



Board Meeting Handout

ACCOUNTING FOR TRANSFERS OF FINANCIAL ASSETS

April 2, 2008

PURPOSE

The purpose of this meeting is to present to the Board the staff's recommendation to amend the derecognition model for financial assets in FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

ISSUE 1: QUALIFYING SPECIAL-PURPOSE ENTITY (QSPE) CONCEPT

The project was originally added to the Board's agenda to resolve specific practice issues relating to rollovers of beneficial interests and the permitted activities of a QSPE. In consideration of significant user and other constituent input and staff research, the staff recommends that the concept of the QSPE be removed from Statement 140. As a result of the removal of the QSPE concept from Statement 140, the scope exemption for QSPEs will be removed from the consolidation guidance in FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*.

Q1. Does the Board agree with the staff's recommendation to remove the concept of a QSPE from Statement 140 (and as a result, from Interpretation 46(R))?

ISSUE 2: OTHER AMENDMENTS

The staff believes that the removal of the QSPE concept will be an improvement to financial reporting. However, the staff believes that additional improvements (as illustrated in issue 3) to Statement 140 are required to improve financial reporting within the existing derecognition framework of Statement 140 in the short term.

Q2. Does the Board agree with the staff's recommendation to amend the derecognition criteria in of Statement 140, beyond the removal of the QSPE concept, as part of the short-term project?

ISSUE 3: DERECOGNITION CRITERIA

The staff recommends that the derecognition criteria (paragraph 9) in Statement 140 be amended as follows (subject to drafting changes) (Added text is underlined and deleted text is ~~struck out~~):

A transfer of a financial assets, a group of financial assets, or a participating interest in an individual financial asset (which are referred to collectively in this Statement as *transferred financial assets*) ~~(or all or a portion of a financial asset) in which shall be accounted for as a sale if the transferor surrenders control over those~~ the transferred financial asset(s). ~~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 financial assets if and only if *all of the following conditions* are met:

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- a. The transferred financial assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership. Transferred financial assets are isolated in bankruptcy or other receivership only if the available evidence provides reasonable assurance that the transferred financial assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its consolidated affiliates included in the financial statements being presented. The isolation analysis must consider all arrangements made in connections with the transfer.
- b. ~~Each transferee (or, if the transferee is a qualifying SPE (paragraph 35), each holder of its beneficial interests) has the right to pledge or exchange the assets (or beneficial interests) it received, and no condition both constrains the transferee (or holder) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor (paragraphs 29–34).~~
- c. The transferor, or any of its consolidated affiliates included in the financial statements being presented or its agents, does not maintain effective control over the transferred financial assets through ~~either~~ (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity ~~or~~, (2) the ability to unilaterally cause the holder to return specific assets, other than through a **cleanup call** (paragraphs 50–54), or (3) a restriction imposed by the transferor on the right of the transferee to pledge or exchange the transferred financial assets.

The recommended amendments to the derecognition model focus on whether the transferor has retained control over a transferred financial asset. Determination of whether the transferor has surrendered control will be assessed under paragraph 9(a)—whether the asset has been isolated from the transferor and its creditors, and under paragraph 9(c)—whether the transferor maintains effective control over the asset. The existing paragraph 9(b) will no longer be included in the derecognition model; however, a criterion similar to the existing paragraph 9(b) will be incorporated into paragraph 9(c). The amendment to paragraph 9(c) will focus on whether the transferor constrains the transferee in a manner that indicates that the transferor maintains effective control over the transferred asset.

In researching potential amendments to Statement 140, the staff considered various derecognition models. Two alternative models considered are as follows:

1. No Continuing Involvement (Alternative B) – This model would replace the existing derecognition criteria with a principle of “no continuing involvement”. That is, if a transferor has **any** continuing involvement with the transferred financial asset, the transfer would not be accounted for as a sale.
2. Accounting Isolation (Alternative 2) – This model would replace the legal isolation criterion (paragraph 9(a)) of Statement 140 with the following criteria to identify if the cash flows of the asset had been isolated from the transferor (accounting isolation):

Criterion A – The transferor, or any of its consolidated affiliates included in the financial statements being presented or its agents, either (1) no longer has the right to receive any economic benefits from the transferred financial asset or (2) has

unconditionally committed to pass through economic benefits provided by a specifically identified financial asset.

Criterion B – The asset recognized by the transferee can only be settled from the economic benefits provided by the specifically identified financial asset. If the transferor or any of its consolidated affiliates included in the financial statements being presented or its agents has enhanced the transferred financial asset such that the transferor is or may be obligated in the future to provide additional cash flows to the transferee from assets other than those specifically identified financial assets, this criterion will not be met. The retention of servicing by the transferor does not provide an enhancement to the transferred financial assets.

The staff does not recommend the no continuing involvement model because of the significant time required to determine what, if any, exceptions would be necessary to make the model operational. Additionally, the staff does not believe a pure no continuing involvement model would properly report the economics of many straightforward transfer transactions.

The staff does not recommend the accounting isolation alternative, as it goes beyond accomplishing the primary objective of the project, which should only be completed in conjunction with the IASB. While practice issues do arise from legal isolation, the staff notes the most pressing problems in the current market are not a result of legal isolation implementation issues.

Q3. Does the Board agree with the staff recommendation to amend Statement 140? If not, what derecognition model does the Board support?

ISSUE 4: UNIT OF ACCOUNT

The staff recommends that the Board provide guidance on when a portion of a financial asset can be derecognized. The 2005 FASB Exposure Draft, *Accounting for Transfers of Financial Assets*, stated that a transfer of a portion of a financial asset is eligible for derecognition if such portion meets the definition of a participating interest. Utilizing the definition provided in the Exposure Draft, with editorial changes, the staff recommends that a participating interest have the following characteristics:

1. It represents an ownership interest in an individual financial asset other than an equity instrument, a derivative financial instrument, or a hybrid financial instrument with an embedded derivative that is not clearly and closely related as described in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.
2. All cash flows received from the asset are divided among the participating interests (including any interest retained by the transferor, its consolidated affiliates, or its agents) in proportion to the share of ownership represented by each. Servicing fees representing adequate compensation and, if applicable, a share of the contractual interest representing all or a portion of the transferor's gain on sale received by the transferor as consideration related to the sale of the participating interest are not included in that determination. The ownership shares remain constant over the life of the original financial asset.
3. Participating interest holders have no recourse, other than standard representations and warranties, to the transferor (or its consolidated affiliates or agents) or to each other, and no participating interest holder is subordinated to another. That is, no participating

interest holder is entitled to receive cash before any other participating interest holder. The rights of each participating interest holder (including the transferor if it retains a participating interest) have the same priority, and that priority does not change in the event of bankruptcy or other receivership of the transferor, the original debtor, or any participating interest holder.

4. Neither the transferor (or its consolidated affiliates, its agents, or a bankruptcy trustee or other receiver for the transferor, its consolidated affiliates, or its agents) nor any participating interest holder has the right to pledge or exchange the entire financial asset in which they own a participating interest.

The staff recommends that the derecognition provisions in Statement 140 should apply to portions that meet the definition of a participating interest, similar to the provision included in the Exposure Draft. Without providing such guidance, the staff believes structuring opportunities will arise that would enable the transferor to circumvent the derecognition criteria, as well as the consolidation criteria in Interpretation 46(R).

As an alternative to the unit of account guidance recommended, the staff also considered defining the term *portion* in Statement 140 as either:

- a. **Alternative 1** - A portion of a specific contractual cash flow of an individual debt instrument or
- b. **Alternative 2** - A pro rata portion of a specific contractual cash flow of an individual debt instrument.

The staff also considered, but does not recommend, the conditions in IAS 39, *Financial Instruments: Recognition and Measurement*, for applying the derecognition criteria for portions of a financial asset

Q4. Does the Board agree with the staff's recommendation to maintain the definition of a participating interest from the Exposure Draft? If not, what definition of a participating interest does the Board support?