

## MINUTES



**To:** Board Members

**From:** Statement 140 Amendment Team  
(Bergstrom, Ext 296; Kapko, Ext. 317)

**Subject:** Minutes of the March 23, 2005 Board Meeting (QSPE's)      **Date:** March 29, 2005

**cc:** Bielstein, Smith, Petrone, Leisenring, Project Team, Mahoney, Thompson, Vincent, Sutay, Gabriele, Swift, Polley, Getz, FASB Intranet (e-mail)

*The Board meeting minutes are provided for the information and convenience of constituents who want to follow the Board's deliberations. All of the conclusions reported are tentative and may be changed at future Board meetings. Decisions become final only after a formal written ballot to issue a final Statement or Interpretation.*

**Topic:** Initial Measurement of a Transferor's Interest in a Financial Asset and Setoff Rights

**Basis for Discussion:** Memorandum 39, dated February 17, 2005; Memorandum 40, dated February 25, 2005; Memorandum 41, dated March 7, 2005; Memorandum 42, dated March 8, 2005, Memorandum 43 dated March 16, 2005 and Memorandum 44 dated March 17, 2005

**Length of Discussion:** 1:20 p.m. to 2:10 p.m.

**Attendance:**

Board members present:	Herz, Schipper, Batavick, Crooch, Young, and Seidman
Board members absent:	Trott (participated by phone)
Staff in charge of topic:	Donoghue
Other staff at Board table:	L.Smith, E. Smith, Laurenzano, Lusniak, Lott (participated by phone), Wilkins, Kapko, and Bergstrom
Outside participants:	Leisenring

### **Summary of Decisions Reached**

The Board discussed a proposed approach for applying the derecognition criteria of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, to portions of financial assets that would address three key issues: (a) clarification of the circumstances in which a qualifying special-purpose entity (QSPE) would be required to achieve sale accounting, (b) the measurement of a transferor's interest in a transferred financial asset (whether the transferor's interest in a financial asset should be initially measured at fair value if the transfer does not involve the transfer of the original asset to a QSPE), and (c) whether to require that the transferor explicitly contract with the transferee to pass through any benefits it may realize from future setoff.

The Board decided to adopt an approach that would allow the derecognition criteria in paragraph 9 of Statement 140 to be applied to a portion of a financial asset if that portion represents a proportionate share of an original asset and there is no recourse to the transferor or subordination. The resulting portions would be called participating interests. The Board agreed that under this approach, a participating interest retained by the transferor would not be considered a new financial asset and should be initially measured at allocated carry-over basis. The Board also agreed that if a portion of a financial asset does not meet the criteria of a participating interest, the whole original asset must be transferred to a QSPE. The resulting interests from a QSPE would be called beneficial interests and the derecognition criteria in paragraph 9 would be applied to the entire original asset. Beneficial interests held by the transferor would be considered new financial assets that should be initially measured at fair value.

In addition, the Board agreed not to require that a transferor pass through benefits of setoff or other dilutive rights to transferees in order to achieve sale accounting.

At a future meeting, the Board will discuss whether to expand the definition of a participating interest to include certain interest-only (IO) and principal-only (PO) strips.

### **Objectives of the Board Meeting**

The objectives of the meeting were for the Board to decide (1) how to apply paragraph 9 to portions of financial assets, (2) whether a transferor's participating interest in a financial asset should be considered a new asset that would be initially measured at fair value, and (3) whether to require that in all circumstances, the transferor explicitly contract with the transferee to pass through any benefits it may realize from future setoff. The objectives of this meeting were met.

### **Matters Discussed and Decisions Reached:**

*The following paragraphs summarize the Board's views on the major issues discussed at the meeting. The views and matters presented in these minutes may not be in the specific order in which they were discussed at the meeting.*

1. Ms. Donoghue began by introducing the two issues that were not resolved at the March 9, 2005 Board meeting:
  - a. Which transferor's interest should be initially measured at fair value and which (if any) should be measured at allocated carry-over basis?
  - b. Whether to require that the transferor agree contractually to pass through any future setoff benefits to transferees or investors in a QSPE.
2. Ms. Donoghue stated that one way to address those two issues might be to adopt an approach similar to the one adopted in IAS 39, *Financial Instruments: Recognition and Measurement*, which describes the conditions under which the derecognition criteria should be applied to a portion of a financial asset and under which they should be applied to the entire original asset. She noted that

one benefit of using the IAS 39 approach is that it could achieve convergence for one aspect of Statement 140 with IAS 39.

3. The proposed approach would permit applying the criteria in paragraph 9 of Statement 140 to a portion of a financial asset if the portion represents a proportionate share of an original financial asset (a participating interest) and there is no recourse or subordination. Derecognition of a participating interest would be permitted if:

- a. The participating interest meets the requirement for isolation as described in paragraph 9(a).
- b. The transferee is able to pledge or exchange its participating interest without constraints as described in paragraph 9(b).
- c. The transferor does not retain effective control over the portion of the asset as discussed in paragraph 9(c).

4. It would require that paragraph 9 be applied to the whole financial asset if the transaction does not meet the definition of a participating interest or the conditions for derecognition of a portion of a financial asset. That means that:

- a. The entire asset must be transferred in a transaction that meets the isolation requirement.
- b. The transferee must either be a QSPE or another entity that takes full ownership of the entire asset that can pledge or exchange the asset without the constraints in paragraph 9(b).
- c. The transferor must not retain effective control over the entire asset as described in paragraph 9(c).

5. Ms. Donoghue stated that the staff recommends that the Board adopt this approach because it is straightforward and may facilitate convergence with IAS 39. However, Ms. Donoghue noted that there are three key differences in the

way that IAS 39 views transactions involving portions of financial assets. In particular:

- a. IAS 39 would allow specifically identified cash flows, for example IOs and POs, to be considered a portion for purposes of applying the derecognition criteria.
- b. IAS 39 would allow disproportionate sharing of a financial asset among third-party participants in situations in which there is more than one counterparty so long as the transferor holds a fully proportionate share.
- c. IAS 39 would allow the derecognition criteria to be applied to *a group of similar financial assets*. It is not clear as to what constitutes *a group of similar financial assets* in the context of IAS 39.

6. Ms Donoghue asked Board members whether they agree with the proposed approach for derecognition of a portion of a financial asset. No one objected to the proposed approach. However, questions were raised about the scope of the approach and what the Board was being asked to decide in this meeting. Ms. Donoghue clarified that at this meeting, the Board was only being asked to determine whether the proposed approach should be applied to a participating interest or portion of an asset as defined by the FASB. She also noted that the staff is in the process of obtaining information from the IASB staff to better understand the differences between a transaction that involves a portion of a financial asset and a transaction that involves the entire asset under the IASB rules. Ms. Donoghue indicated that the staff does not believe that they have provided enough information to the Board to discuss the differences between IAS 39 and the proposed changes to Statement 140 for this meeting. She asked the Board whether or not they wanted to consider making changes to the definition of a participating interest (which does not require a transfer of the original whole asset to a QSPE) to be more consistent with the IASB.

7. Mr. Herz expressed concern that the definition of a participating interest might be too limited and he would welcome an expansion of the definition. He

stated that his agreement with the proposed approach is subject to how the Board, in a future meeting, decides to expand the definition. Ms. Seidman also agreed with Mr. Herz's comments.

8. Ms. Donoghue reiterated that the staff was not prepared at this time to provide sufficient information on the IO and PO issue and that the staff would need time to prepare the Board to discuss the issue further. She noted that the IASB is already receiving questions concerning the guidance in IAS 39 in that area and that they have had difficulty providing guidance to users because the effective date of the amendment to IAS 39 is January 1, 2005. Ms. Donoghue stated that one of the primary problems is the lack of a clear definition of what either an IO or a PO is.

9. Mr. Trott pointed out that defining what IOs and POs are is not unique to this Statement and that IOs have already been defined in the context of paragraph 14 of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. He stated that he believes that the Board has already defined IOs and POs narrowly in that document and that an IO is the contractually identified interest related to the instrument, not the residual of a securitization. Mr. Lott agreed with Mr. Trott's definition.

10. Ms. Lusniak pointed out that in her discussions with the IASB staff, the confusion about paragraph 16(a) was not a lack of clarity in the definition of an IO and PO, but rather what was meant by the parenthetical "a group of similar financial assets." Mr. Lott noted that the Board has yet to address the difference between accounting for transactions involving a single loan and transactions involving a group of loans and said that he believes that it is important for the Board to address this issue.

11. Ms. Schipper asked whether paragraph 16(a)(i) of IAS 39 was broader than just IOs and POs and whether it would include an interest that divides its cash flows as follows: one party gets the first five payments and the other the last six payments. Mr. Leisenring indicated that paragraph 16(a) (i) was more expansive than just IOs and POs and that IOs and POs are only one example of specifically

identified cash flows. He also explained that under paragraph 16(b), the cash flows held by the transferor must be pro rata but that third-party interests could be disproportionate. Ms. Schipper questioned whether the staff was asking the Board to consider adding both IOs and POs to the list of things that the Board currently considers participating interest and allowing third-party interest holders to hold disproportionate interest. She stated that it was her understanding that the staff was not asking the Board to adopt the language in paragraph 16(a) of IAS 39 but to consider the direction of paragraph 16(a)(ii) because IAS 39 permitted situations that had already been considered and rejected by the FASB. The staff confirmed that was the case.

12. The Board agreed to support the proposed approach. The Board asked the staff to develop an analysis of the differences between IAS 39 and the proposed approach that would include (1) possible differences in the definition of IOs and POs and (2) an explanation of the IASB's decision to allow the transferor to apply the derecognition criteria to a portion of a financial asset when the transaction includes interest holders other than the transferor that hold a disproportionate share of the specifically identified cash flows. Mr. Trott stated that he would like both of these issues to be fully considered prior to issuing an Exposure Draft.

#### **Accounting for a Participating Interest Held by a Transferor**

13. Ms. Donoghue questioned whether the Board believes that a participating interest held by the transferor should be initially measured at fair value or allocated carry-over basis. She explained that the underlying question is whether the transfer of a portion of a financial asset is a significant enough change to merit remeasurement of the portion of the asset retained by the transferor. That is, whether the portion of the asset held by the transferor is a new asset.

14. The Board agreed that a transferor's participating interest should not be considered to be a new asset to the transferor and should be measured at allocated carry-over basis. Ms. Schipper noted that she would prefer fair value as a measurement but agreed that it is logical to infer from this approach that a participating interest is not a new asset and therefore should be measured at

allocated carry-over basis. Ms. Seidman noted that she would have preferred no change to the current measurement guidance for retained interests. Ms. Seidman reiterated her prior position (as expressed in the March 9, 2005 Board meeting) and is concerned that there is no conceptual basis for any of the alternatives presented by the staff. However, she believes that the Board should make Statement 140 as practical and operational as possible. She noted that her first preference is not to amend the initial measurement of a transferor's interests but believes that the staff's current recommendation holds more conceptual merit than the Board's tentative decision to require that all transferor's interests be initially measured at fair value.

15. Mr. E. Smith clarified that the carry-over basis represents an allocated carry-over basis. Ms. Schipper added that it is a relative fair-value-based allocation of the original carry-over value. Mr. E. Smith noted that it is important that the transferor recognize a servicing right when a portion of an asset is sold in a participation. Mr. Lott contended that the additional cost incurred to service the portions of the asset as opposed to servicing the whole asset would be de minimus. Several Board members noted that they did not wish to discuss further servicing rights in this project.

#### **Setoff**

16. Ms. Donoghue asked the Board to reconsider its decision to require that in all cases, a transferor be contractually obligated to pass through any benefits it receives from exercising its right to setoff. She asked Board members to consider two alternatives: (1) to require that the transferor pass through the benefits of setoff only for a participating interest that does not use a QSPE or (2) drop the requirement in its totality. Ms. Donoghue said that the staff recommends that the Board not require setoff to be passed through because the staff believes that it is already required by law. Four Board members (Herz, Batavick, Seidman and Young) agreed with the staff recommendation.

17. Ms. Seidman noted that she continues to object to including this requirement on the grounds that she does not think that it is relevant to the

analysis of paragraphs 9(a), (b), or (c) of Statement 140. Mr. Batavick stated that he supports the staff recommendation because he looks at setoff rights as being conditional, and he believes that setoff and other dilutive rights are already dealt with in the marketplace through overcollateralization or pricing agreements and therefore there is no need for a separate mention in the standard.

18. Ms. Schipper and Messers. Trott and Crooch disagreed with the staff recommendation. Ms. Schipper stated that she would prefer the second alternative, to require that setoff is passed through for participating interests. Mr. Trott agreed with Ms. Schipper and stated that he believes that the requirement to pass through setoff benefits should be considered as a part of the pro rata requirement and should be required for participating interests. He stated that he does not believe that it would be possible to require setoff to be passed through when a QSPE is involved because the requirement could be interpreted as continuing involvement by the transferor and thereby preclude sale accounting. Mr. Crooch agreed with Mr. Trott.

**Follow-up Items:**

The Board requested that the staff provide an analysis of the differences between the approach in IAS 39 and the approach being considered by the FASB, in particular, the implications of expanding the definition of a participating interest to include IOs and POs and to allow disproportionate sharing of cash flows among third-party interest holders.

**General Announcements:**

None.