

Accounting for Transfers of Financial Assets Including Loan Participations

Recent news has focused attention on the accounting for financial assets such as cash, loans, and investments. Not just limited to accountants, it is now our friends and family discussing the accounting for mortgage-backed securities, fair value, and off-balance sheet entities. These topics have been a source of debate for the financial institution industry and the Financial Accounting Standards Board (FASB) for many years. While these issues are all important to our industry, the focus of this article is on the transfer of financial assets.

In June 2009, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 166, *Accounting for Transfers of Financial Assets* (Statement 166). Statement 166 was issued to address financial statement user concerns that many of the financial assets (and related obligations) that have been removed from the balance sheet by derecognizing the financial assets and liabilities should instead be reported on the balance sheet of the transferors and to improve the transparency of disclosures. Statement 166 is now referenced under the Accounting Standards Codification (ASC) 860 *Transfers and Servicing*.

Transfers of financial assets include sale agreements, securitizations, securities lending, factoring, participations and could involve the transferor having continued involvement with the financial assets they transferred or with the transferee themselves. This continuing involvement raises concerns over whether or not a sale has occurred and if the transfer should be accounted for as a sale. Continuing involvement could include but is not limited to recourse obligations, guarantees, servicing, repurchase agreements, pledges, or options.

Accounting for Transfers

If the transfer of a financial asset qualifies as a sale, the carrying amount is adjusted to fair value and allocated between the various parties based on the terms of the agreement. The portion sold is removed from the transferor's financial statements, servicing assets (if any), and liabilities (if any) are recognized as well as any gain or loss on the sale.

If the transfer of a financial asset is not accounted for as a sale then it is recognized as a secured borrowing with a pledge of collateral.

Considerations for Community Banks

It is good news for community banks that the provisions of Statement 166 apply only to transactions on or after the effective date; which for most financial institutions is January 1, 2010. As a result there should be no impact to your current loan participations purchased or sold. You will want to contact your attorney and accountant to review your standard participation purchased and sold contracts to ensure the provisions in these agreements do not preclude the sales accounting treatment. Key provisions to review include unequal provisions such as first-in/first out clauses and excessive or inadequate servicing fees.

In many cases, participations are used to reduce loan exposure or to manage the legal lending limit for a loan relationship. If a loan participation is accounted for as a secured borrowing (as in example 2 above), the participation sold portion is recorded as a liability and loan assets are not reduced. It is important to note that this treatment could have the effect of lowering capital ratios as assets would not be reduced.

In addition you will need to consider the impact of the secured borrowing on your legal lending limits. It is possible to have a differing legal and accounting treatment for a participation agreement. Risks of ownership will need to be reviewed to analyze whether or not all risks have passed. Legal and accounting consultation should be sought if there is a question regarding the legal lending limits and a potential secured borrowing.

With a careful review of your participation agreements and some preventive measures, the accounting for participations can remain the same as previously accounted for with some minor exceptions.

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