INVESTMENT COMPANY INSTITUTE

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FASB Proposes Changes To Accounting For Repurchase Agreements

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TO: ACCOUNTING/TREASURERS COMMITTEE No. 7-13 RE: FASB PROPOSES CHANGES TO ACCOUNTING FOR REPURCHASE AGREEMENTS

The Financial Accounting Standards Board recently released a proposed accounting standards update intended to clarify guidance on repurchase agreements and other transfers of securities combined with forward agreements to repurchase the transferred securities. [1] The proposal clarifies existing guidance for determining whether securities to be repurchased are "substantially the same" as those initially transferred. Investment companies that engage in mortgage dollar roll transactions often rely on this guidance to determine whether they maintain "effective control" of the securities transferred and apply secured borrowing or purchase and sale accounting. The proposal would also eliminate the accounting distinction between repurchase agreements that settle at the same time the transferred security matures (repo-to-maturity agreements) and those that settle before the transferred security matures. As a result, repo-to-maturity agreements generally would be accounted for as secured borrowings. Comments on the proposal are due by March 29, 2013.

Background

The proposal indicates that repurchase agreements are agreements in which the transferor (repo party) transfers a security to a transferee (repo counterparty) in exchange for cash and concurrently agrees to reacquire that security for an amount equal to the cash exchanged plus a stipulated interest factor. Repurchase agreements are a mechanism for the transferor to obtain short-term financing and for the transferee to engage in collateralized lending.

Under current GAAP, the transferor typically accounts for the repurchase agreement as a secured borrowing. In this case, the transferor continues to recognize the transferred security and records a liability reflecting the obligation to return the cash received. The determination to account for repurchase agreements as a secured borrowing (or alternatively as a sale of securities and a forward purchase commitment) is based, in part, on whether the transferor maintains effective control of the securities. One of the conditions for maintaining effective control is that the security transferred will be repurchased before it matures. In a repo-to-maturity agreement the forward repurchase date coincides with the transferred security's maturity date, meaning that the transferor does not maintain effective control. The transferor in a repo-to-maturity agreement typically recognizes a sale of the transferred security and a forward purchase agreement.

A mortgage dollar roll is a transaction in which a fund sells a mortgage-backed security to a dealer and simultaneously agrees to repurchase the same or a similar security in the future at a pre-determined price. Whether a mortgage dollar roll transaction qualifies for purchase and sale accounting or instead is treated as a secured borrowing depends, in part, on whether the fund has maintained effective control of the transferred security. One condition for assessing effective control is that the securities to be repurchased are the same or substantially the same as the security sold. To be considered substantially the same the security that was transferred and the security to be repurchased must satisfy each of the following:

1. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which circumstance the guarantor and the terms of the guarantee must be the same);
2. Identical form and type so as to provide the same risks and rights;
3. The same maturity (or in the circumstance of mortgage-backed pass-through and pay-through securities, similar remaining weighted-average maturities that result in approximately the same market yield);
4. Identical contractual interest rates;
5. Similar assets as collateral; and
6. The same aggregate unpaid principal amount or principal amounts within accepted good delivery standards for the type of security involved. Participants in the mortgage-backed securities market have established parameters for what is considered acceptable delivery. These specific standards are defined by the Bond Market Association and can be found in Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities, which is published by the Bond Market Association.

ASU 2011-03 removed the collateral of maintenance requirement from the effective control analysis for repurchase agreements and similar transfers. The removal of the collateral maintenance provision has resulted in increased emphasis on the substantially the same guidance in determining whether the fund no longer controls the securities transferred in a mortgage dollar roll.

Repo-to-Maturity

The proposal would require repo-to-maturity transactions to be accounted for as secured borrowings, even though the initially transferred security is not returned to the transferor at settlement. The Board determined that the exchange of cash is equivalent to the return of the initially transferred security because cash is the only possible form of settlement when the transferred security has matured. Because the transferor retains the credit risk and market value exposure throughout the term of the transaction, the Board decided that the transferred securities should continue to be reflected on the transferor's balance sheet.

Substantially the Same

The proposal provides additional guidance on determining whether securities to be repurchased are substantially the same as the securities initially transferred. The proposal indicates that, in order to be considered substantially similar, the securities to be repurchased should provide the same risks and rights to the transferor so as to place the transferor in the equivalent economic position with the return of a substantially-the-same security as compared with the return of the identical security. The proposal retains the six criteria described above (except that the reference to the Bond Market Association's practices for clearance and settlement would be omitted as a housekeeping change).

The proposal modifies the implementation guidance relating to assessing weighted average maturity and market yield at ASC Topic 860-10-55-35. In particular, the proposal indicates that this assessment would require consideration of the prepayment characteristics of the security sold as compared with the anticipated prepayment characteristics of the security to be repurchased. Also, that historical data and market information on the range of prepayment speeds and market yields for securities with similar characteristics may be considered in assessing whether the security to be repurchased would result in approximately the same market yield as the security initially transferred.

The proposal's basis for conclusions indicates that substantially the same should be interpreted as a narrow construct. For example, the proposal notes that market participants employ good delivery standards for settling mortgage-backed securities trades and that these standards serve a purpose that is different from the objective of the accounting guidance. Accordingly, securities that satisfy industry good delivery standards may not necessarily meet the substantially-the-same characteristics, which may represent a narrower subset of securities.

Disclosure

For repurchase agreements and similar transfers accounted for as secured borrowings, issuers would be required to disclose the gross amount of the borrowing disaggregated by type of collateral pledged.

For repurchase agreements and similar transfers accounted for as sales because the asset to be repurchased is not substantially-the-same, issuers would be required to disclose the amount of securities derecognized during the reporting period. If that amount changed significantly since the last balance sheet date, the issuer would be required to disclose the reason(s) for the change.

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endnotes

[1] The proposal, Effective Control for Transfers with Forward Agreements to Repurchase Assets and Accounting for Repurchase Financings is available on the FASB website.