

Sales of Assets:

This entry covers, for purposes of these reports, the treatment of sales of loans, securities, receivables, and other assets except for the sales of assets subject to repurchase agreements, federal funds transactions, participation in pools of securities, and participations in pools of residential mortgages. For the treatment of these latter types of transactions, see the following entries in this Glossary: "repurchase/resale agreements" (which also covers participations in pools of securities), "federal funds transactions," and "participations in pools of residential mortgages."

For purposes of these reports, some transactions involving the "sale" of assets covered in this entry must be reported as financing transactions (i.e., as borrowings secured by the assets "sold") and others must be reported as sales of the assets involved. The treatment required for any particular transfer of assets depends upon whether the "seller" retains risk in connection with the transfer of the assets.

The following general rule for reporting transfers ("sales") of assets is for purposes of reporting to the bank supervisory agencies and of agency determination of capital adequacy; it is not intended to establish general accounting principles or to establish presumptions about the legal or contractual rights of the parties to the transfer.

General rule -- A transfer of loans, securities, receivables, or other assets is to be reported as a sale of the transferred assets by the reporting selling institution and as a purchase of the transferred assets by the reporting purchasing institution only if the transferring institution:

- (1) retains no risk of loss from the assets transferred resulting from any cause and
- (2) has no obligation to any party for the payment of principal or interest on the assets transferred resulting from --
 - (a) default on principal or interest by the obligor of the underlying instrument or from any other deficiencies in the obligor's performance,
 - (b) changes in the market value of the assets after they have been transferred,
 - (c) any contractual relationship between the seller and purchaser incident to the transfer that, by its terms, could continue even after final payment, default, or other termination of the assets transferred, or
 - (d) any other cause.

Insert to Glossary, pages A-32 through A-34 (cont'd)

If risk of loss or obligation for payment of principal or interest is retained by, or may fall back upon, the seller, the transaction must be reported by the seller as a borrowing from the purchaser and by the purchaser as a loan to the seller.

Exceptions to the general rule:

- (1) Contractual provisions in sales of assets that
 - (a) provide for the return of the assets to the seller in instances of incomplete documentation or fraud, or
 - (b) allow the purchaser a specific limited period of time to determine that the assets transferred are in fact as represented by the seller and to return deficient paper to the seller

will not by themselves and in the absence of any other recourse provision or retention of risk preclude the reporting of the transfer as a sale.

- (2) Another exception occurs in the case of certain bank purchases, with recourse or with repurchase or guarantee provisions, of conditional sales contracts and similar instruments directly from dealers in automobiles and other vehicles, boats, consumer goods, or agricultural equipment and supplies. Such "dealer paper" transactions, when the following conditions are present, essentially represent the bank's direct financing of a purchase of goods that has been arranged by the dealer:
 - (a) each loan is a closed-end contract between a dealer and its customer to finance the customer's purchase of goods from the dealer,
 - (b) contracts that meet the bank's credit standards are transferred to the bank by the dealer at the time of the customer's purchase of goods,
 - (c) the recourse or repurchase provision given to the bank by the dealer relates separately to each individual contract transferred to the bank, and
 - (d) neither the bank nor the dealer intends that the loan contracts be returned in whole or in part to the dealer nor is there any provision in the agreement for such return or repurchase, except by operation of the recourse or guarantee provisions.

In such cases and only in such cases, the dealer paper purchased with recourse or guarantee is to be reported as a loan to the customer of the dealer and not as a loan to the dealer.

However, a bank's purchase with recourse of (1) a block of contracts relating to previous sales of goods that a dealer has been holding since the time of its customers' purchases or of (2) revolving or open-end credit balances from a dealer fall under the general rule stated above and are to be reported as a loan to the dealer from whom purchased. Similarly, "dealer paper" purchased with recourse from another financial institution, e.g., a bank or finance company, is to be reported as a loan to that financial institution.

Insert to Glossary, pages A-32 through A-34 (cont'd)

Interpretations and illustrations of the general rule:

- (1) For any given transfer, the determination of whether risk is retained by the transferring institution is to be based upon the substance of the transfer agreement or other relevant documents or informal commitments and understandings, or subsequent actions of the parties to the transactions, not upon the form or particular terminology used. The presence of a bona fide "sale with recourse" provision would establish the transaction as a borrowing, not a sale, for purposes of the reports. However, the absence of a recourse provision, the absence of the term "recourse," even the presence of a statement to the effect that there is no recourse or, in the case of a participation, the use of the terms "pass-through" or "pure pass-through" will not by themselves establish a transaction as a sale. If other conditions and provisions of the transfer are such as to leave the transferor with risk of loss as described in the general rule, the transfer is a borrowing for purposes of these reports regardless of the terminology used.
- (2) If assets are sold subject to specific contractual terms that limit the seller's risk to a percentage of the value of the assets sold or to a specific dollar amount, the entire proceeds from the transaction shall be reported as a borrowing transaction between the seller and the purchaser and the entire carrying amounts of the transferred assets shall continue to be reported as assets by the seller. For example, if assets are sold subject to a ten percent recourse provision (i.e., the seller's risk is limited to ten percent of the value of the assets sold), the total amount of the proceeds is reported as a borrowing, not just the ten percent limit.

However, if the risk retained by the seller is limited to some fixed percentage of any losses that might be incurred and there are no other provisions resulting in retention of risk, either directly or indirectly, by the seller, the maximum amount of possible loss for which the selling bank is at risk (the stated percentage times the sale proceeds) shall be reported as a borrowing and the remaining amount of the assets transferred reported as a sale. For example, a sale of assets with proceeds of \$1,000,000, with a recourse provision that the seller and buyer proportionately share in losses incurred on a ten percent and 90 percent basis, and with no other retention of risk by the seller, would be reported, both by a reporting purchaser and a reporting seller, as a financing transaction of \$100,000 and a sale transaction of \$900,000 (with the seller also reporting an appropriate gain or loss on the sale part).

- (3) Among the transfers where risk has been retained by the seller and that must be reported by the seller as a borrowing from the purchaser and by the purchaser as a loan to the seller are arrangements such as the

Insert to Glossary, pages A-32 through A-34 (cont'd)

following (this list is illustrative of the principles involved in the application of the general rule and is not all-inclusive) --

- (a) the sale of an asset with a realistic bona fide put option allowing the purchaser, at its option, to return the asset to the seller;
 - (b) the sale of an asset guaranteed by a standby letter of credit issued by the seller;
 - (c) the sale of an asset guaranteed by a standby letter of credit issued by any other party in which risk, either directly or indirectly, rests with the seller; and
 - (d) the sale of an asset guaranteed by an insurance contract in which the seller, either directly or indirectly, indemnifies or otherwise protects the insurer in any manner against loss.
- (4) A transfer where the seller retains risk as a result of a difference in terms between the instrument of transfer and the asset transferred, regardless of the other characteristics of the sale or participation, must be reported as a borrowing transaction. For example, any transfer in which there is a difference in maturity between the underlying asset and the instrument of transfer must be reported as a borrowing.

However, the sale of a loan or other asset subject to an agreement under which the seller will pass through to the purchaser a rate of interest that differs from the stated rate of interest on the transferred asset would not, for this reason alone, require that the transaction be reported as a borrowing provided (1) the seller's obligation to pass interest through to the purchaser is contingent upon the continued interest payment performance of the underlying obligor of the transferred asset (i.e., the seller has no obligation to pass interest through if the obligor defaults in whole or in part on interest or principal) and (2) none of the other characteristics of the sale or participation results in risk to the seller.

- (5) The general rule applies to all transfers of assets (other than those excluded in the opening paragraph of this entry and those specifically covered in the section on exceptions), including sales of a single asset or of a pool of assets and sales of participations in a single asset or in a pool of assets (whether of similar or dissimilar instruments). In participations that are not "syndications" (as described in the Glossary item for that term), the seller of the participations should report the transfer of shares to participants in accordance with the general rule on sale of assets, even though the assets being participated were acquired or accumulated for the express purpose of issuing participations and even though the participation was prearranged with the purchasers of the participations. However, the rule does not apply to the initial operation and distribution of participations in the form of syndications, since in a syndication there is no transfer of assets involved of the type to which the general rule on sale of assets is addressed. Any subsequent transfers of shares, or parts of shares, in a syndicated loan would be subject to the general rule.

Insert to Glossary, pages A-32 through A-34 (cont'd)

- (6) The general rule (and interpretations and exceptions) is also applicable to asset transfers that are made to special or limited purpose entities that are not technically affiliated with the seller. Regardless of the legal structure of the transaction, if risk of loss is retained by the seller, either contractually or otherwise, either directly or indirectly, the transaction is to be reported as a borrowing by the seller even if the sale to the special purpose entity is stated as being without recourse.

Income Statement Effect of Sales of Assets -- In a transaction that must be reported by a reporting seller as a borrowing from the purchaser and by a reporting purchaser as a loan to the seller, the selling bank must continue to report the income on the underlying asset. In such a transaction, the selling bank must also report interest expense on its borrowing from the purchaser while the purchasing bank must report interest income as income on a loan to the seller, not as income on a loan to the underlying obligor.

In a transaction that qualifies as a sale in accordance with the general rule above, the selling bank must remove the book value of the transferred asset from its books and, with the exception noted below, immediately recognize any gain or loss resulting from the sale. The exception arises in connection with the sale of a loan or other asset subject to an agreement in which the seller agrees to pass through to the purchaser a lower rate of interest than the stated rate on the asset sold (after adjusting for a normal servicing fee rate, if servicing is retained by the seller). Because of the uncertainty as to the length of time the seller will receive the interest rate differential due to the possibility of prepayment of or default on the underlying loan or other assets, the gain on the sale resulting from the differential is to be reported as realized over the life of the transferred asset.

However, in a transaction that qualifies as a sale where the seller agrees to pass through to the purchaser a higher rate of interest than the stated rate on the loan or other asset sold, immediate loss recognition is required. The amount of the estimated loss that is to be recognized at the sale date shall not (except as noted below) be less than the present value as of the sale date (after adjusting for a normal servicing fee rate, if servicing is retained by the seller) of the difference between the rate of interest to be passed through to the purchaser and the stated rate on the asset sold over the time remaining to maturity. Only in the case of pools of loans of a type for which there is statistically valid prepayment experience may a prepayment assumption be used in determining the present value of the difference.

The amount of the estimated loss should be reported in Schedule RI as noninterest expense with an offsetting credit reported in Schedule RC, item 20, "Other liabilities," and amortized as the interest rate differential is paid by the selling bank over the remaining life of the asset sold. For sales where the difference in interest may change over time (for example, where the

Insert to Glossary, pages A-32 through A-34 (cont'd)

stated rate on a loan is fixed and the rate to be paid to the purchaser is floating), the difference in interest rates must be reviewed as of each report date and changes in the amount of estimated loss recognized at such time.

NOTE: This Glossary entry replaces the entry for "sale of loans and receivables" now contained in the Glossary.

Insert to Glossary, page A-35

Syndications:

A syndication is a participation, usually involving shares in a single loan, in which several participants agree to enter into an extension of credit under a bona fide binding agreement that provides that, regardless of any event, each participant shall fund and be at risk only up to a specified percentage of the total extension of credit or up to a specified dollar amount. In a syndication, the participants agree to the terms of the participation prior to the execution of the final agreement and the contract is executed by the obligor and by all the participants, although there is usually a lead institution organizing or managing the credit. Large commercial and industrial loans, large loans to finance companies, and large foreign loans may be handled through such syndicated participations.

Each participant in the syndicate, including the lead bank, records its own share of the participated loan and the total amount of the loan is not entered on the books of one bank to be shared through transfers of loans. This type of participation thus does not give rise in its initial operation and distribution to the type of transfer to which the general rule in the Glossary entry for "sales of assets" is addressed. However, any subsequent transfers of shares, or parts of shares, in the syndicated loan would be subject to that general rule for determining whether the transfer is to be treated as a sale of assets or as a borrowing.

NOTE: This new Glossary entry should be inserted at the page indicated.