks and rewards of ownership of the receivables; and*
>
> *ii. reasonable assurance exists regarding the measurement of the consideration derived from the transfer of the receivables.*
>
> *If the transaction is regarded as a sale, it will be necessary to recognize the related gain or loss on sale. The calculation of the gain or loss should take into account all aspects of the transaction including the transferor's expected losses under recourse provisions and the extent to which the transferor remains exposed to risks in addition to credit risk. Any gain on sale should be deferred to the extent it is unrealized.*

In accounting for a transfer of financial assets with recourse, a transferor should comply with the following clarifications and interpretations:

A. Where the criteria for sales treatment are satisfied:

- the asset should be removed from the balance sheet;

- in determining the gain or loss on sale, the issuance costs together with the carrying value of the financial asset should be deducted from the amount of the sales proceeds;

- to the extent there is recourse to the transferor in excess of the expected losses under recourse provisions, any gain on sale is unrealized and should be deferred until it is collected in cash and there is no recourse to the cash. Where recourse other than for expected losses exceeds the gain on sale, this excess should be deducted from the transferor's capital for capital adequacy purposes in accordance with guideline B-5 (see Providing First Loss Protection Facilities). Authorized foreign banks in respect of their business in Canada (foreign bank branches or FBBs) should report the amount, equivalent to the deduction from capital, in the notes to the financial statements contained in the OSFI annual return);

- a loss on sale should be recognized immediately;

- where there is a loss on sale, recourse to the transferor in excess of expected losses should be deducted from the transferor's capital for capital adequacy purposes in accordance with guideline B-5 (see Providing First Loss Protection Facilities). FBBs should report the amount, equivalent to the deduction from capital, in the notes to the financial statements contained in the OSFI annual return);

- where the transferor continues to service the assets sold, the normal servicing fee should be recognized over the servicing period as earned; and

- where the transferor continues to service the assets sold, and the estimated servicing costs at the date of sale or at the end of a subsequent reporting period are expected to exceed the normal servicing fee over the term or remaining term of the assets, the estimated loss on servicing should be accrued and charged to income in the period in which the estimated loss is first determined.

B. Where the criteria for sales treatment are not satisfied:

- the transferor should treat the transaction as a collateralized borrowing or financing; that is, the asset should be retained on the balance sheet and the proceeds from the transfer should be recorded as a liability.

Disclosure

In complying with the general standards of financial statement presentation contained in CICA Handbook Section 1500, the following items should be disclosed in the financial statements.

For transfers of receivables that have been accounted for as sales during the year (*see Scope*):

- the accounting policy with respect to such transactions including the income recognition for the gain or loss on sale, servicing, and issuance costs;

- the characteristics of the securitizations including a description of the transferor's continuing involvement (not limited to servicing and recourse) with the transferred receivables, and the gain or loss from the sale;

- cash flows between the securitization Special Purpose Entity and the transferor, including proceeds from new securitizations, proceeds from collections reinvested in revolving period securitizations, and servicing fees.

For all securitized receivables, including those transferred in prior years, an entity should disclose the following:

- the outstanding amounts remaining as at the end of the year;

- delinquencies at the end of the year;

- credit losses, net of recoveries during the period; and

- the amount by which the total recourse exceeds the sum of the expected losses under recourse provisions and the gain on sale, if any, at the end of the year.

For transfers that do not qualify as sales during the year:

- the amount of the obligations outstanding at the end of the fiscal year and the book value of the assets transferred.

Repurchase and Reverse Repurchase Agreements

Accounting Treatment

Where the terms of a security repurchase agreement do not provide for a transferor to surrender control over the assets transferred as required by paragraph 9 in AcG-12, the transaction should be accounted for as a financing by the transferor and as a loan by the transferee. The securities should remain on the balance sheet of the transferor while the proceeds should be recognized as a liability.

In those few instances where the terms of a security repurchase agreement provide for a transferor to surrender control over the assets transferred as required by paragraph 9 in AcG-12, the transaction should be accounted for as a sale by the transferor and a purchase by the transferee. The securities should be removed from the balance sheet of the seller (transferor) and the consideration recognized as sales proceeds.

Disclosure

In complying with the general standards of financial statement presentation contained in CICA Handbook Section 1500, the following items should be disclosed in the financial statements.

For those transactions that qualify as financings:

- the amount of any obligations related to securities transferred under repurchase agreements outstanding at the end of the year; and

- the amount of any loans made under reverse repurchase agreements outstanding at the end of the year.

For those transactions that qualify as sales:

- the accounting policy with respect to such transactions; and

- a description of the transactions, the sales proceeds, the principal amount, the term and the maturity date of outstanding transactions at the end of the year.

- END -

Description of Terms

The following descriptions are intended to clarify terms used in this guideline.

"Asset securitization" involves an institution (the "transferor") transferring an interest in a group of its own financial assets, in the form of securities, in return for immediate and future consideration. The amount of the future consideration is, at least in part, dependent upon the performance of the transferred assets. The transferor may continue to service such assets for a fee. Such transactions may be done directly with one or more third parties, or through a Special Purpose Vehicle (SPV).

"Expected losses" are the best estimate of losses assessed against a financial asset in determining its fair value at the date of transfer.

"Financing", when related to a transfer of an asset, implies that a sale has not occurred, but rather that the proceeds received by the transferor represents a borrowing from, or obligation (liability) to, the transferee. The transferred asset serves as the collateral for the borrowed funds.

"Issuance costs" are the costs incurred for assembling and selling the securities. These include legal, printing and administration costs and commissions paid.

"Net interest spread" is the estimated net balance of the interest to be generated by the financial assets after payment of interest to the investors and provision for the normal servicing fee.

"Normal servicing fee" represents a reasonable estimate of a market-based fee to service the respective assets transferred over the life of the associated securities. This fee cannot be deferred or reduced below market rates.

"Recourse" represents a potential claim on the transferor (including on an account held for the ultimate benefit of the transferor) with respect to the financial assets transferred. Recourse provisions under a transfer of financial assets cover the rights of the transferee to receive compensation from, or to be otherwise protected by, the transferor on the occurrence of one or more events, where the transferee suffers some form of economic loss from holding the financial asset or securities backed by the financial assets. Recourse to the transferor is generally held by the transferee against (a) future cash flows (from the financial assets) which the transferee holds for the account of the transferor or (b) the transferor in another form.

"Repurchase and reverse repurchase agreements" - In their most common form, security repurchase agreements (repos) are formal or informal money market transactions in which one party (transferor) agrees to "sell" securities, which are typically high grade, to another party (transferee) at a specified price and simultaneously agrees to "repurchase" the same or substituted securities on a specified future date and at a specified price. A reverse repo is the

same transaction as the related repo but viewed from the perspective of the transferee. In these transactions the transferor, generally, does not surrender control over the securities to the transferee. However, in very limited circumstances, the terms of the agreement may require the transferor to surrender control over the securities to the transferee.

"Sale" of an asset entails removing the asset sold from the balance sheet of the transferor and replacing it with the sale proceeds.

"Sales proceeds" are the assets received and/or to be received by the transferor that represent the fair value of the transferred asset on the date of transfer. The portion of the sales proceeds not received in cash on the date of transfer is typically reflected as the present value of certain net estimated interest cash flows to be received in the future from the transferred asset. The receivable representing this portion of the sales proceeds would be equivalent to the present value of the net interest spread less the present value of the provision for the expected losses under recourse provisions and, where the transferee is an SPV, the present value of the estimated operating costs related to the transferred asset. Higher than expected principal prepayments can result in a subsequent reduction of this receivable.

Special purpose vehicle ("SPV") or Special purpose entity ("SPE"))" – ***(CICA Abstract EIC-54, Transfers of Receivables – Definition of Recourse, refers to and describes an SPV. CICA AcG-12, which was issued in 2001, refers to these transferee structures as SPEs).*** Typically, a transferor creates an SPV as a separate legal entity to which it transfers, or "sells," financial assets. The SPV is almost always structured so as not to be eligible for consolidation in the financial statements of the transferor. It finances its acquisition of the assets by issuing to investors interest-bearing instruments that are backed by the assets. The certainty of the receipt of the investors' returns is enhanced by limited recourse to the transferor.

The SPV accumulates the interest cash inflows from the financial assets in a spread account. These amounts are held for future payments of consideration to the transferor after payment of interest to investors and payment of servicing fees and other operating costs. Under the terms of the limited recourse provisions, funds from the spread account are placed in escrow up to a predefined limit from which the SPV is allowed to recover losses (expected losses and other losses in accordance with the terms of the provisions). Amounts from the spread account that exceed the predefined limit are paid to the transferor. After all the receivables have been collected and all obligations have been extinguished, any remaining amount in the spread account or escrow account is paid to the transferor.