

Statutory Issue Paper No. 45

Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements

STATUS

Finalized March 16, 1998

Current Authoritative Guidance for Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements: SSAP No. 103R

This issue paper may not be directly related to the current authoritative statement.

Original SSAP from Issue Paper: SSAP No. 45

Type of Issue:

Common Area

SUMMARY OF ISSUE

1. The Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies contain guidance on accounting for bonds sold subject to reverse repurchase agreements and dollar repurchase agreements.
2. The purpose of this issue paper is to establish statutory accounting principles for repurchase and reverse repurchase agreements, including dollar repurchase and dollar reverse repurchase agreements, that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

collateral is less than the recorded amount, the shortfall shall be used to reduce the admitted asset value of the repurchase agreement.

Reverse Repurchase Agreements

7. Reverse repurchase agreements shall be defined as agreements under which a reporting entity sells securities and simultaneously agrees to repurchase the same or substantially the same securities at a stated price on a specified date within 12 months of the sale date. For securities to be substantially the same, the criteria set forth in paragraph 23 must be met, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.

8. Reverse repurchase agreements shall be accounted for as collateralized borrowings (financing transactions). The underlying securities shall continue to be accounted for as an investment by the

“substantially the same” security. The difference between the purchase and reselling price represents interest income for the lending of short-term funds.

Separate Transactions

14. Agreements to repurchase and resell securities that do not meet the definitions in paragraph 4, 7, or 9 of this issue paper shall be accounted for as two separate transactions, that is, as a sale and purchase or as a purchase and sale, in accordance with the relevant statutory accounting guidance. For example, sales of bonds would result in recognition of realized gains or losses.

Offsetting

15. Reporting entities may operate on both sides of the repurchase agreement market resulting in recording of liabilities and assets representing repurchase and reverse repurchase agreements, respectively. Reporting entities shall offset such liabilities and assets only to the extent that one of the following occurs:

- a. A legal right of offset exists as defined in

paper is consistent with the *FASB Interpretation No. 39, Offsetting of Amounts Related to Certain Contracts—an interpretation of APB Opinion No. 10 and FASB Statement No. 105* (as it relates to reverse repurchase and repurchase agreements) and *FASB Interpretation No. 41, Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements—an interpretation of APB No. 10 and a modification of FASB Interpretation No. 39*. FIN 39 and FIN 41 are adopted in Issue Paper 76.

19. This issue paper also adopts paragraphs 9-13, 15-17, 23-25, 27-30 and 66-71 of FAS 125 as they relate to repurchase agreements, reverse repurchase agreements and dollar repurchase agreements. Paragraph 14 is rejected as it relates to the classifications of securities under FAS 115. FAS 115 was rejected in *Issue Paper No. 26—Bonds, Excluding Loan-Backed and Structured Securities*.

20. The statutory accounting principles outlined in the conclusion above are consistent with the conservatism concept in the Statement of Concepts in that repurchase agreements are reduced by the amounts of any collateral shortfalls. The guidance also prohibits the recognition of gains on sales of

Repurchase Agreements, Reverse Repurchase

⁴ Participants in the mortgage-backed securities market have established parameters for what is considered acceptable delivery. These specific standards are defined by the Public Securities Association (PSA) and can be found in Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities, which is published by PSA.

24. *FASB Interpretation No. 39, Offsetting of Amounts Related to Certain Contracts—an interpretation of APB Opinion No. 10 and FASB Statement No. 105* provides the following guidance:

5. Opinion 10, paragraph 7, states that “it is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists.” A right of setoff is a debtor’s legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the debtor.² A right of setoff exists when all of the following conditions are met:

² For purposes of this Interpretation, cash on deposit at a financial institution is to be considered by the depositor as cash rather than as an amount owed to the depositor.

- a. Each of two parties owes the other determinable amounts.
- b. The reporting party has the right to set off the amount owed with the amount owed by the other party.
- c. The reporting party intends to set off.
- d. The right of setoff is enforceable at law.

A debtor having a valid right of setoff may offset the related asset and liability and report the net amount.³

³ This Interpretation does not address derecognition or nonrecognition of assets and liabilities. Derecognition by sale of an asset or extinguishment of a liability results tinguurceabes

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The failure also should be an event of default under the master netting arrangement required by paragraph 3.c. The event of default, in turn, should entitle the other party to terminate the arrangement and demand the immediate net settlement of all contracts.

26. *FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* provides the following guidance:

Accounting for Transfers and Servicing of Financial Assets

9. A transfer of financial assets (or all or a portion of a financial asset) in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:

- a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership (paragraphs 23 and 24).
- b. Either (1) each transferee obtains the right—free of conditions that constrain it from taking advantage of that right (paragraph 25)—to pledge or exchange the transferred assets or (2) the transferee is a qualifying special-purpose entity (paragraph 26) and the holders of beneficial interests in that entity have the right—free of conditions that constrain them from taking advantage of that right (paragraph 25)—to pledge or exchange those interests.
- c. The transferor does not maintain effective control over the transferred assets through (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (paragraphs 27-29) or (2) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable (paragraph 30).

10. Upon completion of any transfer of financial assets, the transferor shall:

- a. Continue to carry in its statement of financial position any retained interest in the transferred assets, including, if applicable, servicing assets (paragraphs 35-41), beneficial interests in assets transferred to a qualifying special-purpose entity in a securitization (paragraphs 47-58), and retained undivided interests (paragraph

- d. Recognize in earnings any gain or loss on the sale.
The transferee shall recognize all assets obtained and any liabilities incurred and initially measure them at fair value (in aggregate, presumptively the price paid).

³ Although a transfer of securities may not be considered to have reached completion until the settlement date, this Statement does not modify other generally accepted accounting principles, including *FASB Statement No. 35*,

has taken control over the collateral and on the rights and obligations that result from the collateral arrangement:

- a. If (1) the secured party is permitted by contract or custom to sell or repledge the collateral and (2) the debtor does not have the right and ability to redeem the collateral on short notice, for example, by substituting other collateral or terminating the contract, then
 - (i) The debtor shall reclassify that asset and report that asset in its statement of financial position separately (for example, as securities receivable from broker) from other assets not so encumbered.
 - (ii) The secured party shall recognize that collateral as its asset, initially measure it at fair value, and also recognize its obligation to return it.
- b. If the secured party sells or repledges collateral on terms that do not give it the right and ability to repurchase or redeem the collateral from the transferee on short notice and thus may impair the debtor's right to redeem it, the secured party shall recognize the proceeds from the sale or the asset repledged and its obligation to return the asset to the extent that it has not already recognized them. The sale or repledging of the asset is a transfer subject to the provisions of this Statement.
- c. If the debtor defaults under the terms of the secured contract and is no longer entitled to redeem the collateral, it shall derecognize the collateral, and the secured party shall recognize the collateral as its asset to the extent it has not already recognized it and initially measure it at fair value.
- d. Otherwise, the debtor shall continue to carry the collateral as its asset, and the secured party shall not recognize the pledged asset.

Extinguishments of Liabilities

16. A debtor shall derecognize a liability if and only if it has been extinguished. A liability has been extinguished if either of the following conditions is met:

- a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes delivery of cash, other financial assets, goods, or services or reacquisition by the debtor of its outstanding debt securities whether the securities are canceled or held as so-called treasury bonds.
- b. The debtor is legally released⁵ from being the primary obligor under the liability, either judicially or by the creditor.

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Agreements That Maintain Effective Control over Transferred Assets

27. An agreement that both entitles and obligates the transferor to repurchase or redeem transferred assets from the transferee maintains the transferor's effective control over those assets, and the transfer is therefore to be accounted for as a secured borrowing, if and only if all of the following conditions are met:

- a. The assets to be repurchased or redeemed are the same or substantially the same as those transferred (paragraph 28).
- b. The transferor is able to repurchase or redeem them on substantially the agreed terms, even in the event of default by the transferee (paragraph 29).
- c. The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price.
- d. The agreement is entered into concurrently with the transfer.

28. To be substantially the same,⁹ the asset that was transferred and the asset that is to be repurchased or redeemed need to have all of the following characteristics:

- a. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same)
- b. Identical form and type so as to provide the same risks and rights
- c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities have similar remaining weighted-average maturities that result in approximately the same market yield)
- d. Identical contractual interest rates
- e. Similar assets as collateral
- f. The same aggregate unpaid principal amount or principal amounts within accepted "good delivery" standards for the type of security involved.

⁹In this Statement, the term substantially the same is used consistently with the usage of that term in the AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position.

29. To be able to repurchase or redeem assets on substantially the agreed terms, even in the event of default by the transferee, a transferor must at all times during the contract term have obtained cash or other collateral sufficient to fund substantially all of the cost of purchasing replacement assets from others.

30. A call option or forward contract that entitles the transferor to repurchase, prior to maturity, transferred assets not readily obtainable elsewhere maintains the transferor's effective control, because it would constrain the transferee from exchanging those assets, unless it is only a cleanup call.

Repurchase Agreements and "Wash Sales"

66. Government securities dealers, banks, other financial institutions, and corporate investors commonly use repurchase agreements to obtain or use short-term funds. Under those agreements, the transferor ("repo party") transfers a security to a transferee ("repo counterparty" or "reverse party") in exchange for cash¹² and concurrently agrees to reacquire that security at a future date for an amount equal to the cash exchanged plus a stipulated "interest factor".

¹² Other securities or letters of credit rarely are exchanged in repurchase agreements instead of cash.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 1, *Bonds and Loan Backed and Structured Securities*
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 1, *Bonds and Loan Backed and Structured Securities*
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 76—Offsetting and Netting of Assets and Liabilities*
- NAIC Annual Statement Instructions for Life and Accident and Health Insurance Companies

Generally Accepted Accounting Principles

- *AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for*