October 10, 2005

Technical Director—File Reference No. 1225-001
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116


We appreciate the opportunity to comment on the FASB’s Proposed Statement of Financial Accounting Standards, Accounting for Transfers of Financial Assets, an amendment of FASB Statement No. 140 (the Exposure Draft or Proposed Amendment). We support the Board’s objective of clarifying and improving the consistency of application of FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (Statement 140).

We have provided our comments on specific provisions of the Exposure Draft with the expectation that, consistent with its desire to make incremental improvements to accounting standards, the Board will likely issue a final statement in the near term. However, difficult practice issues in evaluating whether the requirements for a special purpose entity to be considered qualifying in accordance with the provisions of Statement 140 have been met continue to arise. In addition, the financial components accounting model as currently designed is a rules-based rather than a principles-based standard and, therefore, inconsistent with the Board’s present standard-setting objectives. 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 accounting guidance. In that regard, we have described certain other accounting alternatives in the Appendix to this letter that we believe the Board should consider further. We expect that through its deliberations the Board and staff may identify other alternatives for consideration as well.

Should the Board elect to finalize the guidance in the Proposed Amendment before undertaking a more comprehensive analysis of the fundamental issues noted above, we believe that certain provisions of the Exposure Draft require clarification or modification...
Technical Director - File Reference No. 1225-001
October 10, 2005
Page 2

to ensure consistent application. Our specific comments on those provisions are provided below. Paragraph references are to the paragraph numbers in the amended Statement 140 unless otherwise indicated.

Permitted Activities of a QSPE

1. The Board should describe by examples or other explicit guidance the activities that a QSPE is permitted to undertake in managing its assets and liabilities that are within the boundaries of significantly limited and entirely specified.

The Board’s current project to amend Statement 140 has as its origin EITF Issue No. 02-12, “Permitted Activities of a Qualifying Special-Purpose Entity in Issuing Beneficial Interests under FASB Statement No. 140.” As noted in paragraph 4 of EITF 02-12, “While Statement 140 is very specific about the activities of a qualifying SPE with regard to the assets it holds and the derivatives it enters into, that Statement contains little discussion about the issuance of beneficial interests [i.e., about the management of the QSPE’s liabilities]. Statement 140 does not specify whether either (a) the conditions for a qualifying SPE require that the terms of beneficial interests to be issued be specified at inception of the entity or (b) the qualifying SPE (or its designee or agent) may establish the terms of replacement beneficial interests.” However, paragraph 35(b) of Statement 140 contains overarching guidance with respect to the permitted activities of a QSPE stating that “its permitted activities (1) are significantly limited, (2) were entirely specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds . . . .” (emphasis added). It was that language in paragraph 35(b) of Statement 140 that caused the concerns in practice that eventually led the EITF to include EITF 02-12 on its agenda. We do not believe the Proposed Amendment resolves the issues that were raised in EITF 02-12.

Paragraph 3(q) of the Exposure Draft provides a new paragraph 45A to be included in the amended Statement 140 that would add explicit restrictions on the circumstances in which it is permissible for a QSPE to manage its liabilities through rollovers of beneficial interests. However, that new guidance does not fully resolve the underlying issue of whether it is possible for a QSPE to manage its liabilities while remaining in compliance with the requirement that its activities be significantly limited and entirely specified in its governing documents. The new paragraph 45A(c) states that rights or obligations “to specify the terms and conditions of the beneficial interests that the qualifying SPE issues, to decide which investors to sell them to, to decide when to issue beneficial interests, or any combination thereof (to direct the financing activities of the SPE) . . . are constrained by paragraph 35(b), which states that the qualifying SPE’s permitted activities must be entirely specified in the legal
documents that established the qualifying SPE or created the beneficial interests in the transferred financial assets it holds and must be significantly limited” (emphasis added). This language is included despite the Board’s recognition of the assertion in paragraph A33 of the Exposure Draft that the “financing activities of certain types of SPEs generally cannot be entirely specified and significantly limited if the entity is to be economically viable. Some flexibility in the terms and conditions of beneficial interest rollovers is required to deal with changing market conditions, and someone must make the necessary decisions.”

As the Board is aware, the issue of what level of discretion is permissible within the boundaries of “significantly limited and entirely specified” also arises with regard to the activities surrounding a QSPE’s assets. For example, some financial assets have provisions that may (a) allow a borrower to require the lender to accept new collateral in substitution for existing collateral and potentially give the servicer of that asset the right to participate in the assessment of whether the conditions precedent to a substitution of collateral have been met, (b) give a lender (or transferee SPE) the right to waive a due on sale provision (i.e., to allow the existing debt associated with a particular asset to be transferred from one owner of the asset to another), or (c) give the servicer of the asset discretion in matters such as forbearance in the event of a natural disaster, catastrophe, or other infrequent or unforeseen circumstances. The response to Question 24A of the FASB Staff Implementation Guide, “A Guide to Implementation of Statement 140 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities” (the FAS 140 Q&A), indicates that the limitations on the permissible activities of a QSPE apply whether those activities are conducted by the QSPE itself or by its agent or anyone else acting on its behalf. We believe the same assertion that is made in paragraph A33 with respect to the economic viability of entirely specifying a QSPE’s financing activities can be made with respect to the activities surrounding a QSPE’s assets. However, the types of arrangements described above continue to raise issues in practice and call into question whether certain types of financial assets can be held by a QSPE because of the restrictions placed on a QSPE in Statement 140 with respect to engaging in lending activities and making decisions.

In order to ensure consistent application of the amended guidance, we believe it is critical for the Board to clearly identify whether or not a QSPE can have any discretion in managing its assets and liabilities, whether the evaluation is different for assets than for liabilities, and if so, why. (We are not aware of any conceptual reason for a difference between the level of discretion that a QSPE can have in managing its liabilities versus the level of discretion that is permitted with respect to its assets.) In addition, if there are certain types of beneficial interest reissuance activities, servicing
activities, or other activities that could occur within a QSPE that are of particular concern to the Board, it would be helpful for the amendment to provide examples of those arrangements. We believe the Proposed Amendment is incomplete without a resolution of these issues.

2. The Board should provide examples of combinations of involvements that do and do not represent a “more-than-trivial incremental benefit” as described in paragraphs 45A and A34. Paragraph A34 states that 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, its consolidated affiliates, or its agents, nor does it intend to require demonstration of the actual receipt of a benefit.” It appears from the guidance in paragraph A34 that the Board does not intend for the presence of just any level of incremental benefit to be considered presumptively more-than-trivial. However, it is not clear what circumstances the Board has discussed that it clearly does and does not intend to represent a combination of involvements that provides a more-than-trivial incremental benefit.

3. Paragraph 45A states that “Involvement with the entity refers to conditional or unconditional rights to receive assets from the entity or obligations to deliver assets to the entity as well as decision-making authority or obligations to provide services to the entity.” This definition is followed by three examples of types of involvements. The Board should explain whether it deliberately intended to exclude servicing of the transferred financial assets from the list of involvements (as it would otherwise seem to fit the definition provided). In addition, the Board should clarify what it views as decision-making in the context of the guidance in paragraph 45A and, specifically, whether it views the servicer’s responsibilities as inclusive of decision-making.

4. The Board should clarify the application of the guidance in paragraph 45A to master trusts. The last sentence in paragraph 45A states that “Beneficial interests issued by a revolving-period master trust are not considered rollovers if the proceeds are applied to reduce the transferor’s interest.” It may not be possible to precisely link the sources and uses of funds in a master trust. Has the Board considered how a transferor would demonstrate that beneficial interest proceeds are applied to reduce the transferor’s interest and, otherwise, demonstrate that the issuance of beneficial interests by a revolving-period master trust do not represent rollovers? Would a pass-through certificate whose balance can increase and decrease (sometimes referred to as a variable funding certificate) with no scheduled maturity representing a beneficial interest in a revolving pool of assets held by a trust be considered a rollover of...
beneficial interests under the guidance in the Exposure Draft? Examples to illustrate the application of this aspect of the Proposed Amendment would be helpful.

5. We recommend that the proposed amendment to paragraph 40 of Statement 140 be included in the final statement resulting from the FASB’s Proposed Statement of Financial Accounting Standards, Accounting for Certain Hybrid Financial Instruments, an amendment of FASB Statements No. 133 and 140, (the Hybrid Instruments Exposure Draft), to ensure that the applicability of that amendment to Statement 140 coincides with the applicability of the interrelated amendment to paragraph 14 of FASB Statement No. 133. As discussed in paragraphs 187 and 188 of Statement 140, the Board included the guidance in paragraphs 40(b) and 40(c) of Statement 140, in part, to address concerns about transferors using QSPEs to enter into derivative transactions to avoid the accounting requirements of Statement 133. It is our understanding that the Hybrid Instruments Exposure Draft, which would eliminate the exemption from applying Statement 133 to beneficial interests in securitized financial assets, is intended to alleviate those concerns. However, as further discussed in our comment letter on the Hybrid Instruments Exposure Draft, it is not clear how the fair value measurement option in the Hybrid Instruments Exposure Draft, as currently proposed, actually would resolve those concerns. Specifically, it is not clear that the evaluation of whether an embedded derivative exists in a beneficial interest would be required to take into consideration the underlying contracts of the SPE that issued the beneficial interests and, even if it does, whether the embedded derivative evaluation could result in different accounting than would be applied to freestanding derivative instruments.

Participations

6. It would be helpful if the Board could more clearly explain or illustrate how setoff rights affect (or do not affect) the analysis of whether there is a participating interest holder that is entitled to receive cash before any other participating interest holder as required by paragraph 8A(c). In paragraphs A13 and A14 the Board appears to indicate that ultimately it decided that setoff rights do not present an impediment to meeting the isolation requirement. However, given the amount of time that the Board spent on that issue in its deliberations of the Exposure Draft, it should make its conclusion an explicit aspect of the guidance in paragraph 8A(c).

7. Paragraph 2(d) of the Exposure Draft states that if a transfer of financial assets does not meet the definition of a participating interest in paragraph 8A or the conditions for surrender of control in paragraph 9 of Statement 140 as amended, “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” (emphasis added) and meeting the conditions of paragraph 9 of Statement 140 as amended with respect to the entire transferred financial asset(s). However, paragraph A23 of the Exposure Draft states that “the Board decided to require that the entire original financial asset first be segregated in a qualifying SPE unless the portions transferred meet the definition of a participating interest (as described in paragraph 8A of Statement 140, as amended by this Statement).” Paragraph A23 thus seems to conflict with paragraph 2(d) because according to paragraph A23, a QSPE would be required for a portion of a financial asset to be derecognized by the transferor when the portion does not meet the definition of a participating interest whereas paragraph 2(d) suggests that a QSPE would not be required in that situation if the transferee is not consolidated by the transferor.

The Board should clarify the circumstances in which a QSPE is required in order for the transferor to derecognize portions of financial assets that do not meet the definition of a participating interest. For example, would a transferor be required to utilize a QSPE in order to achieve derecognition any time the transferor provides servicing for the transferee, even if only temporarily? The Board should also clarify whether it intends for basic interest only / principal only participations not to require a QSPE in order for the transferor to derecognize the transferred portion of the original asset(s). If so, the Board should consider whether to provide guidance with respect to financial assets with an implicit rather than explicit interest component (e.g., many leases do not contain an explicit interest component, but nevertheless have an economic element that represents interest). In addition, the guidance in paragraph 2(d) or A23, as applicable, should be explicitly included in the changes to paragraph 9 of Statement 140.

8. The basis for conclusions of the Proposed Amendment does not explain the Board’s rationale for deciding to allow a transfer to qualify as a participation when the transferor retains adequate compensation for servicing and an interest only strip not to exceed the overall gain on the transfer rather than requiring a pro-rata sharing of 100 percent of the cash flows of the original financial asset. An explanation for that decision would be helpful because it appears to otherwise be contrary to the general principle in paragraph 8A(b) that a participating interest represents a pro-rata share of 100 percent of the cash flows of the entire original financial asset. In particular, it is not clear why an interest only strip can be retained by the transferor, but its fair value cannot exceed any gain on sale of the transferred financial assets. In addition, the Board should consider whether to provide separate guidance with respect to financial assets with an implicit rather than explicit interest component (e.g., many leases do not contain an explicit interest component, but nevertheless have an economic
element that represents interest). We do not believe that the accounting should be different solely due to the presence or absence of contractual terms that may differ from the economics of the transaction.

Isolation – Paragraphs 9(a), (d), and (e)

9. Paragraph 9(a) states that “Transferred financial assets are isolated in bankruptcy or other receivership only if the available evidence provides reasonable assurance that the transferred financial assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any consolidated affiliate of the transferor that is not a special purpose corporation…” 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. However, paragraph A9 in Appendix A states that “Paragraph 27 of Statement 140 includes a requirement that transferred financial assets must be isolated from all entities in the consolidated group that includes the transferor, except for certain bankruptcy-remote entities.” 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). We recommend that the Board clarify how it intends the reference to consolidated affiliates of the transferor in paragraph 9(a) to be interpreted, in a manner that is consistently reflected in both the body of the Proposed Amendment and in Appendix A. In addition, to ensure consistent application of the Board’s intentions relative to the consolidated affiliates of the transferor, the Board should clarify how such arrangements should be considered in legal opinions provided for isolation.

10. The Board should explicitly indicate how it intends for transferor support commitments such as guarantees, liquidity commitments, total return swaps, etc., to impact the determination of whether a transfer meets the isolation test in paragraph 9(a) and 9(e). The Board has added paragraph 9(e) to ensure that no arrangements between the holder of beneficial interests in a QSPE and the transferor, or its consolidated affiliates, can be entered into if such arrangements would have caused the assets to not be considered isolated if the same arrangement was entered into by the QSPE instead of its beneficial interest holders. The Board also described its understanding in paragraph A17 that attorneys rendering true sale at law and nonconsolidation opinions may not have previously been considering or even been aware of the existence of these arrangements when providing such opinions.
Immediately preceding the discussion in paragraph A17 is a discussion in paragraphs A15 and A16 of transferor support commitments. We recommend that the Board clarify whether such commitments should be considered as part of the isolation analysis and its expectations of the impact of including such transferor support commitments on the determination of isolation. The discussion in paragraphs A15 through A17 is unclear on this issue.

11. Paragraph 9(d) requires the isolation analysis to consider any arrangement made in connection with the transfer even if it was not entered into at the time of the transfer. The phrase “in connection with the transfer” may result in inconsistent application of the Proposed Amendment without additional guidance to determine whether a subsequent arrangement is entered into in connection with a previous transfer. We also understand that an arrangement occurring sometime after a transfer to a QSPE may cause the QSPE to no longer be qualifying or cause the isolation test in paragraph 9(a) to no longer be met. In such cases where the QSPE ceases to be qualifying, presumably the guidance in paragraph 55 would apply. However, it is unclear what the accounting would be if the isolation test was failed subsequent to accounting for the original transfer as a sale. We recommend that the amendment include a description of the accounting for such events – e.g., transferred assets are re-recognized and a liability is recorded – including guidance on the measurement issues related to the assets, if any, that should be re-recognized.

12. As noted in paragraph A51, it is the first step in a two-step transfer that results in the isolation of the transferred financial assets (i.e., in which the condition in paragraph 9(a) is met). It is unclear why paragraph 9(e) links the isolation evaluation to arrangements between a QSPE (or its beneficial interest holders) and the transferor (or its affiliates). Does the Board intend for the legal isolation opinion in a two-step transaction to cover the transfer from the bankruptcy-remote SPE to the QSPE? If so, does the Board no longer believe a bankruptcy-remote SPE is needed in the first step of a two-step transfer?

13. In order to ensure consistent application of the isolation analysis, it would be helpful for the Board to clarify whether it intends for the term “arrangement” in paragraphs 9(d) and 9(e) to refer only to explicit contractual arrangements or also to implicit arrangements. In addition, the guidance in these paragraphs does not appear to represent separate standalone conditions, but rather additional guidance for consideration when evaluating whether the condition in paragraph 9(a) has been met and whether an SPE that is intended to be a QSPE really is qualifying. Therefore, we believe the guidance in paragraphs 9(d) and 9(e) would be more understandable if it
were not presented as separate conditions, but rather as additional considerations in the application of paragraph 9(a).

14. The guidance in paragraphs 9, 27A, and 27B with respect to whether the transferred assets have been isolated appears to be focused on the U.S. legal environment to the exclusion of circumstances that may be evaluated differently under the laws in foreign jurisdictions. As written, that guidance may not provide for flexibility in performing the isolation analysis based on the relevant legal jurisdiction in which the transfer occurs. We believe that application of the isolation test should be based on the applicable law in the legal jurisdiction in which the transfer occurs. However, application of the existing isolation requirements is difficult in many jurisdictions outside the U.S.

15. One of the requirements listed in paragraph 27A for a transfer to meet the isolation criteria of paragraph 9(a) is that the transfer must legally be considered a sale. Paragraph 27 clarifies the nature and extent of the supporting evidence required for an assertion that transferred assets have been isolated and indicates that determining whether a transfer is a true sale at law is one source of evidence supporting isolation. However, we are aware of transactions in which legal isolation opinions have been obtained even though there is not a legal sale. In Canada for example, concurrent lease structures, in which the minimum lease payments are "leased" to a third party, are considered transfers of financial assets (i.e., minimum lease payments) under Statement 140 and have received legal isolation opinions even though there is not a sale in legal form. Accordingly, we believe the Board should reconsider whether to require the transfer to legally be a sale in order for the Statement 140 isolation test to be met.

16. We believe the comments at the end of paragraph 27B about whether a legal opinion is necessary to support a conclusion that the isolation test has been met should be deleted. We do not believe that guidance represents accounting requirements, but instead represents audit guidance that should not be included in an accounting standard. If any comment is made, we believe it should state simply that whether the isolation test has been met is a legal determination and the appropriate evidence to support a conclusion in that regard is dependent on the facts and circumstances.

**Constraints – Paragraph 9(b)**

17. Under the provisions of paragraph 9(b) of Statement 140, a transferor is precluded from derecognizing transferred financial assets if the transferor can constrain the transferee from taking advantage of its right to pledge or exchange the transferred financial assets and receives a more-than-trivial benefit as a result. A practice issue
that arises in that regard is whether a transferor’s ownership interest in the transferee that provides the transferor the ability to block actions of the transferee through voting or managerial powers (such as would be the case in many joint venture arrangements) would cause the condition in paragraph 9(b) to not be met. If the appropriate interpretation of paragraph 9(b) is that it would, then it would not be possible for a transferor to derecognize transferred financial assets in a two-step transfer, as the proposed revisions to paragraph 9(b) of Statement 140 are currently written, if the first step of the transfer is to a bankruptcy-remote entity that is a wholly-owned subsidiary of the transferor. Is that the Board’s intent? If not, we suggest that the Board explicitly exclude bankruptcy-remote subsidiaries from the requirements of paragraph 9(b) (i.e., the transferor would not be required to apply the condition in paragraph 9(b) to a bankruptcy-remote subsidiary).

Other Comments and Editorial Suggestions

18. The definition of ‘beneficial interests’ in paragraph 364 of Statement 140 states that such interests are issued by QSPEs. It seems possible that entities other than QSPEs might be able to issue beneficial interests. Does the Board intend that the definition be limited only to QSPEs?

19. In paragraph 4 of the Exposure Draft it would be helpful to describe the accounting in the event that the expanded requirements of paragraph 9(a) are not met at the effective date—e.g., transferred assets are re-recognized and a liability is recorded. Measurement should also be addressed.

20. In the penultimate sentence of paragraph (e) of the Summary to the Exposure Draft, the word “interest” should be changed to “interests”.

21. In the last sentence of paragraph A2, the word “other” should be inserted after the word “several” and before the word “aspects”.

22. In the last sentence of paragraph A39, the word “beneficial” should be inserted after the word “transferor’s” and before the word “interest”.

23. In paragraph 3(a), new paragraph 8A(b) should be changed as follows (added text is underscored, deleted text is struck through):

All cash flows received from the asset, except for servicing fees representing adequate compensation and, if applicable, 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, are divided among the participating interests 
(including any interest retained by the transferor, its consolidated 
affiliates, or its agents) in proportion to the share of ownership represented 
by each, except for servicing fees representing adequate compensation 
and, if applicable, 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. The 
ownership shares remain constant over the life of the original financial 
asset.

24. In paragraph 3(b), new paragraph 9(e) should be changed as follows (added text is 
underscored):

If the transferee is a qualifying SPE, no arrangement or agreement is 
made between any holder of beneficial interests issued by that 
qualifying SPE and the transferor, or its consolidated affiliates or its 
agents, that would have caused the assets not to be isolated as required 
by paragraphs 9(a) and 9(d) if the same arrangement or agreement had 
involved the qualifying SPE instead of its beneficial interest holders.

25. In paragraph 3(d), new footnote 3a, the word “transferors” should be changed to 
“transferors’”.

26. In paragraph 3(x), the example in paragraph 65 appears to represent a transaction that 
the Board does not believe would require a QSPE (refer to language in paragraph 66 
in which the use of a QSPE is an optional modification of the transaction structure). 
Thus, implicitly, the transaction illustrated in paragraph 65 must represent a 
participation under the guidance in the Proposed Amendment. However, the example 
in paragraph 65 illustrates a situation in which the servicing compensation is greater 
than adequate compensation because there is a positive fair value upon initial 
recognition. This appears to be contrary to the guidance in the new paragraph 8A(b) 
(refer to comment 24, above), which limits the amount of the servicing fee to 
adequate compensation if the transaction is to meet the definition of a participation.

27. In paragraph 3(z), new footnote 19a, the words “may be” should be changed to “is”.

28. In paragraph 3(ff), paragraph 83(b), the word “including” should be changed to 
“usually either”.
29. In paragraph 3(oo), footnote * should be changed as follows (added text is underscored, deleted text is struck through):

This amount represents total cash flows received from beneficial interests other than servicing fees by the transferor other than servicing fees. Other cash flows include, for example, all cash flows from interest-only strips and cash above the minimum required level in cash collateral accounts.

* * * * *

If you have any questions about our comments or wish to discuss any of the matters addressed herein, please contact either Mark Bielstein at (212) 909-5419 or Kimber Bascom at (212) 909-5664.

Sincerely,

KPMG LLP
Appendix

Overall Comments About QSPEs and the Financial Components Accounting Model

The notion of a QSPE as currently articulated in Statement 140 is difficult to reconcile to a particular concept. A QSPE does not, for example, represent a completely passive vehicle whose only function is to deliver the cash flows from its existing assets to its existing beneficial interest holders, a fact that the Board acknowledges in paragraph A29 of the Exposure Draft. Rather, the notion of a QSPE seems to have been developed as a means to allow the Board to accommodate certain common commercial arrangements within the condition in paragraph 9(b) of Statement 140. Yet, as currently proposed, the Exposure Draft seems to be expanding the use of QSPEs in order to meet the requirements for derecognition of portions of financial assets in certain circumstances because the Board views the QSPE as a mechanism to ensure that the pre-existing requirements of paragraph 9 of Statement 140 are applied in a more restrictive fashion. This is confusing when one considers the historical discussions that led the Board to create the notion of a QSPE in the first place.

As a result of the foregoing, we believe it would be appropriate for the Board to undertake a complete reconsideration of the purpose and function of QSPEs in the financial components accounting model. In conjunction with that reconsideration, we believe it would also be sensible for the Board to consider whether the financial components accounting model is consistent with the Board’s current move toward principles-based accounting standards. We believe the following alternatives in particular deserve further comprehensive consideration and due process by the Board in addition to its ongoing consideration of whether to converge the accounting for transfers of financial assets to the model in IAS 39, Financial Instruments: Recognition and Measurement. We expect that through its deliberations the Board and staff may identify other alternatives for consideration as well.

Alternative A: Revise the notion of a QSPE to be considered solely an agent of its beneficial interest holders rather than a completely passive entity.

Under this alternative, a QSPE would have certain principle characteristics. For example, we have identified four potential characteristics. First, a QSPE would be permitted to function solely as an agent of its beneficial interest holders. Second, a QSPE would not be permitted to be controlled (by effective control or through any other means such as outright legal control) by any of its beneficial interest holders (including the transferor, if the transferor is a beneficial interest holder). Third, in order to prevent abuses by transferors, a QSPE would be required to demonstrate that none of its activities are solely for the benefit of the transferor. Finally, because it is unlikely that a QSPE could be deemed to function solely as an agent of its beneficial interest holders if it holds assets with a contractual life that exceeds the term of the beneficial interests in those assets, a QSPE would not be permitted to issue revolving (or rollover) beneficial interests in a long-term pool of assets. However, under this alternative, a QSPE may not necessarily be a passive vehicle. Rather, this alternative would involve permitting a QSPE to take any actions that an agent might otherwise be directed to take on behalf of the party that it
Appendix

is representing. In addition, because its only function would be to serve as an agent of its beneficial interest holders, a QSPE would have no assets or liabilities of its own for accounting purposes. Therefore, FASB Interpretation No. 46(R), Consolidation of Variable Interest Entities (FIN 46), would not be relevant in determining whether a QSPE is controlled by one of its beneficial interest holders.

The current provisions of Statement 140 regarding QSPEs were originally provided by the Board as an exception to the specific requirements of paragraph 9(b) of Statement 140, which otherwise apparently would have precluded many common commercial transactions from qualifying for sale accounting. This is discussed in paragraphs 122 and 127 of FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. Specifically, paragraph 122 of Statement 125 states that "if the transferee is a special-purpose entity, the ultimate holders of the assets are the beneficial interest holders, and the important rights [for purposes of the paragraph 9(b) analysis] concern their ability to exchange or pledge their interests." Paragraph 127 states further that:

Qualifying special-purpose entities issue beneficial interests of various kinds—variously characterized as debt, participations, residual interests, and otherwise—as required by the provisions of those agreements. Holders of beneficial interests in the qualifying special-purpose entity have the right to pledge or exchange those interests but do not control the individual assets held by the qualifying special-purpose entity. The effect of establishing the qualifying special-purpose entity is to merge the contractual rights in the transferred assets and to allocate undivided interests in them—the beneficial interests. Therefore, the right of holders to pledge or exchange those beneficial interests is the counterpart of the right of a transferee to pledge or exchange the transferred assets themselves. (Emphasis added.)

Although Statement 125 suggested, as the Board may have been led to believe, that QSPEs were used in commercial transactions prior to the issuance of the guidance in Statement 125, entities with the types of characteristics and restrictions specific to QSPEs, as described in Statements 125 and 140, generally did not previously exist in practice and would not exist if it were not for the requirements of those Statements because the restrictions developed by the Board may exceed those that are considered necessary in the market to protect the beneficial interest holders in the transferred assets.

This alternative may alleviate the historical difficulty encountered by the Board in trying to define the permissible activities of a QSPE in a way that is compatible with practices that have become customary in the marketplace while at the same time preserving meaningful limits to those permissible activities. Because the current notion of a QSPE is an arbitrary concept, it can only be defined by accounting rules that are not necessarily intuitive. This is evident in the differing interpretations about the purpose of a QSPE and the permissible activities of a QSPE that have been asserted in practice over time.
Accordingly, this alternative may be more consistent with a principles-based standard-setting approach than attempting to maintain the current notion of a QSPE. This alternative also limits the function of a QSPE to performing the activities that beneficial interest holders would otherwise need to perform on their own in managing the economic risks and rewards arising from their interest in the transferred financial assets, with the following safeguards against possible abuse by the transferor:

- A QSPE could not be controlled by the transferor,
- None of a QSPE’s activities could be solely for the benefit of the transferor, and
- A QSPE would not be permitted to issue revolving (or rollover) beneficial interests in a long-term pool of assets.

*Alternative B: Eliminate the financial components accounting model and revert to a model that is based solely on the level of retained economic risks and rewards.*

Under this alternative derecognition of financial assets would be determined based on whether the transferor retains a level of economic risks and rewards with respect to those assets that is consistent with the level of risks and rewards retained by a borrower under a collateralized loan arrangement. However, this alternative would not necessarily be a return to an accounting model similar to that of FASB Statement No. 77, *Reporting by Transferees for Transfers of Receivables with Recourse*, under which derecognition was possible even when the transferor retained a substantial recourse obligation, as long as that obligation could be reasonably estimated. Further discussion would be required to specify the level of risks and rewards retention that would cause a transferor not to derecognize transferred financial assets. Some possible thresholds include a majority, more than a minor amount, substantially all, a significant portion, etc.

We recognize that the Board explicitly discussed and rejected this alternative in its deliberations on Statement 125. Some of the significant reasons for the Board’s rejection of the economic risks and rewards model include the following:

- It created inconsistencies in the circumstances that distinguished sales from secured borrowings, thereby confusing both users and preparers of financial statements.
- It resulted in the possibility for ongoing recognition of assets that the transferor no longer controlled.
- Its application was highly dependent on the sequence of transactions leading to the acquisition of financial assets. An example of this type of situation is described in paragraph 136 of Statement 140:

  For example, if Entity A initially acquired an undivided subordinated interest in a pool of financial assets, it would recognize that subordinated interest as a single asset. If, on the other hand, Entity B initially acquired a pool of financial assets identical to the pool in which Entity A participates, then sold a senior interest in the pool and continued to hold a subordinated interest identical to the undivided
interest held by Entity A, Entity B might be judged under a risks-and-rewards approach to have retained substantially all the risks of the entire pool. Thus, Entity B would carry in its statement of financial position the entire pool of financial assets as well as an obligation equal to the proceeds from the sale of the undivided senior interest, while Entity A would report its identical position quite differently. Those accounting results would disregard one of the fundamental tenets of the Board’s conceptual framework [as stated in FASB Concepts Statement 2, paragraph 119]; that is, "... accountants must not disguise real differences nor create false differences."

We also recognize that the Board explicitly discussed and rejected suggestions that QSPEs be subjected to the consolidation requirements of FIN 46 in its deliberations of the Exposure Draft. Indeed, paragraph A31 of the Exposure Draft states that:

Some respondents to the June 2003 Exposure Draft recommended that the Board subject qualifying SPEs to the requirements of Interpretation 46(R), while others recommended exempting those SPEs from the requirements. The Board decided not to subject qualifying SPEs to the requirements of Interpretation 46(R) because of significant differences between that interpretation and Statement 140. That is, Statement 140 is based on the notion that a qualifying SPE is a passive entity for which control and, therefore, consolidation is not an issue. However, Interpretation 46(R) does not distinguish between entities based on their passive or active nature. If qualifying SPEs were subject to Interpretation 46(R), a sole transferor to a qualifying SPE that holds a subordinated beneficial interest would frequently be the primary beneficiary because its interest would probably absorb a majority of the entity’s expected losses. That difference would have made the qualifying SPE provisions in Statement 140 ineffective. Transferred financial assets would have been derecognized and immediately recognized through the consolidation of the qualifying SPE. (Emphasis added.)

Arguably, subjecting QSPEs to the consolidation requirements of FIN 46 would be similar to applying a derecognition standard for transfers of financial assets that is based on whether the transferor retains a majority of the economic risks and rewards of the transferred financial assets. The language in paragraph A31 suggests that the Board explicitly thought about whether the financial components model should operate in a manner that allows for derecognition of a portion of a financial asset, even when the transferor of that portion of the asset retains a majority of the economic risks and rewards with respect to the entire financial asset, and decided that it should. That decision is consistent with the fundamental concepts of the financial components accounting model. However, the rules-based nature of the Statement 140 accounting guidance is not consistent with the Board’s stated objective of pursuing a more principles-based
standard-setting approach, and therefore, reconsideration of the financial components model may be appropriate.