Appendix

In December 1983, the Financial Accounting Standards Board issued Statement No. 77, "Reporting by Transferors for Transfers of Receivables with Recourse." The purpose of the statement was to establish criteria for distinguishing between those transfers of assets with recourse that should be recognized as a sale and those that should be treated as a borrowing for the transferor and a loan for the transferee.

To quote from FASB 77:

> A transfer of receivables with recourse shall be recognized as a sale if all of the following conditions are met:
>
> a. The transferor surrenders control of the future economic benefits embodied in the receivables. Control has not been surrendered if the transferor has an option to repurchase the receivables at a later date.
>
> b. The transferor's obligation under the recourse provisions can be reasonably estimated. Lack of experience with receivables with characteristics similar to those being transferred or other factors that affect a determination at the transfer date of the collectibility of the receivables may impair the ability to make a reasonable estimate of the probable bad debt losses and related costs of collections and repossessions. A transfer of receivables shall not be recognized as a sale if collectibility of the receivables and related costs of collection and repossession are not subject to reasonable estimation.
>
> c. The transferee cannot require the transferor to repurchase the receivables except pursuant to the recourse provisions.

The conclusion in FASB 77 reversed the conclusion the AICPA had reached in Statement of Position (SOP) 74-6, "Recognition of Profit on Sales of Receivables with Recourse", and in a March 1980 Issues Paper on transfers of receivables with recourse.

To quote further from FASB 77:

> The conclusions in SOP 74-6 were based on two reasons: (a) transfers of receivables with recourse have many of the same characteristics that collateralized loans have and (b) the transferor's retention of risk through the recourse provision precludes immediate recognition of gain or loss. Those reasons also were used to support the conclusions in the AICPA's March

> 1980 Issues Paper on transfers of receivables with recourse. Although transfers of receivables with recourse may have many of the same characteristics that collateralized loans have, the Board concluded that a substantive distinction can and should be made between transactions accounted for as sales of receivables with recourse and loans collateralized by receivables. Further, the Board believes that the retention of risk should not automatically disqualify a transaction for recognition as a sale if the retained risk can be reasonably estimated.

The FASB vote on FASB 77 was five to two, with Messrs. March and Sprouse dissenting.

> Mr. March and Mr. Sprouse dissent because they believe that a transfer of receivables with recourse, hypothecated receivables, and a loan collateralized by receivables are merely different forms of financing transactions having substantially similar substance. They believe that the proceeds from those transactions, including transfer of receivables with recourse, should be reported initially as liabilities and that the particular form of the transaction should not produce significantly different accounting results. That conclusion is in general agreement with recommendations of the AICPA in the March 1980 Issues Paper, "Accounting for Transfers of Receivables with Recourse."

To continue with the March-Sprouse dissent from the FASB decision:

> Whether an asset of the transferor (the receivables) has or has not been eliminated by a transfer with recourse should depend on whether the "probable future economic benefits" embodied in the asset have in fact been transferred or whether those benefits continue to reside with the transferor. To have an asset, a business enterprise must control its probable future economic benefits to the extent that the enterprise is in a position to receive those benefits to the general exclusion of others. Probable future benefits and related inherent risks cannot be dissociated; bearing related risk is necessarily implicit in controlling future benefits. When a holdback, dealer's reserve, or other arrangement provides adequate protection against loss to the transferee, the economic benefits and inherent risks related to receivables transferred with recourse are controlled by the transferor -- that is, the benefits and risks accrue to the transferor to the general exclusion of others. The financial well-being of the transferor is improved by collection; the well-being of the transferee is unchanged. Either the receivables are collected or the transferor makes them good; presumably, the transferee is indifferent as to who pays.

The Reports Task Force of the Federal Financial Institutions Examination Council has studied carefully the current Call Report instructions on sale of

loans and receivables in light of the entire discussion in FASB 77. In order to avoid unnecessary differences between financial accounting presentations and the Call Report, the banking agencies try to keep the Call Report instructions consistent with generally accepted accounting principles (GAAP) wherever possible, i.e., unless the exercise of their statutory supervisory responsibilities in light of banking and financial developments, conditions, and practices requires specific limited departures from GAAP. In this instance, the agencies have determined that important supervisory concerns prevent the adoption of FASB 77 in toto as the reporting standard.

FASB 77 uses criteria for recognition of a transfer as a sale that are based on the transfer of benefits rather than on the transfer of both benefits and risk. (Arguably, as the minority FASB opinion points out, the criteria of FASB 77 do not even accomplish the transfer of benefits). However, the supervisory responsibilities of the banking agencies require that, for purposes of supervisory reporting to them, primacy be given to the incidence of risk: where does the risk reside after the transfer of an asset. In recourse arrangements, all or the bulk of the risk is retained by the transferor. Financial institutions routinely transfer many types of assets in a variety of arrangements that include some type of recourse provisions. In substance, many of these transactions are strictly financing vehicles, yet under FASB 77 many would be regarded as sales.

FASB 77 requires that before a transfer can be treated as a sale, it must be possible to make a reasonable estimate of the transferor's obligation under the recourse provisions. It is conceivable, though by no means certain, that this could be done for pools of consumer loans or residential mortgages. However, it is very difficult, if not impossible, to do it for commercial loans, construction loans, international loans, or loans to

financial institutions. Moreover, what is a "reasonable" estimate today may not turn out to be reasonable tomorrow. Indeed, one's view of whether it is possible to make a reasonable estimate may change very quickly. Most importantly, what is relevant for supervisory purposes is not the ability to estimate the risk, but the existence of a risk.

In some transfers, the transfer agreement may call for a partial or limited recourse provision. Even when the terms on their face seem to provide a limited recourse, the recourse may, in fact, be total. For example, in the transfer of a group of high quality assets with a "reasonably estimated" loss rate of one percent, if the transferor assumes the risk of default up to a maximum of ten percent of the total dollar value of the assets transferred, it is obvious that the transferor retains the total risk inherent in the assets transferred.

Under FASB 77, if the transferor states that he believes that the total risk can be reasonably estimated at zero and other conditions are met, the transferor would show no liability for risk whatever stemming from the transfer in the above example. Were the estimated risk of loss ten percent of the total value of the assets transferred, a ten percent liability would be booked. (However, under the Call Report instructions, since risk of loss remains with the transferor, all of the transferred assets would remain on the transferor's balance sheet, with the total amount of the transaction reported as a borrowing.) Under FASB 77, a whole succession of similar transactions could ensue, with the transferor retaining the risk of loss from each package of transferred assets. In a sense, if either no liability or only a ten percent liability from each transfer is booked by the transferor, a pyramiding of risk would have occurred for the transferor and the balance sheet would reflect only a fraction of the assets on which the transferor is

carrying the risk of default. Supervisory concern about this hidden exposure is an important reason why the banking agencies (in the past and currently) look to the retention of risk as the touchstone to distinguish between sales and financing transactions in supervisory reporting.

The option of a true sale of assets, at some price, is always available to a bank. If the reasonable estimate of anticipated loss is ten percent of the value of the asset package, the assets will have to be sold at a discount. If the transferor concludes that the best estimate of anticipated loss is zero, and can convince the market that this is the case, then the assets can be sold at book without recourse. When "sales" can only be made with recourse, there may be a tendency for a bank to "sell" only its highest quality assets and keep those of lower quality, creating another cause for supervisory concern.

For all of these reasons, the agencies have determined that the recourse criterion relating to transfers of assets be retained in the Call Report instructions and that the criteria of FASB 77 not be adopted for such reporting purposes.