Letter of Comment No: 20
File Reference: 1210-001

Dear Sir/Madam,

RBC Financial Group would like to thank the Financial Accounting Standards Board (“Board”) for the opportunity to comment on the Revised Exposure Draft on Accounting for Transfers of Financial Assets, the Exposure Draft on Accounting for Certain Hybrid Financial Instruments and the Exposure Draft on Accounting for Servicing of Financial Assets (collectively “the Exposure Drafts”).

With regards to the Revised Exposure Draft on Accounting for Transfers of Financial Assets, we support the Board’s initiative to improve comparability, simplify the guidance on activities of Qualifying SPEs (“QSPEs”) and improve consistency in the application of FASB Statement 140. In particular, we agree with the concept that arrangements between the transferor and beneficial interest holders should be assessed outside of the transfer to ensure sale accounting is not tainted. We also agree with the concept that transfers should be monitored for subsequent arrangements that would invalidate the original accounting treatment.

However, we do have specific comments on certain other areas of the Exposure Drafts. We are concerned with the overall applicability of the additional legal isolation requirements, especially the additional requirements for transfers of partial financial assets. We disagree with the Board’s reliance on QSPEs in achieving legal isolation. We are also concerned with an entity’s ability to assess the Qualifying status of an SPE where another party, with multiple involvements, judges itself able to extract a more-than-trivial benefit, and thus considers the SPE non-qualifying.

With regards to the Exposure Draft on Accounting for Hybrid Financial Instruments, we support the Board’s decision to allow a fair value election for hybrid instrument. This amendment is an important achievement in the process of convergence with International Accounting Standards. We would like to further request the Board to allow a fair value election for certain existing instruments that are currently bifurcated under FAS133 as well as timely release of the Fair Value Option Standard.

The attached appendix contains a discussion of our concerns in detail.

Should you have any questions regarding the issues discussed in this letter, please do not hesitate to contact me,

Thank you,

Yours very truly,

Mrs. Linda F. Mezon
Chief Accountant
Appendix: Combined Comments for the Exposure Drafts – Amendments of FASB Statement 140 and 133

The paragraph references are to Appendix C of the Exposure Drafts, unless otherwise indicated.

Comments on Revised Exposure Draft: Accounting for Transfers of Financial Assets:

1. Transfers of a partial financial interest

We disagree with the proposal on transfers of portions of financial assets. The proposed exposure draft prohibits sale accounting for portions of financial assets unless the interests in the assets that are transferred meet the definition of a “participating interest” defined by paragraph 8A and the legal isolation requirements of paragraph 9. If these two conditions are not satisfied, the entire financial asset must first be transferred to a QSPE. We believe there may be unintended consequences of paragraph 8A that would disallow sale accounting for several types of securitization transactions in the market today. We request the Board to clarify its intentions with regards to two aspects of this proposal.

A) What is the Board’s intention or intended scope with respect to paragraph 8A?
B) Why is a QSPE required to be inserted in order to achieve legal isolation?

New term: “Participating Interest” reference: paragraph 8A

We have concerns with the applicability of the definition of “Participating Interest”. Per paragraph 8A, a participating interest would exhibit the following characteristics (among others):

“All cash flows received from the asset are divided among the participating interests in proportion to the share of ownership represented by each, ref. 8A(b); no participating interest is subordinated to another. That is, no participating interest holder is entitled to receive cash before any other participating interest holder. The rights of each participating interest holder (including the transferor if it retains a participating interest) have the same priority, and that priority does not change in the event of bankruptcy or other receivership of the transferor, the original debtor, or any participating interest holder. ref. 8A(c)”.

It would appear that the only type of transaction that would fit the requirements of 8A would be loan participation arrangements. While the Board continues to accommodate sale accounting for loan participation arrangements by allowing de-recognition without use of a QSPE, the majority of other securitization transactions would potentially not qualify for sale treatment. This comprehensive scope would result in consequences that may not reflect the Board’s original intentions.

For example, in some securitization transactions, a financial asset is transferred to a repackaging vehicle and the cash flows of the transferred assets are normally tranched, where the most junior tranche provides first loss protection to holders of other tranches. This most junior tranche is often retained by the seller as a retained interest. With that in mind, it is questionable whether any seller would divide the cash flows in the way paragraph 8A seems to suggest. Consequently, we do not believe paragraph 8A can be readily applied for all securitization transactions. It is also our experience that legal isolation has not been an issue in these arrangements as each transfer has been evidenced by a legal opinion attesting to legal isolation and bankruptcy remoteness. Based on the foregoing analysis, we do not believe all transfers should be within the scope of paragraph 8A.
Use of a QSPE to achieve legal isolation

As discussed above, it would be difficult for the current structures of most securitization transactions to meet the definition of participating interest and obtain sales treatment. As such, transferors would be forced to insert a QSPE to achieve sale accounting under the proposed guidance. We are not clear why the use of a QSPE enhances legal isolation under these circumstances where, in fact, current transfers can and do achieve legal isolation without a QSPE, as evidenced by legal opinions. Unless bankruptcy laws have changed, we do not see any reason or any incremental benefits in using a QSPE to achieve legal isolation. We agree with the comments in the Basis for Conclusions, Alternative Views:

(1) Paragraph A49: “Those Board members believe that the Board has not demonstrated that the benefits of that proposed accounting changes outweigh the cost. Those costs include not only the direct cost of establishing qualifying SPEs where none are currently required but also the indirect costs of requiring more transferors to evaluate and apply the detailed guidance about qualifying SPEs”. We request the Board to provide further clarification as to why a QSPE is required.”

(2) Paragraph A52: “The approach proposed in this Exposure Draft would make what is now an exception the rule for all disproportionate sharing of cash flows. That is, a separate legal entity would need to be established to divide up a single asset when a simple contract suffices today. Those Board members believe that the mere insertion of a legal entity does not change the substance of the arrangement or serve any valid business purpose...... They consider it inappropriate and directionally incorrect for the Board to require the use of an SPE to achieve a desired accounting result.”

(3) Paragraph A53: “Those Board members acknowledge that practice issues continue to arise in the application of Statement 140. However, they would prefer to defer work on the issues involving partial sales until the Board undertakes a more fundamental review of the financial-components approach as part of a joint project on de-recognition with IASB.”

We feel the proposed amendment for accounting for transfers of partial assets is premature. We request the Board to limit the scope of paragraph 8A to loan participation as we believe this was the Board’s original intention. If we have misunderstood the Board’s intention for paragraph 8A, we request the Board to remove the requirements of 8A and other proposed changes to partial transfers of financial assets from the final amendments to statement 140.

2. Definition of Beneficial Interest

Under the proposal, Beneficial Interest has been redefined as “A right to receive all or portions of specified cash inflows to a qualified SPE (note that the previous wording of “trust or other Entity” was replace by “a qualifying SPE”), including any senior and subordinated shares of interest, principal or other cash inflows to be “passed-through” or “paid-through,” premiums due to guarantors, commercial paper obligations, and residual interests, whether in the form of debt or equity. Reference: paragraph 364, Appendix E, Glossary.” We are not clear as to why this definition is limited to a QSPE. As previously discussed, legal isolation can be achieved without insertion of a QSPE. As such, interests issued, including what is currently retained by the transferor, either in the form of debt or equity, by any legal structure should be considered as Beneficial Interest. We request the Board to reconsider the definition of Beneficial Interest and expand the scope beyond those issued by a QSPE.
3. Receipt of beneficial interests in exchange for the transferred assets

The proposed introduction to paragraph 9 states that a transfer “shall be accounted for as a sale if the transferor surrenders control over the transferred financial assets”. It appears that the Board has removed the requirement that a transfer can be accounted for as a sale to the “extent that consideration other than beneficial interests in the transferred assets is received in exchange”. This amendment is not carried forward to Paragraph 56, which remains unchanged and maintains the restriction by stating “The proceeds from a sale of financial assets consist of the cash and any other assets obtained in the transfer less any liabilities incurred. Any asset obtained that is not an interest in the transferred asset is part of the proceeds from sale”.

Under the existing standards, where beneficial interests in the transferred assets are received as part of the proceeds, they would be excluded from the determination of any gain or loss on sale. This is consistent with the substance of the transaction as the transferred assets only changed form, for example, from a mortgage receivable to a mortgage-back security, without any incremental economic benefit to the transferor.

The proposed amendment to paragraph 9 suggests that sale accounting may now be permitted where a transferred asset is “exchanged” for a beneficial interest in that same asset. We appreciate the fact that the Board has amended the definition of beneficial interest (see quote in section 2 above) to reflect beneficial interests as “proceeds” from sale rather than interests in the transferred asset. We would like to remind the Board that even though the definition has changed, the substance of the transaction has not changed solely due to the insertion of a QSPE in the chain of events. A beneficial interest issued by a QSPE whose sole asset is the transferred asset continues to be an interest in the transferred asset in substance. Under the current proposal, it would be entirely possible for a transferor to achieve off-balance sheet accounting by transferring a financial asset into a QSPE and then take back up to 90% of the beneficial interests issued by the QSPE, either in debt or equity form. Furthermore, as the amended paragraph 11b requires that “the transferor’s beneficial interests and any other interests in the transferred financial assets” be measured at their fair value, this would 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. In other words, this amendment could lead to inflated financial results where the substance of the underlying assets have not changed.

We believe the above scenarios are unintended consequences of the Board’s decision to re-define beneficial interest. We request the Board to retain the restriction on sale accounting to the extent that “proceeds other than beneficial interests or interest in the asset are received in exchange.”

4. Legal isolation and true sale at law.

The exposure draft concludes that isolation is achieved only if the transfer is legally a sale. Paragraph 27A was added in the Exposure Draft to indicate the following: “A transfer... is considered to have isolated the transferred financial assets only if a legal analysis would support the following conclusions under the laws in the applicable jurisdiction:

- The transfer is legally a sale
- In the event of bankruptcy, receivership, or other insolvency of the transferor or any consolidated affiliate of the transferor that is not a bankruptcy-remote entity, the transferred asset would not be deemed to be part of the estate of the transferor or its consolidated affiliates.”

We are concerned with the wording of “the transfer is legally a sale”. We are concerned that because legal environments are not the same for all jurisdictions, the same transfer would be denied sale treatment in some jurisdictions but allowed in other. The additional requirement also represents a divergence from International Accounting Standards where de-recognition is based on a transfer of risks and rewards and does not focus on legal proprietary interests. While we agree that a true sale at law opinion provides substantial evidence for legal

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1 Reference: current FAS 140, paragraph 9.
isolation, we disagree that it should be a significant and critical criterion to achieve sale treatment. Such legal opinion should be used as supporting evidence for a principle based de-recognition criteria to ensure consistency in application of the sale treatment. For the purpose of harmonizing with International Accounting Standards, we request the Board to delete paragraph (a) of 27A and consider wording for the de-recognition criteria that is similar to following wording in IAS39:

Reference: IAS39 paragraph 18 & 19:

18. An entity transfers a financial asset if, and only if, it either:
(a) transfers the contractual rights to receive the cash flows of the financial asset; or
(b) retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients in an arrangement that meets the conditions in paragraph 19.

19. When an entity retains the contractual rights to receive the cash flows of a financial asset (the 'original asset'), but assumes a contractual obligation to pay those cash flows to one or more entities (the 'eventual recipients'), the entity treats the transaction as a transfer of a financial asset if, and only if, all of the following three conditions are met.
   (a) The entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset. Short-term advances by the entity with the right of full recovery of the amount lent plus accrued interest at market rates do not violate this condition.
   (b) The entity is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows.
   (c) The entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay. In addition, the entity is not entitled to reinvest such cash flows, except for investments in cash or cash equivalents (as defined in IAS 7 Cash Flow Statements) during the short settlement period from the collection date to the date of required remittance to the eventual recipients, and interest earned on such investments is passed to the eventual recipients.

5. Bankruptcy Remoteness and consolidated affiliates of the transferor

We recognize that the proposed amendments to paragraph 9a relating to obtaining legal isolation are intended to emphasize the critical premise of bankruptcy remoteness. Particularly, the proposed paragraph 9a now includes wording currently included and retained in paragraph 27, addressing bankruptcy remoteness from “any consolidated affiliate of the transferor that is not a special purpose corporation or other entity designed to make remote the possibility that it would enter bankruptcy or other receivership”.

However, certain proposed amendments to areas of paragraph 27 and the proposed paragraph 27A appear to inconsistently make references to “jurisdiction”. Specifically, an existing provision in paragraph 27 combined with a proposed amendment reads: “All available evidence that either supports or questions an assertion shall be considered. That consideration includes whether the contract or circumstances permit the transferor to revoke the transfer. It also may include consideration of differences due to jurisdiction where bankruptcy or other receivership would take place, whether a transfer of financial assets would likely be deemed a true sale at law, whether the transfer is affiliated with the transferee and other factors pertinent under applicable law.” This appears to imply that any/all jurisdictions outside those involved directly in the transfer may need to be considered.

The proposed paragraph 27A states “A transfer of a financial asset, a group of financial assets, or a participating interest in an individual financial asset is considered to have isolated the transferred financial assets only if a legal analysis would support [the following] conclusions under the laws in the applicable jurisdiction.” This statement appears to imply that only applicable jurisdictions need to be considered.

We are concerned that the above inconsistency and emphasis prescribe that a legal isolation analysis and true sale opinion would need to consider all consolidated affiliates within and across jurisdictions even though such
affiliates may not have any connection to the transfer or participation in the chain of title of the transferred assets. To consider every consolidated affiliate, regardless of its involvement, would create a significant operational burden that could also prove cost prohibitive, especially for large multinational corporations.

We do not believe this was the Board's intent. We are of the view that the more practical and relevant approach is to limit the scope of a legal analysis to only those consolidated affiliates of the transferor that have had a direct involvement or interest in the transfer, or with the transferred assets. We respectfully request the Board to eliminate the above inconsistency and to clarify it's position.

6. Qualifying Status of a SPE that has ability to rollover beneficial interests

Under the proposed terms of paragraph 35e, a SPE with the ability to roll over (retire and reissue) beneficial interests can achieve qualifying status only when no party receives a more-than-trivial benefit by virtue of having two or more involvements with the SPE. While we agree and support the Board's intention to preserve the passive nature of a QSPE, we have concerns over the applicability of one's ability to assess whether a third party has extracted “a more-than-trivial benefit” from its involvement with the entity. Assessing whether a party involved with a QSPE has the ability to obtain a more-than-trivial benefit will require an analysis of all relevant facts and circumstances available to that party, in addition to application of professional judgement. Consequently, it is possible that two parties involved with the same SPE, each with access to different levels of information, may come to two different conclusions regarding paragraph 35E and qualifying status.

Consider the following: Entity A has more than one type of involvement with a SPE and information is available to Entity A to evaluate whether the opportunity for a more-than-trivial incremental benefit exists through its multiple involvements. Information such as the terms and conditions governing the involvements, including the fees charged and the stated intent of the parties to the agreements are readily available to Entity A.

Now consider Entity B, an independent third party to Entity A. Entity B has a single involvement in the same QSPE. It may not be possible for Entity B to determine if Entity A receives a more-than-trivial benefit from its multiple involvements due to a lack of detailed information to which only Entity A has access. For example, the exact terms of a liquidity facility, or the level of fees provided to the commercial paper dealer or administrator is frequently not made available to other parties involved with a QSPE. Consequently, while information to evaluate paragraph 35e may be available to the party with two or more involvements, it is typically not available in the same level of detail to other parties involved with the QSPE. Therefore, based on the available facts and circumstances and in the process of applying professional judgement, parties may come to differing conclusions on qualifying status.

The requirement of using professional judgement also adds complexity to application of FASB Statement 140. Judgement would vary among practitioners. The current proposal could potentially lead to financial results that are not comparable among reporting entities. Furthermore, the concept of a qualifying status of SPE is based on legal facts where the entire permissible activities of a QSPE would be laid out in its governing documents. As these legal facts are clearly documented, judgement is not required to determine if a SPE is entirely passive in nature and that it has obtained qualifying status. Consequently, this new requirement represents a divergence from the current concept that the qualifying status is determinable purely based on legal facts where judgement is not required, especially when information may not be readily available to support and confirm conclusions.

We request the Board to provide a definition of a “more-than-trivial” benefit or define arrangements where the Board considers to provide a “more-than-trivial” benefit to any of the parties involved. Clear and concise definitions would eliminate the need to exercise judgement in order to determine qualifying status of a SPE.

Comments on Exposure Draft: Accounting for Certain Hybrid Financial Instruments:

We support the Board's decision to permit fair value measurement for hybrid instrument. We would like to discuss two aspects of the proposed amendment.
1. Removal of requirement to fair value the entire instrument when the Embedded Derivative cannot be identified or measured

The exposure draft removed the requirement from paragraph 16 of FAS 133 which stated: "If an entity cannot reliably identify and measure the embedded derivative instrument that paragraph 12 requires be separated from the host contract, the entire contract shall be measured at fair value with gains or losses recognized in earnings, but it may not be designated as a hedging instrument pursuant to this statement." This statement forces fair value measurement when a derivative cannot be clearly identified. We are concerned that, with the removal of this statement, entities may choose not to fair value a hybrid instrument (i.e. continue to follow accrual method of accounting) where it clearly contains an embedded derivative and will support this accounting conclusion on the grounds that the embedded derivative cannot be reliably identified and measured. We appreciate the fact that there are numerous embedded derivatives that are difficult to identify due to complexity of cash flows and nature of transactions, especially with the deletion of Derivative Implementation Issue D1, which will subject beneficial interests to the bifurcation rules of FAS 133. It is therefore increasingly important for the Board to ensure that the concept of fair value measurement for hybrid instruments is followed consistently.

We recommend the Board retain the wording in paragraph 16 as quoted above. For the reasons above as well as for the purpose of convergence with International Accounting Standards, we request the Board to consider similar concepts as presented by International Accounting Standards No. 39 ("IAS 39"), paragraph 11 and 12 in addition to providing a fair value option for hybrid instruments:

11. An embedded derivative shall be separated from the host contract and accounted for as a derivative under this Standard if, and only if:
   (a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract
   (b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
   (c) the hybrid (combined) instrument is not measured at fair value with changes in fair value recognized in profit or loss

12. If an entity is required by this Standard to separate an embedded derivative from its host contract, but is unable to measure the embedded derivative separately either at acquisition or at a subsequent financial reporting date, it shall designate the entire hybrid (combined) contract at fair value through profit or loss.

The conclusion of wording similar to IAS 39 would result in two choices in accounting for a hybrid instrument: (a) bifurcate the embedded derivative that meets the requirement of paragraph 12 of FAS 133 and carry it at fair value (which can be designated in a hedging relationship) or (b) elect fair value option for the entire hybrid instrument (which cannot be designated in a hedging relationship).

2. Effective date and transition

We agree that the Fair Value Option should be available on an instrument-by-instrument basis. We do, however, have concerns that the fair value option is only available for those instruments that are entered into after the permitted transition date. Our experience indicates that application of paragraph 12 of FAS 133 has resulted in bifurcation of many structured notes, long and short term alike. Under the proposed terms, a reporting entity would not be able to apply the fair value option to any existing hybrid instruments that are subject to the bifurcation rules of FAS 133. The same instrument, if entered into after the transition date, would have the fair value option as an accounting alternative. This disparity in two different accounting approaches for similar transactions would create a discrepancy in earnings for two instruments that are otherwise identical, except for time of issuance; it would also create additional operational burdens when application of FAS 133 already presents sufficient operational challenges. We believe transactions with similar terms should be subject to the same accounting alternatives. To that extent, we recommend the Board consider allowing the fair value
election option on an instrument-by-instrument basis for all hybrid instruments previously bifurcated that have not been designated in a hedge relationship. This proposal addresses the Board’s concern\(^2\) that it would be operationally difficult for an entity to elect the fair value option if the bifurcated embedded derivative has been designated in a hedge relationship. This proposal also allows the reporting entity an opportunity to eliminate accounting mismatch and align its accounting with underlying economics of the transactions.

We are also concerned with the impact that the Board’s Fair Value Option project. We request the Board to carry forward our comment on this subject to the Fair Value Option project may have with the proposed amendment. We also request the Board to consider timely release of the Fair Value Option Standard. A comprehensive guidance in this area would consolidate accounting literature on this topic in US GAAP, as well as move towards harmonizing with IAS 39.

\(^2\) As stated per paragraph A30 of Accounting for Certain Hybrid Financial Instruments Exposure Draft