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

Re: File Reference Nos. 1210-001, 1220-001, and 1225-001  
Exposure Drafts of Proposed Statements of Financial Accounting Standards

Dear Mr. Smith:

We are pleased to submit comments on behalf of the staffs of the five federal financial institution regulatory agencies on the following Exposure Drafts of proposed Statements of Financial Accounting Standards issued by the Financial Accounting Standards Board (FASB):

- Accounting for Transfers of Financial Assets, an amendment of FASB Statement No. 140;
- Accounting for Servicing of Financial Assets, an amendment of FASB Statement No. 140; and
- Accounting for Certain Hybrid Financial Instruments, an amendment of FASB Statements No. 133 and 140.

We see merit in the FASB's proposals that would allow institutions in some cases to simplify their accounting practices and improve their ability to hedge items such as certain servicing assets and liabilities and certain hybrid financial instruments. However, we do not support the proposed initial valuation of transferors' beneficial interests and retained servicing assets at fair value rather than at their allocated previous carrying amount. We also have significant concerns about the characteristics that an interest in an individual financial asset must have in order to qualify as a "participating interest" and about the designation of certain servicing assets and liabilities by class rather than by subclass. Our concerns about these elements of the FASB's proposals are discussed more fully in the enclosed appendix.

The exposure draft on transfers of financial assets would revise the isolation test and other derecognition provisions of FASB Statement No. 140. However, certain provisions would take effect upon issuance of the final standard (and would apply to certain transfers occurring prior to that date) and others would apply, for public companies, to transfers occurring after the end of
the first fiscal quarter beginning after the issuance of the final standard. Many transferors will need to modify documents used in their transfers, consult with legal advisors concerning legal opinions, review existing transactions, and revise transaction structures. Therefore, we recommend that the FASB provide for a longer implementation period following the issuance of a final standard on transfers of financial assets in order to allow for a more orderly transition to the revised standard.

We would welcome the opportunity to discuss our comments with you further.

Sincerely,

Robert F. Storch  
Chief Accountant  
Federal Deposit Insurance Corporation

Charles H. Hohn  
Deputy Associate Director  
Board of Governors of the Federal Reserve System

Zane D. Blackburn  
Chief Accountant  
Office of the Comptroller of the Currency

Jeffrey J. Geer  
Chief Accountant  
Office of Thrift Supervision

David M. Marquis  
Director, Office of Examination and Insurance  
National Credit Union Administration

Enclosure
Interagency Comments on Exposure Drafts of Amendments to Statement of Financial Accounting Standards No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (FAS 140)


Participating Interest – Definition of Recourse

Proposed paragraph 8A of FAS 140, as it would be amended, identifies the characteristics of a “participating interest.” According to paragraph 8A(c), one characteristic is that “[p]articipating interest holders have no recourse to the transferor (or its consolidated affiliates or agents) or to each other.” The Glossary in Appendix E of FAS 140 (paragraph 364) defines recourse in part to be “[t]he right of a transferee to receive payment from the transferor of those receivables for . . . (c) adjustments resulting from defects in the eligibility of the transferred receivables.”

In a loan participation, a transferor’s responsibility to make adjustments resulting from defects typically arises from the standard representations and warranties that are customarily included in participation agreements. Based on the specific language contained in paragraph 8A(c), it is our understanding that the presence of these standard representations and warranties may cause these arrangements to fail the “no recourse” characteristic of a participating interest. This would defeat the purpose behind the FASB’s creation of the concept of a participating interest, the transfer of which is intended to qualify for sale accounting treatment without the use of a qualifying special purpose entity (QSPE). Because the standard representations and warranties contained in most participation agreements are provided for the purpose of reimbursing a transferee if the transferor misrepresents the nature of the loan, the borrower, or the transferor’s underwriting efforts and not for the purpose of providing reimbursement for credit losses that might arise after the transfer of the participation, we do not believe that the presence of such representations and warranties in a loan participation agreement should preclude the transfer of a loan participation from being accounted for as a sale. Therefore, we urge the FASB to revise the “no recourse” characteristic of a participating interest so that it excludes those representations and warranties falling within clause (c) of FAS 140’s definition of recourse that do not function as a credit enhancement.

Participating Interest – Government-Guaranteed Loans

Based on discussions with the FASB staff, we understand that questions have been raised as to how the characteristics of a participating interest should be evaluated in the context of transactions in which an institution transfers the portion of an individual loan that is guaranteed by a U.S. Government agency and retains the unguaranteed portion of the loan. U.S. Government agencies that provide these guarantees include the Small Business Administration (SBA) and the Department of Agriculture’s Farm Service Agency. Many institutions, including
a significant number of smaller community institutions, originate or purchase these Government-guaranteed loans and transfer the guaranteed portions into the secondary market using a transfer document issued by the guaranteeing agency.

Under the SBA’s secondary market program, for example, in certain circumstances following the borrower’s default on a guaranteed loan, the transferee holding the guaranteed portion receives cash from the SBA for the remaining balance of that portion of the loan, but the holder of the unguaranteed portion does not receive cash at the same time. We understand that some may view this outcome as being contrary to the characteristic of a participating interest cited in proposed paragraph 8A(c) that states that “no participating interest holder is entitled to receive cash before any other participating interest holder.” However, we believe that, when the SBA distributes cash to the holder of the guaranteed portion of the loan, it is more appropriate to treat this transaction as the transfer of the guaranteed portion of the loan from one holder to a new holder (the SBA). The guaranteed portion of the loan remains outstanding and the borrower’s obligation has not been extinguished. All of the cash flows received from the loan after the holder of the guaranteed portion has transferred this interest to the SBA continue to be divided among the holders in proportion to their respective shares of ownership in the loan.

The SBA’s transfer document also indicates that the transferor of the guaranteed portion has no authority to unilaterally repurchase the transferred guaranteed portion. However, in certain circumstances following the borrower’s default, the SBA may offer the transferor the option to repurchase the guaranteed portion from the transferee. The SBA may also approve such a repurchase in an emergency situation when a change in the loan’s repayment terms is necessary to prevent the failure of the borrower’s business. These should be viewed as conditional repurchase options under paragraphs 9(c) and 55 of FAS 140 rather than as an entitlement of the holder of the guaranteed portion to receive cash before other holders of interests in the loan under proposed paragraph 8A(c). This view would be consistent with the concept of not maintaining “effective control” under FAS 140 when the guaranteed portion is transferred and, therefore, the conditional options should neither prevent the guaranteed and unguaranteed portions of the loan from qualifying as participating interests nor preclude sale accounting at the date of transfer. However, once either option is no longer conditional based on the terms of the SBA’s transfer document, the transferor is deemed to have regained effective control over the guaranteed portion and therefore must recognize it as an asset because it can no longer be treated as sold.

In addition, we note that the SBA’s transfer document requires the transferor to refund any premium received on the transfer of the guaranteed portion to the transferee if either the borrower repays the loan within 90 days of the transfer or certain borrower default conditions are met within less than one year of the transfer. The definition of recourse in Appendix E of FAS 140 also encompasses “[t]he right of a transferee of receivables to receive payment from the transferor of those receivables for (a) failure of debtors to pay when due, [or] (b) the effects of prepayments.” As previously mentioned, proposed paragraph 8A(c) states that one characteristic of a participating interest is that “[p]articipating interest holders have no recourse to the transferor.” We understand that the transferor’s obligation to refund the premium occurs infrequently. Under existing FAS 140, the transferor recognizes the premium refund obligation as a liability incurred at fair value when accounting for the sale of the guaranteed portion of the
loan. Because the SBA imposes this premium refund obligation on the transferor, we believe that it should be excluded from the scope of the "no recourse" characteristic in paragraph 8A(c) and that its existing accounting treatment under FAS 140 should be retained.

As a practical matter, if the guaranteed and unguaranteed portions of a U.S. Government-guaranteed loan such as an SBA loan fail to qualify as participating interests, the lender would be required to transfer the entire loan to a QSPE to achieve sale accounting. The QSPE would then issue separate beneficial interests in the guaranteed and unguaranteed portions of the loan. Based on the feedback we have received, it would not be cost effective for smaller institutions, which may be the only source for Government-guaranteed loans in certain communities, to structure transfers of the guaranteed portions of such loans through QSPEs.

Furthermore, we do not believe that the well established practice of dividing Government-guaranteed loans into their guaranteed and unguaranteed portions for purposes of transferring the guaranteed portion to another party should disqualify these transactions from sale accounting. We are not aware of accounting abuses that have arisen in the market for the Government-guaranteed portions of loans that would justify a change in the existing accounting treatment of these transfers under FAS 140, which takes the Government guarantee into account in the valuation of the sold versus retained portions of the loan. Therefore, we urge the FASB to clarify that when a loan partially guaranteed by a U.S. Government agency is divided into guaranteed and unguaranteed portions, the transfer of the guaranteed portion would be eligible for sale accounting without having to resort to the use of a QSPE, which would avoid a potentially significant disruption to the credit availability initiatives administered by the SBA and other U.S. Government agencies.

**Transferor’s Beneficial Interest**

Paragraph 11 of FAS 140, as it is proposed to be amended, would require that a "transferor’s beneficial interest" be initially measured at fair value rather than at its allocated carrying amount based on relative fair values. In the Board’s view, this change in initial measurement is warranted because the beneficial interest is a new asset. According to paragraph A38 of the Exposure Draft, if an entire financial asset has been transferred to a QSPE and the transferor has given up control of that asset, any beneficial interest the transferor receives in return is a new asset even if the cash flows come from the asset originally held by the transferor. We disagree with the FASB’s conclusion that a transferor’s beneficial interest should be treated as a new asset, thereby triggering initial fair value measurement. In our view, such a conclusion is not consistent with the substance of the arrangement and would reduce the transparency of the sale transaction.

Although the transferor must surrender control over the entire transferred individual financial asset or group of financial assets to satisfy the conditions for sale accounting under the proposed revision, the transferor must then gain control of an interest in the transferred financial asset(s) in order to recognize the interest as an asset in the accounting for the sale transaction. Putting aside the steps the transferor has been required to take in order to derecognize the cash flows over which other parties have obtained control, including the establishment of a QSPE and a transfer of the financial asset or assets in their entirety to the QSPE, the substance of what has occurred is
that the transferor continues to control a portion of the cash flows from the original financial assets. In that case, with respect to the portion of the cash flows over which the transferor has effectively maintained control, we do not believe that the earnings process has been completed nor that the cost basis of these controlled cash flows should be restated to fair value, resulting in the recognition of a gain or loss on the instrument the Exposure Draft refers to as the transferor’s beneficial interest.

Thus, we agree with the views of the dissenting Board member that are expressed in paragraph A54 of the Exposure Draft. In particular, we share the concern of this Board member who believes that the proposed remeasurement of retained beneficial interests at fair value “introduces discretionary timing of gains and losses on entire assets for nonsubstantive economic changes (such as the use of a qualifying SPE to sell a small disproportionate interest in the cash flows of an asset, which would trigger recognition of the gain or loss on the whole asset, even though the transferor retains control over most of the cash flows of the asset).” Such discretionary timing of gains and losses on entire assets raises significant supervisory concerns about earnings and capital management and the transparency of the transaction. In essence, allowing the transferor’s beneficial interest to be measured initially at fair value encourages the types of transaction structuring that the Securities and Exchange Commission suggested should be eliminated in its “Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 on Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers.” Therefore, we urge the Board to eliminate the proposed requirement for initial fair value measurement of a transferor’s beneficial interest.

Exposure Draft, Proposed Statement of Financial Accounting Standards,
Accounting for Servicing of Financial Assets,
an amendment of FASB Statement No. 140

Initial Measurement of Servicing Assets

The Board has proposed to amend paragraphs 10 and 11 of FAS 140 to also require that transferors recognize and initially measure servicing assets at fair value in all transfers of financial assets that satisfy the conditions to be accounted for as a sale. Under FAS 140 at present, similar to the treatment of a transferor’s beneficial interests, these servicing assets are initially measured at their allocated previous carrying amount based on relative fair values. Paragraph 61 of FAS 140 states that “[s]ervicing is inherent in all financial assets; it becomes a distinct asset or liability only when contractually separated from the underlying assets by sale or securitization of the assets with servicing retained or separate purchase or assumption of the servicing.” Because of the inherent nature of servicing, and consistent with the views expressed above concerning the transferor’s beneficial interest, we do not believe that, in substance, the cash flows represented by the contractually specified servicing fees when servicing is retained by the transferor in an asset sale or securitization, together with the other benefits of servicing that already belonged to the transferor prior to the sale or securitization, represent a new asset. In addition, consistent with the preceding comments, we have similar supervisory concerns about earnings and capital management and the transparency of the transaction. Accordingly, we
recommends that the transferor's initial measurement of servicing assets retained in a sale or securitization should continue to be determined on an allocated carryover basis and should not be changed to fair value.

**Classes of Servicing Assets and Liabilities**

The FASB has proposed to amend paragraph 13 of FAS 140 to permit, for each class of separately recognized servicing assets and liabilities, an entity to choose to apply one of two subsequent measurement methods, either the amortization method or the fair value measurement method. An entity would be required to apply the same subsequent measurement method to each servicing asset or liability in a class. The class of servicing assets and liabilities must be determined based on the major asset type being serviced. “Major asset type” is described in the existing FAS 140 disclosure requirements in paragraph 17 that apply to securitized financial assets as, for example, “mortgage loans, credit card receivables, and automobile loans.”

While these major asset types may be appropriate for disclosure purposes, requiring their use for purposes of identifying classes of servicing assets and liabilities to which a subsequent measurement method is to be applied is problematic, particularly for mortgage loans. A wide variety of loans with differing risk characteristics falls within the broad category of “mortgage loans.” For example, mortgage loans can be closed-end or open-end (e.g., home equity lines of credit) and can be secured by different types of property (e.g., single family residences, multifamily residential property, and commercial real estate). Prepayment risk and default rates also differ across mortgage loans (e.g., 30-year fixed-rate amortizing mortgages and option adjustable-rate mortgages). Although mortgage servicing rights are commonly transferred, the depth and liquidity of the market for different “subclasses” of mortgage loans can vary significantly. In addition, the extent of market information and the corresponding reliability of market assumptions and valuations can vary greatly by subclasses of mortgage servicing assets and liabilities.

As a consequence, we understand that servicers often employ different strategies for mitigating the risks inherent in different subclasses of mortgage servicing assets and liabilities. Some servicers may choose to economically hedge only certain subclasses of mortgage servicing and not others. Thus, the proposed requirement that an entity apply a single subsequent measurement method for its entire class of mortgage servicing assets and liabilities may add to income statement volatility for certain subclasses of servicing while reducing it for other subclasses. This may also be true for the servicing of other “major asset types.” We therefore recommend that the FASB revise its servicing rights proposal to permit the choice of subsequent measurement method to be made for each subclass, rather than class, of separately recognized servicing assets and liabilities. In developing guidance on subclasses, it may be useful to look to the existing impairment requirements in FAS 140, which will be retained for the amortization method. Under these requirements, an entity must stratify servicing based on one or more of the predominant risk characteristics of the underlying financial assets.