



December 5, 2005

LETTER OF COMMENT NO. 55 A

Mr. Lawrence Smith  
 Director of Technical Application and Implementation Activities  
 Financial Accounting Standards Board  
 401 Merritt 7  
 P.O. Box 5116  
 Norwalk, CT 06856-5116

**RE: Proposed Statement of Financial Accounting Standards, *Accounting for Transfers of Financial Assets, an Amendment of FASB Statement No. 140 (File No. 1225-001)***

Dear Mr. Smith:

The Accounting Standards Executive Committee of the American Institute of Certified Public Accountants (AcSEC) appreciates the opportunity to comment on the Exposure Draft (ED) of proposed amendment to Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 140). Although three concurrent Exposure Drafts amending FAS 140 were issued for comment, AcSEC has decided to address the concerns of the above-referenced ED separately, because we are especially concerned about the proposed guidance in this ED. While AcSEC supports the Board's desire to improve the guidance surrounding transfers of financial assets, we find this ED to be complex, contradictory and at times confusing. Additionally, we feel that the Board has not adequately articulated its rationale in the Basis for Conclusions for pertinent proposals outlined in the ED, which can give rise to inconsistencies in implementation, because constituents have historically relied on the Basis for Conclusions for clarification and assistance in implementing the requirements of accounting standards. As a result, AcSEC finds the Board's purpose unclear and the concepts and principles underlying the ED's provisions lacking. We believe that after issuing this amendment, the Board should take a fresh look at FAS 140 in its entirety in conjunction with the International Accounting Standards Board, with a goal of creating a simpler standard acceptable to both, rather than attempting to make further piecemeal changes to an already amended, complex standard.

AcSEC had previously issued a letter dated November 7, 2005 in general support of the other two EDs on hybrid financial instruments and servicing rights for your consideration. In that letter, we offered suggestions that were pertinent to all three EDs related to transition and effective date, some of which we also include here. We will focus on what we have identified as the more challenging provisions in this Exposure Draft, which relate to recognition of gain on a transferor's beneficial interests, the introduction of the concept of a participating interest leading to increased use of qualifying special purpose entities (QSPEs), isolation analysis, potential issues with multi-step transactions, rollovers of beneficial interests, and other matters. We have provided our specific comments below.

### Derivative Instruments in QSPEs

AcSEC supports the Board's modification of the language in paragraphs 35 and 40 of FAS 140, because we believe that it will resolve many of the issues regarding the derivatives held by QSPEs. The proposed changes will eliminate the existing uncertainties about these activities and the administrative and operational burden of monitoring the notional amount of derivatives and the beneficial interests owned by parties not affiliated with the transferor subsequent to their issuance. These changes improve the Standard.

#### *Recognition of Gain on Transferor's Beneficial Interests*

Paragraph 11(d) of the proposed ED requires the transferor to recognize and initially measure at fair value assets obtained and liabilities incurred in connection with the assets transferred to a qualifying SPE, including the transferor's beneficial interests. AcSEC disagrees with this concept for reasons similar to the ones articulated in our previous letter dated November 7, 2005 with respect to servicing rights. We do not see any significant economic differences between a participating interest and a transferor's beneficial interests that would justify different accounting. Since in both instances the transferor keeps a part of the transferred assets, the assets have only changed in form, but not substance. The transferor's beneficial interests still retain the economics and cash flows relating to parts of the transferred assets just as participating interests do. This issue is particularly significant for guaranteed mortgage securitizations where the qualifying status of an SPE is not contingent on any of the beneficial interests being sold to third-party investors. Therefore, under this proposed guidance, transferors of those asset types can retain 100% of the assets "sold" and be required to recognize a gain on the entire transfer, although their economic position is unchanged. We believe that this result improperly elevates the form of the interest retained over the substance of the transaction. AcSEC finds this troublesome and agrees with the alternative view outlined in paragraph A54 of the ED.

We believe the proposed approach also permits entities to circumvent the limitations in FASB Statement No. 115 on transfers of investments between categories. An entity could not reclassify available-for-sale investments to trading to trigger an unrealized gain in earnings. However, that entity could transfer such securities to a QSPE, retain beneficial interests representing up to 90% of the underlying securities, and record a gain in earnings.

#### **Participating Interests**

Paragraph 8A in the proposed amendment of FAS 140 introduces the term *participating interest*. If a transfer of financial assets does not meet the definition of a participating interest as defined in this paragraph, then according to paragraph 2(d) "sale accounting can be achieved only by transferring an entire financial asset or group of financial assets to a qualifying SPE or other entity that is not consolidated with the transferor...". As a result, the proposed guidance by the Financial Accounting Standards Board (FASB) will require increased usage of QSPEs for transfers of portions of financial assets that do not meet the criteria of the newly defined term, *participating interests*. Although the concept of QSPEs has been accepted in U.S. generally accepted accounting principles since Statement of Financial Accounting Standards No. 125 was issued, we do not believe the expanded use of QSPEs solely to facilitate accounting for transfers as sales improves financial accounting, particularly since the QSPE is purely a useful accounting mechanism and is not needed to accomplish the economic goals of securitizations. Mandatory use of QSPEs in order to account for transactions as sales where the transferor has surrendered control of the transferred assets and the transferee has the right to pledge or exchange the assets makes no conceptual sense, does not enhance

the legal isolation of the transferred assets, complicates the accounting and diverges from the ongoing goal of convergence with international standards.

The word “recourse” as defined in the ED’s glossary refers, in part, to “adjustments resulting from defects in the eligibility of the transferred receivables.” That language includes standard representations and warranties, which are routinely incorporated in bank loan participation agreements. As such, some transferors would be precluded from recognizing sale treatment for simple loan participations, because under the proposed definition of a participating interest, interest holders may not have recourse to the transferor, its consolidated affiliates or agents, or to each other. We understand that the effect of this definition may have been unintended and urge the Board to clarify that ordinary representations and warranties should not prohibit sale accounting treatment for these transactions. Some AcSEC members recommend an alternative approach to achieve this result. They recommend that the Board exclude that language from the definition of recourse, since ordinary representations and warranties appear in virtually every transaction in the normal course of business and seem different in substance from recourse for subsequent deterioration in the credit quality of the transferred financial assets. Those AcSEC members believe that a transferor should record liabilities for its obligations resulting from defects in eligibility, but would not characterize those obligations as recourse.

In addition, AcSEC asks that the Board clarify whether an interest-only strip representing the gain on sale or servicing rights can be subordinated without disqualifying a participating interest, since, under the priority of payments waterfall, such subordination effectively provides recourse for the transferee.

Another characteristic of a participating interest is that the servicer of transferred assets may only receive “servicing fees representing adequate compensation.” In such a case no servicing asset or liability will be recognized. However, the Board clearly contemplates that normal servicing giving rise to a servicing asset or liability is acceptable in paragraph 10 (d) of the proposed Statement. We note that a cap is imposed on the amount of the transferor’s interest-only strip, which is limited to “...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.” We believe that normal servicing should be acceptable, provided that the combined total of the gain on the sale of the underlying assets and the servicing rights are subject to this cap.

## **Legal Isolation**

The legal isolation criterion set forth in proposed paragraph 9(d) of the revised FAS 140 would require that attorneys “must consider any arrangement or agreement made in connection with a transfer even if it was not entered into at the time of the transfer.” We believe that attorneys may have difficulty in applying this in practice, because they will have to rely on management’s representations on actual transactions, as well as on management’s intentions, in order to obtain a certain level of comfort. Furthermore, if a contract or other agreement were not entered into or contemplated at the time the asset transfer was completed, attorneys would not be able to express an opinion including such possible future agreements. It is not clear how far into the future attorneys must look in drafting an isolation opinion, nor is it clear when the provisions of existing paragraph 55 of FAS 140 would take over from proposed paragraph 9(d). If the Board is concerned about possible abuses occurring through side agreements, that can be addressed directly by requiring that legal opinions consider all arrangements or agreements, including oral agreements, entered into at the time of the transfer. If the Board is concerned about possible abuses occurring through future modifications, then we

believe the existing guidance in paragraph 55 suffices. Accordingly, we are particularly puzzled as to the purpose of the clause, “even if it was not entered into at the time of the transfer,” at the end of paragraph 9(d) and recommend that it be deleted.

Proposed paragraph 9(e) of the revised FAS 140 would also require the legal analysis to opine on the effect on legal isolation of supposed arrangements, as well as on the actual transaction being considered. Again, we do not believe that attorneys would feel comfortable basing their opinions on hypothetical or “imaginary” factors, if in fact assets are legally isolated. We do not believe that this paragraph enhances the legal isolation analysis already required under FAS 140. However, if the Board decides to retain paragraphs 9(d) and 9(e), we recommend that they be combined with paragraph 9(a) to better convey the link between new and existing criteria for achieving isolation of transferred assets for accounting purposes.

### ***Legal Isolation and Audit Guidance***

The Board should also consider potential inconsistencies between accounting and auditing standards as a result of the proposed changes. For example, paragraph .05 of AICPA, Professional Standards, AU Section 9336, “*Using the Work of a Specialist: Auditing Interpretations of Section 336*,” states that “Use of a legal specialist may not be necessary to obtain competent evidential matter to support management’s assertion that the isolation criterion is met in certain situations, such as when there is a routine transfer of financial assets that does not result in any continuing involvement by the transferor.” In contrast, paragraph 27B of the revised FAS 140 states that, “A legal opinion is not required if a transferor has a reasonable basis to conclude that the appropriate legal opinion or opinions would be given if requested. For example, the transferor might reach a conclusion without consulting an attorney if it had experience with other transfers with the same facts and circumstances, including under similar applicable laws and regulations.” We also note that AU Section 9336’s sample opinions do not provide for the expanded isolation analysis proposed in paragraphs 9(d) and 9(e) of the revised FAS 140. AcSEC believes that the FASB should coordinate with the auditing standard setters in issuing consistent guidance.

### ***Multi-step Transactions***

The Board added proposed guidance to paragraph 9(b), which imposes additional constraints for multi-step transfers. It requires that if a transaction involves a series of steps designed to isolate the transferred financial assets then each entity that receives the transferred financial assets is a transferee that must have the right to pledge or exchange those assets without any restrictions that provide more than a trivial benefit to the transferor. AcSEC is not clear as to why this guidance is needed and believes that these requirements add unnecessary complexity to already complex transactions and could result in precluding sale accounting altogether for a great many multiple-step transactions. For example, in a two-step transaction, a corporate transferor will sell assets to a wholly owned and consolidated bankruptcy remote entity, which then transfers the assets to a QSPE. The second transfer from the bankruptcy remote entity to the QSPE is a predetermined act that could be misconstrued as a “constraint” providing more than a trivial benefit to the transferor and, therefore, might preclude the transferor from derecognizing the assets and obtaining sales treatment.

Additionally, under the proposed wording, the transferor could be considered as not surrendering control of the transferred assets, because the initial transfer was to a wholly owned bankruptcy remote entity, which does

**not have qualified status. This scenario is very troubling to AcSEC. We believe the new sentences in paragraph 9(b) conflict with paragraph 83 of FAS 140, which says that two-step transfers should be taken as a whole in evaluating whether the transferred assets have been isolated. In fact, we believe those provisions to be unnecessary and recommend that the Board delete the two last sentences added to paragraph 9(b) to avoid potential disruptions to multi-step transactions.**

### **Rollovers of Beneficial Interests**

We do not support defining rollover activities in the accounting standard. Rather, similar to the limitation imposed on other activities of a QSPE, AcSEC believes that the proposed standard should state that rollover activities must be significantly limited and those activities must be fully described in documents that established the QSPE or the rollover program. However, if the Board retains a definition of rollovers of beneficial interests, clarifications are needed.

Paragraph 45A of the revised FAS 140 states that a transferor with two or more involvements with a QSPE may administer a program of rolling over beneficial interests only if the transferor and its affiliates or agents do not obtain more than a trivial incremental benefit from this combination of involvements relative to the benefit obtained if separate parties had administered those programs. Otherwise, the SPE could lose its qualifying status. AcSEC disagrees with this provision and believes it would create significant operational difficulties for several reasons. These include: (1) a *more-than-trivial-benefit* is undefined, (2) involvements of third-party administrators cannot be monitored, and (3) if there is no third-party provider, how can it be demonstrated that the transferor has not obtained an *incremental* benefit exceeding that a separate provider could obtain?

According to paragraph A34, “the Board does not intend that the existence of a combination of involvements held by a single party will establish a presumption that a more-than-trivial incremental benefit is received by that party.” That language seems contradictory to paragraph 45A, which attempts to define or identify instances when this concept would apply. It states that, “*Opportunity to obtain a more-than-trivial incremental benefit* refers to a party’s opportunity, as a result of holding a combination of rights or obligations, to enhance its rights or to minimize its obligations related to the qualifying SPE in comparison to the opportunities associated with the same rights or obligations if each right and each obligation were held by separate, unrelated parties.” As such, it is not clear what circumstances represent a combination of involvements that provide a “more-than-trivial-benefit,” or if some combinations are more acceptable than others. We request that the Board either clarify the concept to facilitate consistent application or, since there is no definition of what is considered to be a “more-than-trivial benefit,” eliminate the term because it imposes an additional burden upon constituents to analyze whether any party has received that undefined benefit.

Also, under paragraph 45A of the revised FAS 140, AcSEC does not believe that a transferor would be able to monitor whether a third-party administrator (and its related parties) has acquired more than one involvement in a QSPE subsequent to entering into an arrangement with the QSPE to manage a rollover program so as to ensure that the qualifying status is maintained. (For example, an affiliate of a third-party provider might acquire beneficial interests of the QSPE without the transferor’s knowledge.) Moreover, holders of interests in the QSPE would not know if the interests were disqualified and were, therefore, now subject to the provisions of FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*.

*Transition Provisions and Effective Date*

We find the transition guidance to be confusing; however, we support prospective application of all three exposure drafts. Due to the overlap of the proposed statements, the FASB emphasizes the importance of considering all three documents together in order to better understand the overall effect on FAS 140 and respondents expected that there would be more synergy among the EDs with regard to transition guidance. For example, the Hybrid Instruments ED would be effective even before being issued. We therefore recommend that the transition provisions be more explicit, be combined in one tabular format covering all three of the proposed standards to ease understandability, and be included as a single table in each final standard. Finally, we ask that the effective date be delayed for not less than three months after issuance of the final document and not be retroactive, in order to give companies the time needed to study the final amendments and implement necessary procedures and internal controls.

We also support making the isolation provisions applicable to all QSPEs created after the effective date of the ED, because it would be unfair to subject existing QSPEs to new rules regarding isolation that did not exist at the time they were formed. Amending QSPEs to meet any new accounting requirements can be quite burdensome, particularly for master trusts, since approval by a majority of third-party beneficial interest holders is required. However, the Board should clarify that new transfers to a master trust should meet the new isolation guidance.

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We thank the Board for its consideration and would welcome the opportunity to further discuss this matter with Board members and their staff.

Sincerely,

Ben Neuhausen  
Chairman

AcSEC

Linda Bergen  
Chair

FAS 140 Amendments Task Force