

MINUTES



To: Board Members
From: Jacobs (ext. 451), Hoyt (ext. 298)
Subject: Minutes of the May 30, 2007 Board Meeting—Transfers of Financial Assets: Linked-Presentation Model
Date: June 11, 2007

cc: L. Smith, Bielstein, Leisenring, Golden, MacDonald, Wilkins, Lott, Barker, Lusniak, Donoghue, Hoyt, Detling, Chookaszian, Zecher, Polley, Gabriele, Sutay, Allen, Klimek, Thomas (IASB), FASB Intranet

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Topic: Transfers of Financial Assets: Linked-Presentation Model

Basis for Discussion: Memorandums 71, 72, 74, and 76, dated February 16, February 28, May 3, and May 24, 2007, respectively

Length of Discussion: 8:30 to 9:30 a.m.

Attendance:

Board members present: Herz, Batavick, Crooch, Linsmeier, Seidman, Trott, and Young

Board members absent: None

Staff in charge of topic: Jacobs, Donoghue, Zecher, and Hoyt

Other staff at Board table: L. Smith

Outside participants: None

Summary of Decisions Reached:

The Board decided that removing the qualifying special-purpose entity (SPE) concept from FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, is an approach worthy of further research. Additionally, the Board instructed the staff to further develop a linked-presentation model as a solution to the issues in the short-term project to amend Statement 140.

The Board directed the staff to focus this research on a linked-presentation model that (a) amends paragraph 9(b) of Statement 140 to remove the concept of a qualifying SPE and (b) is applicable only to transferors of financial assets.

The Board also requested that the staff consider the effects of amending paragraph 9(b) on the remaining criteria in paragraph 9, including previous tentative decisions reached by the Board in the Statement 140 Amendment project (for example, the tentative decision to use a *hypothetical legal opinion* when assessing paragraph 9(a)).

Objectives of the Meeting:

The objectives of the meeting were to discuss the initial feedback received from the Servicer Discretion Resource Group on the Passive Asset/Liability model (PAL model) and to discuss the staff's research on a Linked-Presentation model (LP model) as an alternative to the PAL model.

With respect to the LP model discussion, the staff's specific objectives were to determine the following:

- a. Whether the Board believes that removing the qualifying SPE concept from Statement 140 is an approach worthy of further research as a solution to the issues in the short-term project to amend Statement 140.
- b. Which alternative derecognition threshold the Board wishes to research further.
- c. Which entities the Board believes should be eligible for linked presentation.

The objectives of the meeting were met.

Matters Discussed and Decisions Reached:

INTRODUCTION

1. Mr. Jacobs began the meeting by stating that the purpose of the meeting was for the Board to discuss the initial feedback received from the Servicer Discretion Resource Group on the PAL model and to discuss the staff's research on an LP model as an alternative to the PAL model.

BACKGROUND—THE PAL MODEL

2. Mr. Jacobs stated that the staff researched the PAL model. It is a model that would limit the activities of a qualifying SPE to those that involve only basic servicing (defined in the model) and would restrict the permitted assets and liabilities of a qualifying SPE to those financial instruments that are truly passive, in the strictest sense of the word *passive*.
3. Mr. Jacobs stated that the staff worked with the resource group to analyze the PAL model. The staff provided resource group members with an outline of the PAL model and asked them to explain how the model might affect current transactions and to offer input on how to make the model workable in practice. The staff also asked for responses to specific questions about the model.
4. Mr. Jacobs stated that the resource group members' feedback was highly beneficial and thanked the resource group members for the time that they dedicated to providing the input. The overall tone of the response received was generally consistent. For various reasons, respondents were nearly unanimous in their reluctance to support a strict interpretation of the passive concept as a workable solution to the issues in this project. That is, all respondents question which asset classes would qualify as passive.
5. Mr. Jacobs stated that the staff continues to believe that the PAL model is not radically different from the Board's intentions in supporting the original concept of a qualifying SPE. The staff acknowledges that the PAL model is more specific than the current guidance in Statement 140, which explains why respondents concluded that

certain asset classes would not meet the restrictive definition of *passive*, but the underlying premise that a qualifying SPE can only hold passive instruments is not new.

6. Mr. Jacobs stated that, based on resource group members' comments and additional research the staff performed since receiving those comments, it is evident to the staff that applying the PAL model would result in similar financial reporting to a complete removal of the qualifying SPE concept. Therefore, the staff has performed initial research on an alternative to the PAL model. Mr. Jacobs stated that the staff refers to this alternative as the LP model, although the linked display is just one element of the model. An LP model was initially suggested by certain resource group members and widely supported by others.

THE BASIC LINKED-PRESENTATION MODEL

7. Mr. Jacobs stated that, in its simplest form, the LP model removes the qualifying SPE concept from Statement 140 and creates specific criteria to determine when assets and liabilities in a secured borrowing should be presented as **linked** on the face of the balance sheet. The LP model is not a **net-presentation** model. The LP model requires that the gross assets and liabilities be displayed on the balance sheet, with additional footnote disclosures. However, they are presented as linked, on the left side of the balance sheet, if specific criteria are met.
8. Mr. Jacobs stated that the objective of this model is (a) to reduce complexity in Statement 140 by removing the qualifying SPE concept and (b) to record transfers of financial assets in accordance with the economics of the transaction.
9. Mr. Jacobs continued by stating that removing the qualifying SPE concept from Statement 140 would result in the following changes to paragraph 9(b) [deleted text is ~~struck out~~]:

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).

10. Mr. Jacobs stated that, in the staff's view, linked presentation would be required when a financing meets the following principle:

Where a transfer of financial asset(s) is recorded as a secured borrowing, but the financing sequesters the financial asset(s) such that:

- a. The finance will be repaid only from proceeds generated by the specific item it finances (or by transfer of the item itself) and there is no possibility whatsoever of a claim on the entity being established other than against funds generated by that item (or the item itself)
- b. The entity has unconditionally committed to pass through the cash flows received on that asset or those assets.

The finance should be shown deducted from the gross amount of the item it finances on the face of the balance sheet within a single asset caption ("Linked Presentation"). The gross amounts of the item and the finance should be shown on the face of the balance sheet and not merely disclosed in the notes to the financial statements.

11. Mr. Jacobs stated that the staff supports an LP model for numerous reasons, including:

- **Linked presentation appropriately reflects the economics of the transactions:** Because a transfer, in which the transferor maintains continuing involvement with the transferred financial assets, is neither completely a sale nor a secured borrowing, Mr. Jacobs stated that the staff believes that an alternative model is required to provide users with appropriate information regarding those types of transactions and that information can best be provided within an LP model.

The staff acknowledges that the financial-components approach, as described in the Statement 140's basis for conclusions, is also designed to:

- a. Be consistent with the way participants in the financial markets deal with financial assets, including the combination and separation of components of those assets
- b. Reflect the economic consequences of contractual provisions underlying financial assets and liabilities.

[paragraph 141(a) and 141(b)]

However, when the staff views economics of the transactions, it tends to increase the importance of the perspective of financial statement users with less emphasis on the focus of “participants in the financial markets” (for example, investors in individual security classes).

- **Academic Research and Analysts’ Views:** Mr. Jacobs stated that the staff also has analyzed the academic research and views of users of financial statements, including equity analysts. The information reviewed by the staff raises doubts about whether securitizations transfer meaningful risk and implies that such transactions are closer to secured borrowings than they are to a complete sale.
- **Simplification:** Mr. Jacobs stated that qualifying SPEs are a complex concept, as evidenced by the numerous implementation issues that have arisen over the years. Given that the removal of the qualifying SPE concept provides similar results to the PAL model, as interpreted by the staff, the staff believes that the added benefit of simplifying Statement 140, by removing the qualifying SPE concept, is worthy of further research as part of an LP model.

12. Mr. Jacobs then asked the Board if it believes that removing the qualifying SPE concept from Statement 140 is an approach worthy of further research as a solution to the issues in the short-term project to amend Statement 140.

13. Mr. Trott stated that he believes the PAL model is consistent with the Board’s intent in FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, and Statement 140.

14. The Board agreed that removing the qualifying SPE concept from Statement 140 is an approach worthy of further research. [All Board members agreed.]

ISSUE 1: DERECOGNITION THRESHOLD

15. Mr. Jacobs continued by stating that the removal of the qualifying SPE concept amends paragraph 9(b) such that if the transferee is constrained from pledging or exchanging the transferred assets and such constraint provides more than a trivial

benefit to the transferor, the transaction would be accounted for as a secured borrowing. Therefore, securitizations, which generally impose constraints on the securitization trust (to protect the beneficial interest holders), in which the transferor has a continuing involvement, would not qualify for derecognition.

16. Mr. Jacobs stated that the removal of the qualifying SPE concept raises the first issue: should the model provide an alternative derecognition threshold for transactions that restrict the transferee's right to pledge or exchange the assets it received?

17. Mr. Jacobs stated that the staff is presenting the Board with four alternatives for the direction of future research on an alternative derecognition threshold:

View A: **No.** Transfers in which the transferee is constrained and the transferor maintains continuing involvement with the transferred assets should not result in derecognition. However, basic servicing for market-based compensation would not be considered continuing involvement. This view maintains paragraph 9(b), as amended under the basic LP model.

View A': **No.** This view removes paragraph 9 of Statement 140 in its entirety and replaces it with the simplified principle that financial assets are only derecognized when the transferor has no continuing involvement. Removing paragraph 9 also will address the legal isolation issues that are part of the project to amend Statement 140.

View B: **Yes.** Derecognition should be allowed for transactions in which the transferor does not maintain a **majority of the risks and rewards** of the transferred assets. The threshold for determining whether the transferor has transferred a majority of the risks and rewards should be consistent with FASB Interpretation No. 46 (revised 2003), *Consolidation of Variable Interest Entities*. That is, derecognition is appropriate when the transferor is not considered the primary beneficiary of the transferee (the previously qualifying SPE).

View C: **Yes.** Derecognition should be allowed for transactions in which the transferor does not maintain a **majority of the risks and rewards** of

the transferred assets. However, unlike View B, the new threshold for derecognition should apply to all asset transfers, not only to transfers to entities. This change would be achieved by removing paragraph 9(b) of Statement 140 in its entirety.

18. Mr. Jacobs then asked which of those alternative derecognition thresholds the Board believes should be researched further.
19. Mr. Trott stated that the proposed View A appears to carry over similar problems with making a distinction between basic servicing and any other kind of continuing involvement, which the PAL model also was unable to resolve. He stated that he is concerned that the proposed LP model may be shifting complexity and issues to another area rather than resolve them—specifically, that financial assets transferred to entities established for securitizations may not remain significantly restricted under the proposed View A.
20. Mr. Trott also stated that he is concerned that an LP model, although not yet covered in the staff's research papers, would likely present the net assets retained as simply an arithmetic result of subtracting the fair value of the gross assets and gross liabilities. He stated that this net number may be an inappropriate representation because a significant portion of risk in the retained assets is derived from subordination and the net number may not represent fair value. He stated that he is concerned that an LP model may result in an elimination of better reporting of the retained asset (that is, at fair value), as currently prescribed under Statement 140.
21. Mr. Trott stated that he supports View A but only under the condition that the criteria for linked presentation are restrictive and that one of the criteria is that the financial assets are “sequestered” under the financing, as included in the principle presented by the staff.
22. Ms. Seidman stated that she supports View A', which is broader than just an amendment of paragraph 9(b), because it simplifies Statement 140 and expresses, in accounting terms, the appropriate derecognition threshold. Previous decisions in this ongoing project have been fundamental in nature, including, in her view, the

proposed amendment to paragraph 9(a) to require a hypothetical legal opinion. If this project is going to make fundamental changes, then she would support going for the “bigger” simplification provided by View A'.

23. Ms. Seidman stated that she supports View A' for the following reasons:
- a. The principle in View A' corresponds with analysts' views, which purport that, to the extent risks are retained by the transferor, the transaction is accounted for as a secured borrowing.
 - b. While not entirely convergent with international standards, the derecognition threshold in View A' is similar to that described in IAS 39, *Financial Instruments: Recognition and Measurement*, which initially asks whether substantially all risks and rewards have been surrendered. That is, View A' is a step in the right direction.
 - c. A linked presentation would provide better information about these types of transactions.
 - d. View A' is vastly simpler than maintaining paragraph 9 of Statement 140, while providing similar results to using a legal analysis.
24. Ms. Seidman further stated that, whatever view is supported by the Board, the LP model should contemplate all transfers of assets, not just securitizations.
25. Mr. Linsmeier stated that he supports View A but with an “extended” view that considers the effects of amending paragraph 9(b) on the remaining criteria in paragraph 9, including previous tentative decisions reached by the Board in the project to amend Statement 140 (for example, the tentative decision to use a hypothetical legal opinion when assessing paragraph 9(a)). He stated that he supports removing the concept of a qualifying SPE, but that he also would support revisions to Statement 140 that would address issues relating to affiliated/related-party involvement through possible revisions to paragraph 9(c) and that would eliminate lawyers' involvement in derecognition decisions by removing paragraph 9(a). However, in evaluating this approach, he would have the staff assess how all of the proposed changes to paragraph 9(a), 9(b), and 9(c) collectively address the issues

being addressed related to Statement 140, and he would prefer, if possible, that each issue be addressed by making revisions to one subparagraph only. Mr. Linsmeier believes that in making revisions to paragraph 9, accounting concepts relating to derecognition would best be addressed through modifications to paragraph 9(b) and 9(c) and, therefore, if paragraph 9(a) needs to be retained that lawyers only be asked to give opinions consistent with legal and not accounting concepts.

26. Mr. Crooch stated that it is easy for him to dismiss the possibility of View B or View C because he is not comfortable pursuing a view that determines derecognition based on a majority of the risk and rewards. He supports View A because it is not as significant of a change to Statement 140 as View A'.
27. Mr. Batavick stated that he is neither confident with the operationality of recent revisions to paragraph 9(a) nor is he confident with maintaining Statement 140 as it stands. He stated that it would be more worthwhile to further research View A'.
28. Mr. Young stated that he supports View A because he is concerned that a project that incorporates View A' would take additional time.
29. Mr. Herz stated that his preference would be to further research View A' for two reasons. First, he does not believe that paragraph 9(a), as it stands, is conceptually sound or operational. Second, he believes that the concept of continuing involvement, as expressed under View A', would likely envelope the principle set forth in paragraph 9(c). In his view, View A would probably take more time than View A' because of the difficulty of maintaining paragraph 9 after removing the concept of a qualifying SPE.
30. The Board agreed to further research View A, with an extended view as described by Mr. Linsmeier in paragraph 25. [All Board members agreed.]

ISSUE 2: ELIGIBILITY FOR LINKED PRESENTATION

31. Mr. Jacobs continued by stating that the removal of the qualifying SPE concept from GAAP will affect both transferors (under Statement 140) and primary beneficiaries of entities that were previously qualifying SPEs (under Interpretation 46(R)). Therefore,

the staff believes that the Board should discuss the five situations listed in the audience handout as potentially eligible for linked presentation:

- a. Transferors that **are not** the primary beneficiary of the transferee/variable interest entity (VIE)
- b. Transferors that **are** the primary beneficiary of the transferee/VIE
- c. Non-transferors that are the primary beneficiary of a transferee/VIE (that is, there must have been a Statement 140 transfer of financial assets)
- d. Non-transferors that are the primary beneficiary of a VIE (that is, there does not need to be a Statement 140 transfer of financial assets, rather, any primary beneficiary would be eligible)
- e. Entities that consolidate a voting interest entity (in accordance with Accounting Research Bulletin No. 51, *Consolidated Financial Statements*).

32. Mr. Jacobs stated that the staff's recommendation is to limit eligibility to only transferors (both (a) and (b)) since the consideration of any other entities would be outside the scope of Statement 140. The staff views eligibility as a presentation issue rather than a determination under a risk-and-rewards approach. Additionally, limiting the scope to only transferors of financial assets, within the scope of Statement 140, would ensure that only financial assets would be eligible for linked presentation.

33. Mr. Jacobs conceded that consideration of other entities could be part of a subsequent project, performed after the amendment to Statement 140 is finalized. Mr. Jacobs then asked the Board which entities it believes should be eligible for linked presentation.

34. The Board agreed to consider both (a) and (b), but with further staff research as to whether eligibility should be delineated between a transferor who is the primary beneficiary and a transferor who is not the primary beneficiary.

35. Ms. Seidman noted that the LP model should not be limited to just entities, that is, other transactions should be eligible (for example, repurchase agreements and loan participations). Mr. Linsmeier noted that the research on whether a transferor, who is

also the primary beneficiary, should be eligible for linked presentation would be useful in any subsequent project to apply linked presentation to all primary beneficiaries.

Follow-up Items:

None.

General Announcements:

None.