

COMMENT LETTER SUMMARY: Accounting for Transfers of Financial Assets

General Summary

1. A total of 53 comment letters were received from respondents on the Exposure Draft (ED), *Accounting for Transfers of Financial Assets*. The majority of respondents generally objected to the changes proposed by the ED. KPMG (comment letter # 44) summarized these views stating:

Accordingly, we believe the Board should consider fundamental issues affecting the accounting for transfers of financial assets, including the financial components model and the notion of qualifying special purpose entities (QSPEs) generally. Those issues may require further due process by the Board to adequately address and, accordingly, we believe it would be better for the Board to make further progress toward the resolution of those issues before finalizing any significant changes to the Statement 140 QSPE and financial components guidance.

2. Respondents generally commented on the following provisions of the ED:

Participating Interests—Paragraph 8A¹

Isolation—Paragraph 9(a)¹

Paragraphs 9(d) and 9(e)¹

Paragraph 9(b)¹

Permitted activities and assets of qualifying special-purpose entities (QSPEs)

Initial Measurement

Effective Date and Transition

Other Issues

¹See Appendix C of the proposed Statement.

The staff prepared this comment letter summary to facilitate constituent's understanding of the issues provided by respondents to a particular Exposure Draft. This material is presented for discussion purposes only; it is not intended to reflect the views of the FASB or its staff. Official positions of the FASB are determined only after extensive due process and deliberations.

Comments on Participating Interests—Paragraph 8A in Appendix C of the Proposed Statement

3. The overwhelming majority of respondents commented on the guidance relating to participating interests as described in paragraph 8A of the proposed statement and other related paragraphs. A minority of respondents supported the concept and most of the characteristics of a participating interest. The National Association of State Credit Union Supervisors (NASCUS) (comment letter #8) summarized their support for the concept of *participating interests* stating:

NASCUS is pleased that the language changes in this amendment define a “Participating Interest” and that the revisions to FAS 140 provide that transfers which meet the above provisions can qualify for sale treatment.

4. The majority of respondents disagreed with the concept and the definition of participating interests. UBS (comment letter # 37) summarized this view, stating:

We therefore suggest that the proposed paragraph 8A is deleted in its entirety and that the financial components approach is continued.

5. Almost half of the respondents who disagreed did so because a QSPE would be required in order to account for a transfer as a sale if transferred portions of financial assets do not meet the criteria of paragraph 8A. Those respondents expressed concern that requiring the use of a QSPE would: (a) increase transactions costs, (b) increase complexity, (c) raise regulatory issues, (d) not enhance legal isolation, and (e) not enhance the representational faithfulness of the underlying transactions. Community Bankers of Wisconsin (CBW) (comment letter # 2) captured some of those points in describing the impact on its Mortgage Partnership Finance (MPF) programs² and stated:

² These are financing structures in which participating MPF banks either buy existing mortgage loans from the participating members or fund the mortgage loans through their members at the time of closing. Currently, the mortgage loans are reported on the MPF bank’s balance sheet while the participating members report these loans off-balance sheet.

The requirement of a QSPE would significantly impede these lenders' access to the MPF Program, particularly for small and mid-sized institutions, by unnecessarily raising the cost of selling loans to a MPF Bank and adding an additional layer of complexity to these transactions. The use of a QSPE will add no further accounting clarity to what is already a straightforward sale transaction. In addition, the economic substance of the transaction is unaffected by the artificial insertion of a "QSPE" vehicle in the transaction structure. Further, the requirement of a QSPE will raise regulatory issues for the FHLBs which may not be allowed to create or have a residual interest in a QPSE.

6. Several respondents expressed concern that the requirement in paragraph 8A(b) of the proposed Statement, which states, "All cash flows received from the asset are divided among the participating interests...in proportion to the share of ownership," would have a significant negative impact on transactions that involve transfers of guaranteed loans. The Independent Bankers of Colorado (IBC) (comment letter #22) elaborated on this point, stating:

Many IBC member banks originate loans guaranteed by the SBA and other governmental agencies. These banks are currently able to offer these loans to the public in significant quantities because there exists a market to purchase the guaranteed portions of those loans. There would be little, if any, investor interest in continuing this practice if investors are required to purchase a proportionate share of the unguaranteed loan. This will have the effect of impairing the availability of needed credit, particularly to small borrowers.

7. Several respondents expressed concern with the "no subordination" requirement in paragraph 8A(c) of the proposed Statement because certain securitizations are structured in such a way that losses are initially borne by the transferor. As a result, those transactions would need to use a QSPE in order to meet sale accounting requirements. Western Corporate Federal Credit Union (WesCorp) (comment letter #10) describes a structure involving participations in pools of loans, stating:

A typical loan participation transaction that credit unions enter into is where the originating credit union sells a 90% participation in its loans and retains the servicing rights as well as a 10% interest in

the loans. All the rights to the underlying loans are conveyed consistent with the ownership percentages 90% and 10%. However, the originating credit union may retain a small subordinated interest, generally 5%, in the pool of loans against which losses are initially allocated and will provide reserves for the expected losses, which is usually significantly less than the limited subordination.

8. Several respondents expressed concern that normal market representations and warranties should not be considered recourse provided that they do not provide credit enhancement. Wachovia (comment letter #52) summarized this concern, stating:

Further, we believe the definition of “recourse” has a drafting error as it inappropriately includes standard representations and warranties that do not provide a form of credit recourse.

9. One respondent (J.P. Morgan Chase, comment letter #15) expressed concern that some might incorrectly interpret the guidance to require the use of a QSPE for all transfers of financial assets in their entirety. That respondent suggested that the final amendment make explicit that transfers of financial assets in their entirety do not *always* require the use of a QSPE.

10. Several respondents agreed with the Alternative View in regard to paragraph 8A (paragraphs A49–A54 of the proposed Statement).

11. Although most respondents generally disagreed with the proposed addition of paragraph 8A, they made a number of suggestions to clarify or modify certain aspects of that paragraph. The key concerns and suggestions raised in the comment letters are listed in the appendix to this memorandum.

Comments on Isolation—Paragraph 9(a) in Appendix C of the Proposed Statement

12. Roughly half of the respondents who commented on the ED addressed the provisions on isolation. The majority of those respondents disagreed with the changes to the isolation provisions specified in paragraphs 9(a), 9(d), 9(e), 27A and

27B of the proposed Statement. A minority of respondents agreed with the changes to paragraph 9(a). NASCUS (comment letter #8) stated:

NASCUS supports the changes to the language of Paragraph 9 of FASB Rule 140. We believe this language provides reasonable assurance of when a financial asset qualifies as a loan sale. It also provides more latitude for credit unions when using loan participations as a tool to diversify risk.

13. Respondents generally disagreed with the requirement that a transfer must be “legally a sale” in paragraph 27A(a) because they believe that isolation may be achieved without a legal sale. The Commercial Mortgage Securities Association (CMSA) (comment letter # 28) made this point in relation to FDIC regulated banks, stating:

For certain transfers by FDIC regulated banks or by non-United States domiciled transferors, it may be possible to “legally isolate” transferred assets without a transfer that is legally a sale or without obtaining True Sale and Substantive Non-Consolidation opinions.

14. Several respondents observed that in some non-U.S. jurisdictions, an entity may isolate financial assets without obtaining a legal sale by structuring the transaction in a particular way. Clifford Chance (comment letter #7) elaborated on this point, stating:

It is possible as a matter of English law to isolate a loan sub-participated under an English law sub-participation agreement from the estate of an English incorporated transferor in its insolvency using a secured loan arrangement. Secured loan arrangements can be structured such that on the transferor’s insolvency, the transferee has recourse to the underlying participated loan in priority to claims of the transferor’s other creditors. The isolation is achieved without a “legal sale.”

15. Several respondents expressed concern that the provisions in paragraphs 27A and 27B of the proposed Statement would put institutions that are required to follow U.S. GAAP at a competitive disadvantage to other institutions that follow IAS 39, *Financial Instruments: Recognition and Measurement*, because the IASB

has no isolation requirement. J.P. Morgan Chase (comment letter # 15) summarized this point stating:

If the requirement for a true sale opinion is imposed as contemplated by paragraphs 27A and 27B of the ED, institutions who sell loans in the London market through English incorporated consolidated subsidiaries will not be able to derecognize the loans under US GAAP despite technically meeting the isolation requirement.

16. One respondent (America's Community Bankers, comment letter #30) expressed concern that true sale opinions are costly and cautioned that they are only as reliable as their inputs, stating:

The process of obtaining a true sale opinion is costly and usually only available from sophisticated law firms, which makes it even more difficult and unlikely that banks in smaller markets will be able to readily obtain the opinions when doing participations. The opinions are based on the facts given to the lawyers through representations and warranties made by management. The opinions are only as good as these factual representations and contain so many assumptions and qualifications that they are really of little value.

17. Several respondents suggested that the isolation requirement as currently written in Statement 140 be retained without amendment. CMSA (comment letter #28) stated:

CMSA sees no reason why a legal standard that may apply only to certain United States based transferors should be applied to transferors to whom it does not apply and is not applicable. Accordingly, CMSA requests that the Final Amendments retain only the current Statement 140 "legal isolation" requirement, and not include detailed rules on the precise legal opinions or standards necessary to achieve "legal isolation."

18. Several respondents requested that the phrase "consolidated affiliate" in paragraph 9(a) of the proposed Statement be clarified because the phrase could be interpreted differently. Those respondents observed that the "consolidated affiliate" could relate to (1) affiliates consolidated by the transferor or (2) the parent company and all of its subsidiaries (in the event that the transferor is a

subsidiary). KPMG (comment letter #44) explained how the phrase “consolidated affiliate” could be misinterpreted stating:

This phrase can be read and interpreted to mean that the transferor is required to evaluate only arrangements involving only those affiliates that are included in the *transferor’s* consolidated financial statements....The language in paragraph A9 suggests that the transferor is required to evaluate arrangements involving affiliates that are included in the *transferor’s* consolidated financial statements as well as in whose consolidated financial statements the transferor is included (e.g., the transferor’s parent company).

19. Several respondents supported the view that the isolation analysis should only consider entities consolidated by the transferor. Merrill Lynch (comment letter # 18) suggested that the isolation analysis should be limited to “affiliates that are a party to or are directly involved in the transaction.” Merrill Lynch also stated that:

[T]here are situations in which a transfer of assets may pass the legal isolation test even though an affiliate of the transferor provides some level of support or credit enhancement. However, as long as it is limited, and as long as the transferred assets are outside the chain of title of the transferor, a legal isolation opinion may be rendered.

20. CMSA (comment letter # 28) requested that the phrase “affiliate, qualifying SPE, or other SPE” in paragraph 27B of the proposed Statement be clarified because AU 9336, *Using the Work of a Specialist: Auditing Interpretation of 336*,

[R]equires substantive non-consolidation opinions for United States transferors when the transferee is an affiliate of the transferor....[T]he concept of substantive non-consolidation may not apply in countries outside the United States. Accordingly, CMSA recommends that the Proposed Amendment be conformed with AU 9336, so non-consolidation opinions are only required for United States based transferors when the transferee is an “affiliate.”

21. Several respondents expressed concern about how to interpret the “reasonable basis” guidance in paragraphs 27A and 27B. Mortgage Bankers Association (MBA) (comment letter #32) described some of the ways “reasonable basis” can be interpreted, stating:

While some MBA members believe a “reasonable basis” as used in paragraph 27A refers to circumstances in which legal opinions have been obtained for similar transactions in the past, others believe it refers to all available evidence that supports or questions an assertion of isolation, regardless of whether legal opinions have been obtained in the past.

22. Grant Thornton (comment letter #25) commented on the example in paragraph 27B, which indicates that a transferor might have a reasonable basis to conclude that a legal opinion would not be required if the transferor had experience with other transfers with the same facts, by stating:

We do not believe that this is an appropriate example of when a legal opinion might not be required to support a conclusion that transferred assets have been isolated from the transferor. It is unlikely that a transferor would have past experience in bankruptcy or other receivership. We suggest including an example in which the transferor has no continuing involvement with the transferred assets or the transferor has obtained a legal opinion for other recent transfers with the same facts and circumstances and the transferor can conclude that there have been no subsequent changes in relevant laws or regulations.

The respondents who expressed concern with the phrase “reasonable basis” suggested that the guidance in paragraphs 27A and 27B be clarified, possibly through the use of examples.

Comments of Paragraphs 9(d) and 9(e) in Appendix C of the Proposed Statement

23. Roughly one quarter of the respondents who commented on the ED addressed the provisions in paragraphs 9(d) and 9(e) of the proposed Statement. The overwhelming majority of those respondents either disagreed with the provisions or requested that the provisions be clarified.

24. Several respondents disagreed with the provisions in paragraph 9(e) and the guidance in the first two sentences of paragraph A17 of the ED because isolation should not be based on theoretical circumstances or affiliates that are not involved

in the transfer. ASF (comment letter # 29) suggested deleting those provisions, stating:

We are requesting these deletions because we believe that the proposed hypothetical isolation analysis goes beyond legal isolation, which has previously been the sole requirement under paragraph 9(a).

25. One respondent (CMSA, comment letter #28) noted that paragraph 9(e) and paragraph A17 of the basis for conclusions are inconsistent because paragraph A17 indicates that legal opinions must hypothetically evaluate any involvement by all consolidated affiliates (including bankruptcy-remote entities [BRE's]) of the transferor with a transferee or beneficial interest holder of a QSPE. However, paragraph 9(e) only addresses involvements with beneficial interest holders of the QSPE.

26. Further, the CMSA suggested that the provisions in paragraphs 9(e) and A17, when applied to a transaction that involves a BRE that is an affiliate of the transferor, are inconsistent with the paragraphs 80–83 of Statement 140 because:

[A]ssuming such bankruptcy remote SPE's involvement was provided by the transferor would, in most cases, preclude attorneys from issuing true sale and substantive non-consolidation opinions – this is the reason two step transfers using a bankruptcy remote special purpose entity are used in most securitizations.

27. One respondent (Countrywide, comment letter #20) suggested deleting paragraph 9(d) of the proposed statement entirely because paragraph 55 of Statement 140 already requires re-recognition of transferred financial assets if subsequent events bring the assets back in the transferor's control.

28. One respondent (Citigroup, comment letter #23) expressed concern that the timeframe in paragraph 9(d) is too open-ended, stating:

It is not clear how much time has to elapse before a new agreement with a counterparty does not need to be considered as part of a paragraph 9(e) isolation analysis and when paragraph 55 takes over from paragraph 9(e) where a transferor has regained effective control of a transferred asset.

29. Respondents made a number of suggestions to clarify or modify certain aspects of the provisions in paragraphs 9(d) and 9(e) of the proposed Statement. The key concerns raised in the comment letters include:

- a. Concern about transactions that fail the isolation test subsequent to being accounted for as a sale (KPMG, comment letter #44)
- b. Clarify whether isolation analysis is required on an ongoing basis and whether agreements made at any time in connection with transferred assets will require a reassessment of the status of the QSPE (IMA, comment letter #49)
- c. Clarify what constitutes an “arrangement” (Swiss Re, comment letter #40)
- d. Clarify whether an “arrangement” refers only to contractual arrangements or whether it also applies to implicit arrangements (KPMG, comment letter #44)
- e. Concern that legal counsel may not consider the provisions in paragraphs 9(d) and 9(e) when rendering a true sale opinion (J.P. Morgan Chase, comment letter #15)

Comments on Paragraph 9(b) in Appendix C of the Proposed Statement

30. Roughly one-quarter of respondents who commented on the ED addressed the provisions in paragraph 9(b). The overwhelming majority of those respondents disagreed with the provisions. Several respondents disagreed with the provisions in paragraph 9(b) because a series of inextricably linked transactions should be evaluated in their entirety. Bank of America (comment letter #45) summarized the view of those who had this concern, stating:

Therefore, we believe that the analysis should not focus on intermediate transferees but should instead evaluate the rights of the ultimate transferees to determine whether the requirements of paragraph 9(b) have been met.

31. A number of respondents expressed concern that the provisions in paragraph 9(b) were too strict. Citigroup (comment letter #23) summarized this concern stating:

We believe that such a requirement is not conceptually necessary and could result in virtually every multi-step transfer being viewed as a secured borrowing.

32. Several respondents disagreed with the requirement that a *transferor* may not be constrained from pledging or exchanging its beneficial interests because by meeting the other requirements within paragraph 9, the transferor will demonstrate that control has been surrendered. One respondent observed that it is more evident that the transferor surrendered control when the transferor is constrained from pledging or exchanging its assets. MBNA (comment letter #12) summarized both of these views stating:

This requirement is unnecessary since the intent of 9(b) is to ensure the transferor has surrendered control of the transferred financial assets such that a transferee is free to pledge or exchange them. The extent to which a transferor itself is constrained from pledging or exchanging the transferred assets, we believe, should be viewed as a further indication that the transferor has in fact surrendered control. As a result, we recommend that the parenthetical text “(including the transferor itself if it holds a beneficial interest)” be removed from the proposed additions to paragraph 9(b).

33. Several respondents expressed concern that the provision identified in paragraph 29 of this memorandum conflicts with the provisions in paragraph 83 of the ED, which provides for two-step transactions in which the first transferee is a BRE. Those respondents observed that the BRE is generally pre-programmed to transfer assets to a specific QSPE, and, as a result, the BRE does not have the *ability* to pledge or exchange its assets. Merrill Lynch (comment letter #18) expressed these views, stating:

This appears to directly conflict with the guidance in paragraph 83 which explicitly allows for a two-step transaction,

whereby the first transfer is to a bankruptcy remote entity that is not a QSPE, and the second transfer is to an entity that is a QSPE. In the transaction described in paragraph 83, we do not see how the first entity (the bankruptcy-remote entity or BRE) would satisfy the new requirement of paragraph 9b because it is directed by the transferor to immediately sell its assets to the second entity (and this direction presumably provides more than a trivial benefit to the transferor because it is essential to effect the securitization transaction).

34. Several respondents offered a number of resolutions to the conflict between the provisions in paragraphs 9(b) and 83, including: (a) delete the last sentence of 9(b) or view its guidance as application guidance and add it to paragraph 27, (b) exclude preprogramming features from the scope of paragraph 9(b), or (c) apply the 9(b) provisions to the consolidated group and test whether the transferee can pledge its assets to nonconsolidated transferees. Merrill Lynch elaborated on the latter resolution stating:

We believe the provisions of 9b should apply to the consolidated group, and therefore the test of whether the transferee can freely pledge or exchange the transferred assets should be applied only to those transferees that are not consolidated, for accounting purposes, with the transferor.

35. Several respondents expressed concern about multi-step transfers in which the intermediate BREs typically have limited discretion with what the entity can do with the transferred assets and because any limited discretion could be perceived as providing a more-than-trivial incremental benefit to the transferor. Countrywide (comment letter # 20) elaborated on this concern, stating:

Requiring satisfaction of the additional language in paragraph 9(b) at each step of a multi-step securitization is problematic as currently worded. Each of the entities in a multi-step securitization is limited on what it can do with the assets being transferred. For example, in a two-step structure, the Bankruptcy Remote Special-Purpose Corporation (BRSPC), wholly owned by the transferor, is required to transfer the assets obtained from the transferor to the qualifying SPE Trust Issuer. That “constraint” could be interpreted as providing more-than-trivial benefit to the transferor.

36. Respondents made a number of suggestions to clarify or modify certain aspects of the provisions in paragraph 9(b). The key concerns and suggestions raised in the comment letters include:

- a. Clarify that servicing rights are not considered beneficial interests in paragraph 9(b) (MBA, comment letter #32).
- b. Concern about whether a more-than-trivial incremental benefit includes the retention of servicing rights by the transferor (Countrywide, comment letter #20).
- c. Concern about whether the first sentence of paragraph 9(b) applies to intermediate QSPE's in a multi-step transfer (MBNA, comment letter #12).
- d. Concern that the provisions of paragraph 9(b) could not be met when a transferor has an ownership interest in a transferee that permits the transferor to block actions of the transferee through voting or managerial powers (for example, joint ventures) (KMPG, comment letter #44).

Comments on Permitted Assets and Activities of QSPEs

37. Two fifths of respondents who commented on the ED addressed three separate issues related to the permitted assets and activities of QSPEs. These issues can be categorized as issues related to:

- a. Paragraphs 35 and 40, which remove the prohibition on a QSPE holding passive derivative financial instruments that pertain to transferor's beneficial interests
- b. Rollovers of beneficial instruments
- c. Prohibition on holding equity instruments.

Paragraphs 35 and 40, which remove the prohibitions on a QSPE holding passive derivative financial instruments that pertain to transferor's beneficial interests

38. The majority of respondents who commented on changes to paragraphs 35 and 40 generally supported the proposed changes to paragraphs 35(c)2 and 40. Merrill Lynch (comment letter # 18) expressed such support, stating:

There is one aspect of the Transfers ED that we do strongly support, which is the Board's decision to change the limit on the amount of passive derivative instruments that a QSPE can hold to the total notional amount that pertains to all beneficial interests issued or sold by the QSPE, including beneficial interests sold to the transferor (paragraphs 35(c)2 and 40(a)).

39. More than half of the respondents who supported the changes to paragraphs 35(c)2 and 40 suggested that those changes be incorporated within the hybrids ED primarily because those paragraphs directly correlate with that amendment. J.P. Morgan Chase (comment letter # 15) summarized this point stating:

[W]e support the proposed deletions in paragraph 35c2 and paragraph 40 and suggest that [the] Board include such changes in the Hybrids ED.

40. Some respondents suggested that paragraph 40 be completely removed because the rescission of Statement 133 Implementation Issue No. D1, "Application of Statement 133 to Beneficial Interests in Securitized Financial Assets," and the requirement to measure embedded derivatives requiring bifurcation at fair value have eliminated the need for that paragraph. Bank of America (comment letter #45) expressed the concern of those respondents, stating:

[G]iven the recently-issued Exposure Draft, *Accounting for Certain Hybrid Financial Instruments, an amendment of FASB Statements No. 133 and 140*, we question whether the restrictions in paragraphs 40(b) and 40(c) that limit the amount and type of derivatives that can be held by a QSPE are still necessary.

Rollovers of beneficial interests

41. More than half of the respondents who addressed QSPEs commented on rollovers of beneficial interests. The majority of those respondents disagreed with the provisions of paragraph 45A of the proposed statement because (a) the provisions conflict with the concept of control, (b) a significant number of rollover

transactions involve parties with more than one involvement or right, and (c) the questions raised by EITF Issue No. 02-12, “Permitted Activities of a Qualifying Special-Purpose Entity in Issuing Beneficial Interests under FASB Statement No. 140,” as to the nature and extent of discretion inherent in re-issuance of beneficial interests requires the Board’s attention.

42. Several respondents expressed concerns with the meaning of “more-than-trivial incremental benefit” and how to identify such a benefit. MBNA (comment letter #12) expressed these concerns, stating

There is inherent difficulty in applying any provision that requires judgment; determining when a benefit is “more-than-trivial” is a prime example. It would be helpful to both issuers and their auditors if the final Statement could include some examples of arrangements that the Board has seen that they consider to provide some party with a more-than-trivial incremental benefit.

43. Several respondents were unclear why master trusts are not rollovers. The IMA (comment letter #49) expressed this view, stating:

[I]t is unclear what the exception language for a revolving-period master trust is intended to accomplish or to what extent it will be effective. It is also unclear whether the treatment afforded revolving-period master trusts changes once the revolving period ends.

Prohibition on holding equity instruments

44. More than a quarter of the respondents who addressed QSPEs supported the prohibition of a QSPE from holding equity instruments. The IMA summarized this point, stating:

We support the proposed paragraphs 35(c)(1) and 35(c)(5) prohibiting a qualifying SPE from holding equity instruments, unless those equity instruments were received as a recovery of collateral from a financial asset.

45. Several respondents suggested that a QSPE should be permitted to hold certain equity instruments such as shares of money market funds and titling trust certificates. The IMA expressed this view, stating:

[T]wo scope exceptions may be required for pass-through certificates representing interests in financial assets that are in equity form (such as titling trust certificates) and shares of money market funds.

46. Several respondents expressed concern with the meaning of “significantly limited” and “entirely specified” used in paragraph 35(b). Ernst & Young (comment letter #48) requested that the final Statement include additional guidance on the types of discretion that meet the requirement for “significantly limited and entirely specified.”

Comments on Initial Measurement

47. One quarter of the respondents who commented on the ED addressed measurement. The majority of those respondents agreed with the “fair value” provisions in paragraphs 10(d) and 11(b) of the proposed Statement. Merrill Lynch (comment letter #18) stated:

We do not object to this change on a conceptual basis as we are in agreement with the FASB’s broader effort to record transactions at fair value.

48. One respondent (UBS, comment letter #37) stated:

We believe that a retained interest in a non-qualifying SPE should be considered a new asset, assuming the transferor does not consolidate the SPE. As explained in paragraphs A37 to A41 of the Basis for Conclusions, the Board based its decision to require initial fair value measurement of a retained beneficial interest on the fact that, when using a qualifying SPE, a transferor has surrendered control. A transferor retaining an interest in a non-consolidated non-qualifying SPE has also surrendered control. As a result, we believe that a retained interest should initially be measured at fair value even if it is not issued by a qualifying SPE, as long as the transferor has surrendered control over the transferred asset.

49. One respondent (PWC, comment letter #36) generally agreed with recognizing the beneficial interest retained by the transferor being measured at fair value; however, they expressed concern that a lawyer might find it difficult to conclude that all of the assets were legally sold to the QSPE because the transferor has retained a piece of the assets.

50. Several respondents expressed concern that the provisions on fair value would provide an easy mechanism to recognize an embedded gain in a financial asset without transferring any economic ownership or risk to a third party. Citigroup (comment letter #23) expressed this view, stating:

Recording all transferor's beneficial interests at fair value will require gains and losses to be recognized even when the transferor retains all or most of the cash flows from the transferred assets. While we appreciate the intellectual consistency of the "new asset" concept, we believe that the practical implications of this change are truly radical.

51. Several respondents expressed concern about the possible ramifications of the proposed guidance when applied to assets that are not subsequently accounted for at fair value with changes in value being recorded in earnings. Merrill Lynch (comment letter #18) expressed this concern after describing a transaction where an available-for-sale security is transferred to trading, stating:

While it is arguable whether a "new" security has been created by virtue of selling only a small portion of the beneficial interests to third parties, we believe that if the FASB decides to move forward with its proposal, to prevent abuse, it should require that the transferor's beneficial interests be marked to market through earnings both initially as well as subsequently.

52. One respondent (First Horizon National Corporation, comment letter #17) read the revised example for paragraph 60 of Statement 140 to mean that a participating interest that is retained by the transferor is a new financial asset that should be initially measured at fair value. This respondent asked for clarification on any

changes that the Statement would require for a transferor's subsequent balance sheet classification and accounting for a participating interest.

53. Several respondents disagreed with the fair value provisions in paragraph 11 of the proposed Statement and generally expressed the same concern as J.P. Morgan Chase (comment letter #15), who stated:

We are concerned that application of the proposed guidance in paragraph 11b to certain securitization structures provides an opportunity for earnings management in cases in which the transferred assets were not measured by the transferor at fair value with changes recognized in earnings both prior and subsequent to the transfer. Similar to the dissenting board member's view, we believe that any relevance brought about by a momentary fair value measurement should be addressed in a more comprehensive review of subsequent measurement throughout the life of a financial instrument.

54. RBC Financial Group (comment letter # 43) expressed concern that the fair value requirement in paragraph 11(b) of the proposed Statement:

[W]ould result in a potential step-up in the carrying value where a transferred asset is merely converted into a beneficial interest in the same asset.

Comments on Effective Date and Transition

55. Three respondents agreed with the effective date and transition guidance, stating that the beginning of the fiscal year is the best time for an accounting change of this magnitude for nonpublic companies. Respondents generally agreed with the guidance in paragraph 8 of the proposed Statement that states a formerly qualifying SPE should continue to be a QSPE until the latter of six months after the effective date of the Statement or until it has rolled over a majority of beneficial interests.

56. Respondents asked for clarification on how to determine that a majority of beneficial interests have been rolled over for entities that issue both beneficial interests that rollover and others that do not: Is majority assessed in terms of total

number of beneficial interests or total dollar value? Also, respondents asked whether only the outstanding beneficial interests that roll over or all beneficial interests issued by the QSPE are considered in the analysis.

57. Respondents made a number of suggestions to clarify or modify certain aspects of the transition provisions in paragraph 4 of the proposed Statement. The key suggestions made in the comment letters include:

- a. Clarify what constitutes a continuing obligation. Specifically, are servicing commitments and limited subordination considered continuing obligations?
- b. Clarify what commitments are considered commitments to transferred financial assets versus commitments to beneficial interests.
- c. Clarify why paragraphs 9(a), 27A, and 27B of the proposed Statement have different effective dates.
- d. Clarify why paragraph 35(c)(2) of the proposed Statement has a different effective date than the hybrid financial instruments ED.

58. Respondents requested prospective application of the provisions in the ED and many respondents requested a delay in the effective date to provide ample time for institutions to implement necessary changes to comply with the provisions. Respondents requested a variety of effective dates, with the latest request being January 1, 2007, and the possibility of early adoption, particularly for paragraphs 35(c) and 40. One respondent raised a concern that multiple effective dates and mid-year adoption will decrease comparability of financial statements.

Other Comments

59. Respondents also commented on the definition of beneficial interest. Respondents asked what term is appropriate to describe interests issued by a non-qualifying SPE and suggested expanding the scope of the definition of *beneficial interest* beyond interests issued by QSPEs.

60. Other suggestions included:

- a. This project should be written as a revision instead of an amendment.
- b. This standard should be written in plain English.
- c. The FASB should consider completing this project as a joint project with the IASB to achieve convergence.
- d. The amendment should clarify when sale versus secured borrowing treatment is appropriate.

61. The disclosures discussed in paragraph 17(g) of the proposed Statement should be required for all SPEs, not just QSPEs

Appendix

Questions Posed and Suggestions Made by Respondents to Clarify Paragraph 8A

1. “Ownership interest” should be defined in legal terms because the purpose of establishing a QSPE is to achieve legal isolation. As such, participating interests should be defined solely from a legal perspective.
2. The last sentence of paragraph 8A(b) should be replaced or deleted because it (a) fails to acknowledge that the loan documents may provide for multiple funding events for lines of credit and that participants may transfer interests, (b) ownership percentages may be tied to pool balances and, as a result, if the pool balance changes, so will the ownership balance, and (c) a LIFO/FIFO loan participation would be prohibited.
3. Clarify the inconsistency between paragraph 10(d), which discusses recognition of “servicing assets and liabilities,” and paragraph 8A(b), in which participating interests include only transactions in which the “servicing fees representing adequate compensation.”
4. Clarify the phrase “representing adequate compensation” because it implies that servicing an asset would disqualify the transferred asset from meeting the definition of participating interest.
5. Why can a transferor retain an interest only strip, when its fair value cannot exceed any gain on sale of the transferred assets?
6. Consider that there may be reasonable fees, other than those strictly tied to servicing, which are not divided proportionately based on the share of ownership
7. Is the “in proportion” criterion designed to prohibit any subordination among classes or between interests in the same class?

8. The last sentence in paragraph 8A(c) could be interpreted to preclude sale accounting treatment for one-step, standard, nonrecourse, loan participations because of the existence of transferor setoff rights. Therefore, that paragraph should explicitly state that setoff rights do not present an impediment to isolation.