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LETTER OF COMMENT NO. 17

Mr. Russell G. Golden  
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**Proposed Statement of Financial Accounting Standards, *Accounting for Transfers of Financial Assets*, an amendment to FASB Statement No. 140  
File Reference No. 1610-100**

Dear Mr. Golden:

We appreciate the opportunity to comment on the Financial Accounting Standards Board's (the Board or FASB) proposed Statement of Financial Accounting Standards, *Accounting for Transfers of Financial Assets, an amendment to FASB Statement No. 140* (the Exposure Draft), which is a revision of the August 2005 FASB Exposure Draft, *Accounting for Transfers of Financial Assets*.

We support the Board's effort to amend certain key provisions of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (Statement 140), primarily the proposed elimination of the qualifying special-purpose entity (SPE) concept from Statement 140 and the exception from applying FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities* (Interpretation 46(R)), to qualifying SPEs. However, we are concerned with the practicability of certain proposed amendments, in particular those related to the new paragraph 9(b) of the Exposure Draft.

Under the Exposure Draft, if the transferee is constrained from pledging or exchanging the transferred financial asset and such constraint is not designed primarily to provide a benefit to the transferee, the transferor is considered to maintain effective control over the transferred financial asset. We believe the requirement for the transferor to assess whether the constraint is designed primarily to provide a benefit to the transferee is overly subjective and not operational as currently presented in the Exposure Draft. Clearly outlining the accounting framework to be applied when analyzing this criterion will be important since this amendment represents a significant revision to the existing guidance. This issue, as well as other provisions in the Exposure Draft that we believe warrant further consideration or clarification, is discussed further below.

Similar to our observations on the recent proposed FASB Staff Position No. FAS 140-e and FIN 46(R)-e, *Disclosures about Transfers of Financial Assets and Interests in Variable Interest Entities* (the proposed FSP), we agree that enhanced disclosures regarding transfers of financial assets are needed to understand the extent of a transferor's continuing involvement with transferred financial assets. However, we do have certain comments on the proposed disclosures, which were

included in our comment letter on the proposed FSP. For your convenience, we have included below the relevant excerpts from our comment letter dated 15 October 2008 on the proposed FSP.

\* \* \* \* \*

**Constraints primarily designed to provide the transferee with a benefit**

The new paragraph 9b(3) provides that restrictions on the transferee's ability to sell or pledge the transferred asset would provide the transferor with effective control and therefore preclude sales accounting unless the restriction is designed *primarily* to provide the transferee with a benefit. While we agree the transferee's ability to sell or pledge the transferred financial asset would represent an important criterion to demonstrate that the transferor has surrendered control of the financial asset, we do not believe the Board's discussion in paragraphs 54A-D and A36 has sufficiently clarified the application of the new principle. Moreover, we do not believe the proposed provision is operational as currently written.

The application of the proposed provision is unclear as the transferor must determine the purpose and intent behind the restriction. What if the transferor and the transferee are both benefiting from the restriction? While the transferor is often the party designing the constraint and would therefore understand the intended purpose, determining who "primarily benefits" from the constraint will be very subjective. For example, constraints barring securitization vehicles from selling or pledging assets held may benefit beneficial interest (BI) holders that desire to have a static portfolio of assets on which the BI holder's cash flows are dependent. Additionally, the constraint may help provide favorable tax treatment (e.g., REMIC eligibility). However, these benefits also provide economic benefit (beyond simply knowing the asset location) to the transferor by permitting higher credit ratings on the BIs as well as broadening the pool of potential BI investors - all arguably resulting in lower funding costs for the securitization vehicle. In other words, one could assert that the BI holders pay the transferor for any benefit they are receiving as it is considered in determining the fair value of the BIs they purchase. In many cases, these features not only provide benefits to the transferor at the initial transfer date (i.e., in the form of higher proceeds and lower funding costs), but thereafter to the extent the transferor retains residual interests or other arrangements that benefit from the future performance of the securitization vehicle's net assets (e.g., when the BIs are "rolled over" in future periods).

In another example, assume the transferor does not directly restrict the securitization vehicle/transferee from selling or pledging the transferred assets but does so indirectly by retaining portfolio management rights, which put the transferor/manager in the position of controlling the decisions of whether or not the vehicle will sell or pledge the transferred assets. Some believe this role is simply that of a fiduciary. However, the transferor/manager may hold other interests (e.g., general partner or limited partner interests, equity ownership, etc.) that, in combination with the management role, may blur the distinction between whether the transferor/manager is acting solely as a fiduciary, as a principal, or both.

The examples above illustrate that although the constraint may benefit the BI holders in the securitization vehicle, it also benefits the transferor. How would the Board have transferors decide

which group is “primarily benefiting”? Such a decision is akin to a “chicken or egg” dilemma, which we currently do not believe will result in either consistent or transparent reporting among transferors.

We do not believe the conceptual basis for permitting the transferor to limit the transferee’s ability to sell or dispose of financial assets transferred to it has been adequately explained, including in situations in which the transferee is a securitization vehicle. If the transferee is not controlled by the transferor, it would seem that the transferee should have all the rights of owning the transferred assets, including the ability to sell or pledge those assets, and those rights would be controlled by the third party appointed by its investors to manage the entity. Given the discussion above regarding the difficulty in determining which party “primarily benefits,” we believe the Board should reconsider the Exposure Draft’s approach to this part of the derecognition criteria.

We recommend that the Board carry forward the existing criterion in paragraph 9 (b) of Statement 140, which permits the imposition on a transferee of a constraint on selling or pledging transferred assets provided the benefit to the transferor is *trivial*, subject to certain amendments described below. To further clarify the determination of a trivial benefit, we believe the Board should consider the type of financial asset being transferred. For example, constraints are less likely to benefit a transferor when the transferred financial assets are homogeneous and highly liquid such that they are easily replaced in the market. In contrast, constraints on financial assets that are heterogeneous and less liquid may be meaningful to the transferor who may have unique knowledge of the transferred financial assets and their expected performance.

Consideration of both the initial benefit as well as any ongoing benefit would also seem important in determining whether the transferor is benefiting and thereby controlling the previously transferred assets. For example, when applying this guidance, a transferor that initially benefitted but that did not have any continuing involvement with the transferred financial assets would not be precluded from recognizing a sale. The Exposure Draft proposes to eliminate Q&A 22A from the Statement 140 Implementation Guide. If the Board agrees with our recommendation to primarily retain the existing criteria of paragraph 9 (b) as discussed above, we propose that Q&A 22A be revised rather than be eliminated in its entirety.

### **Deconsolidation of a variable interest entity that owns only financial assets**

In some transactions, a company accumulates financial assets (e.g., leveraged loans or debt securities) within a variable interest entity (VIE) and once critical mass is obtained, the equity in the VIE is sold and the company retains portfolio manager rights. Many times other interests are also retained by the company, such as a portion of the equity. Some companies have argued that these transactions do not represent a transfer of financial assets under Statement 140 (other than perhaps the equity interest in the VIE that is sold for cash), and therefore, the sales criteria of Statement 140 do not apply. However, we observe that if the company applied the sales criteria of Statement 140 to these transactions, it may not achieve sales treatment. In these instances, derecognition of the transferred assets would generally be precluded as the terms of the portfolio management agreement typically provide the transferor (manager) with rights to decide whether the financial assets are sold, pledged or held. In other words, the transfer would not meet the sales criterion of paragraph 9 (c) of Statement 140.

In an SEC staff speech (Armando Pimentel in December 1997 at the American Institute of Certified Public Accountants National Conference on Current SEC Developments, Washington, D.C.), it was noted that such transactions are subject to the guidance in Statement 125 (Statement 140's predecessor), in determining whether the assets may be derecognized (i.e., the company must meet both the guidance regarding the transfer of financial assets in addition to the guidance for deconsolidation). Otherwise, the company could circumvent the financial asset transfer rules.

We believe the Board should clarify that the transactions described above are within the scope of Statement 140 and the Exposure Draft.

### **Definition of participating interests**

In defining the characteristics of a participating interest, paragraph 8B(a) of the Exposure Draft states: "It represents a proportionate ownership interest in an entire financial asset other than an equity instrument, a derivative financial instrument, or a hybrid financial instrument with an embedded derivative that is not clearly and closely related as described in Statement 133." We observe that the Board has not explained why the specified financial instruments have been excluded from the definition of a participating interest. We believe that further clarification of the Board's basis for conclusion would be helpful to its constituents.

In paragraphs A13 and A14 of Statement 140 (also carried forward to the Exposure Draft) the Board addressed the issues of setoff rights and their unique considerations when assessing the legal isolation requirements of paragraph 9(a). Paragraph A13, states: "A setoff right is a common law right of a party that is both a debtor and a creditor to the same counterparty to reduce its obligation to that counterparty if that counterparty fails to pay its obligation. Attorneys told the Board that in the event of the bankruptcy or receivership of either the obligor of the financial asset or the transferor of the financial asset, both parties could retain the ability to exercise a setoff right involving a financial asset that had been transferred. In the event of the bankruptcy of the transferor, the transferee may only have an unsecured claim against the transferor for its share of the amount set off."

While the Board ultimately decided that setoff rights would not be an impediment to meeting the isolation requirements for derecognizing transferred assets, it is not clear whether the Board intended a similar conclusion when defining a "participating interest." Paragraph 8B(c) of the Exposure Draft states: "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. Participating interest holders have no recourse, other than standard representations and warranties, to the transferor (or its consolidated affiliates included in the financial statements being presented or agents) or to each other, and no participating interest holder is subordinated to another. That is, no participating interest holder is entitled to receive cash before any other participating interest holder in its role as a participating interest holder."

Based on our understanding of setoff rights, the bankruptcy of a transferor could affect the priority of payments to participating interest holders if the transferor also has outstanding liabilities with the obligor of the original financial asset (i.e., related to the participating interest). Therefore, it appears

that only an entity that is designed to be bankruptcy remote may sell participating interests in financial assets and meet the criterion of paragraph 8B(c). Regardless if our understanding is correct or what the Board intended, we believe the definition of a participating interest should explicitly address the issue of setoff rights to avoid confusion in practice.

### **Transferor's ability to bid at a required auction**

We noted the changes to paragraph 53 of the Exposure Draft in which the phrase "*the* residual interest" was revised to read "*a* residual interest." This change could provide needed clarity with respect to a practice issue that currently exists in which some preparers have asserted that the previous term "the residual interest" combined with the example given and the last sentence of the paragraph should be interpreted such that the Board would preclude sales treatment only in situations in which the transferor owns 100% of the residual interest and is permitted to participate in the transferee's liquidation auction. While the new language in the revised paragraph 53 leads one to believe the Board would also preclude sales treatment in situations in which less than 100% of the residual interest is owned by the transferor, the last sentence may cause some confusion because it discusses recovering "any excess paid over fair value through its residual interest in the transferred financial assets." However, we note that if the transferor owns less than 100% of the residual interest only a portion of the excess paid will be recovered by the transferor. It is not clear whether the Board believes there is any level of ownership a transferor can hold in the residual interest of the transferee that would not lead to a conclusion that the transferor has not surrendered control of the transferred assets. Any amount of residual interest held by the transferor would result in the ability to bid higher than another bidder that did not hold a residual interest. If greater than 50% of the residual interest were held, the majority of any excess would be reclaimed. However, if less than 50% of the residual interest were held by the transferor, the majority of the proceeds in excess of fair value would be remitted to the third party residual holders.

In order to promote greater comparability across effected entities, we recommend that the Board take this opportunity to clarify its intent in paragraph 53 of the Exposure Draft. If the Board believes that a transferor that retains any portion of the transferee's residual interest and an ability to bid at the transferee's required liquidating auction precludes sales accounting, it should state so explicitly. However, if the Board believes sale accounting may be permissible, provided the transferor is not able to reclaim the transferred assets and 100% of all consideration paid above fair value (i.e., by holding less than 100% of the residual interest), we recommend the Board provide further examples or implementation guidance to clarify the circumstances and levels of ownership in which this would not cause a transferor to fail the derecognition criteria. The uniqueness or scarcity of the assets in question should be a consideration in determining any permissible level of residual interest that may be retained by the transferor.

### **Extent of disclosures**

The Board has indicated that user demands for greater transparency in financial reporting, especially during these unprecedented market conditions, is the impetus for the proposed FSP and Exposure Draft. We generally agree with the existing disclosure requirements and proposed amendments, although we have certain comments reproduced below from our comment letter dated 15 October 2008 on the proposed FSP.

Notwithstanding our general agreement with the usefulness of the disclosures, we observe that the emphasis on transactions involving SPEs may inappropriately suggest that there is greater risk associated with continuing involvement in SPEs than with other similar financial assets or liabilities. For example, Statement 140 requires disclosures intended to illustrate the sensitivity of assumptions used in the valuation of retained beneficial interests. Similar disclosures are not required for financial assets and liabilities outside the scope of Statement 140 that are classified as "level three" in the of fair value hierarchy described in Statement 157. Consequently, we believe the Board should carefully consider comments of preparers and users in determining which disclosures should be required. We also suggest that the Board add a project to its agenda to develop a comprehensive disclosure framework, as recently recommended by the SEC Advisory Committee on Improvement to Financial Reporting, to limit the inconsistencies in the extent of disclosures required by different standards.

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Included below are the relevant excerpts from our comment letter dated 15 October 2008 on the proposed FSP.

#### **Aggregation of disclosures**

*We believe the aggregation provisions in the proposed FSP could prove helpful in presenting the necessary information in a concise and meaningful manner. However, we believe it lacks clarity in how the aggregation provisions may be applied and could result in inconsistent application. Moreover, the volume of additional disclosures required by the proposed FSP could potentially confuse users unless properly aggregated in a meaningful manner. We recommend the Board provide further guidance through examples or other means to promote consistency in application of the aggregation provisions among all financial statement preparers (Preparers). We note that the Board believes FSP SOP 94-6-1, Terms of Loan Products That May Give Rise to a Concentration of Credit Risk (FSP SOP 94-6-1), already provides additional aggregation guidance that should be considered by Preparers. However, we believe some of the guidance within FSP SOP 94-6-1, as well as other considerations to be developed, should be specifically incorporated into the proposed FSP (directly or by reference).*

#### **Disclosures required by paragraph 17i**

##### Scope of continuing involvement

Paragraph 17i of the Exposure Draft appears to require a significant volume of disclosure relating to all forms of continuing involvement, regardless of the significance of that involvement. We believe this could place a significant burden on many Preparers. We recommend that the Board clarify the scope of the continuing involvement subject to paragraph 17i disclosures and provide justification for its conclusions. To mitigate the potential burden of this proposed amendment, we recommend that the Board consider certain scope exceptions. For example, the Board may consider not mandating such disclosures when the only form of continuing involvement between the transferor and the SPE represents a derivative financial instrument whose underlyings are market interest rates or currency exchange rates and that provide for cash settlements that are not subordinate to the general claims of the entity's creditors (e.g., plain vanilla interest swap). We question the usefulness of the proposed disclosures in these instances as the transferor's continuing involvement with the SPE is no

different than a bank that writes such a derivative to an unrelated counterparty. We also observe that the Board already has recognized in paragraph B14 of FIN 46(R) that rights and obligations under these types of instruments generally are unlikely to cause the holder to be the primary beneficiary of a VIE.

Transferors that have continuing involvement in financial assets that it has transferred to an SPE

Paragraph 17i applies to a “transferor [that] has continuing involvement in financial assets that it has transferred to an SPE (including those transfers that are accounted for as sales and those that are accounted for as secured borrowings) at the date of the latest statement of financial position presented.” We recommend that the disclosure requirements of this paragraph be separated into two categories: (1) transfers of financial assets that have continuing involvement that are accounted for as sales and (2) transfers accounted for as secured borrowings. All of the requirements of paragraph 17i would apply to category 1. However, if a transfer is accounted for as a secured borrowing, we question whether all of the disclosure requirements are relevant since these items remain on the balance sheet of the transferor. Examples of less relevant disclosures include the disclosure requirements regarding how the transferor’s risk profile has changed as a result of the transfer to an SPE that is accounted for as a secured borrowing and the requirements for providing a sensitivity analysis.

Liquidity arrangements

The new disclosure requirement in paragraph 17(i)(2)(e) of the proposed FSP would require transferors with continuing involvement in financial assets transferred to an SPE to disclose the liquidity arrangements provided by third parties related to the transferred assets. We believe compliance with this requirement may be difficult in circumstances in which the transferor is not the administrator or the sponsor of the SPE. A transferor that is not involved in the formation or daily affairs of the SPE may not be privy to the details of the SPE’s finance arrangements. We recommend transferors that are not the administrator or sponsor of the SPE be exempt from the disclosure requirements of this paragraph.

Sensitivity analysis

Paragraph 17i(5) of the proposed FSP requires companies to disclose a sensitivity analysis or stress test showing the hypothetical effect on the fair value of financial assets or liabilities that relate to continuing involvement of the transferor (including any servicing assets or servicing liabilities) of two or more unfavorable variations from the expected levels for each key assumption in the valuation, independently from any change in another key assumption. Although it is a current requirement of Statement 140, we observe that the sensitivity analysis becomes difficult to evaluate when key assumptions that are interrelated are instead separately stressed and disclosed (e.g., a change in the assumed discount rate would often warrant a change in prepayment assumptions). This presentation may artificially magnify or mitigate the fair value effect of movements in key assumptions. However, we also recognize that the standard already requires that Preparers describe the limitations of these sensitivity or stress disclosures. Rather than require Preparers to describe the limitations of such disclosures, we believe the Board should consider allowing Preparers greater flexibility to determine the most appropriate approach to stressing and presenting the key valuation

assumptions (i.e., stressing more than one assumption with a single sensitivity analysis). We believe the Securities and Exchange Commission's Market Risk Disclosures provides guidance and alternatives that may be useful for Preparers to consider when disclosing the sensitivity analysis required by Statement 140.

We recognize that greater flexibility for Preparers may not promote the Board's objective of enhancing the comparability and relevance of disclosures among effected entities. Therefore, if the Board decides not to modify this disclosure requirement, we believe the Board should consider retaining the existing examples in Statement 140 and providing further implementation guidance (i.e., new examples that better illustrate how the objectives could be reasonably addressed or expanded considerations for aggregating and presenting data). We believe Preparers generally have found the existing examples helpful.

#### Implicit arrangements

Paragraphs 17i(2) of the proposed FSP requires disclosure of, among other things, "qualitative and quantitative information ... giving consideration to both explicit and implicit arrangements..." Paragraph 17i(2)(c) of the proposed FSP requires disclosure of "the terms of any arrangements that could require the [transferor or entity] to provide financial support..." We note that "implicit arrangements" is not a defined term within the proposed FSP. While FIN 46(R) addresses the concept of "implicit variable interests," and FSP FIN 46(R)-5, *Implicit Variable Interests under FASB Interpretation No. 46*, provides interpretative guidance on that concept, it is unclear whether the Board intended to introduce the same concept within the proposed FSP.

Depending on the Board's intent, we note that the guidance in FIN 46(R) and FSP FIN 46(R)-5 may not be operational in the context of the proposed FSP. Accordingly, we recommend that both the Board's intentions and the term "implicit arrangements" be clarified in the proposed Statement. Although we understand the potential usefulness of disclosures of implicit arrangements, we believe the requirement to disclose "any" arrangement is overly broad and requires a great degree of speculation on the part of the Preparers. We believe disclosures of implicit arrangements should be limited to circumstances in which the entity believes it is at least reasonably possible (as defined in FASB Statement 5, *Accounting for Contingencies*) that it will provide financial or other support to the transferee or its beneficial interest holders (e.g., liquidity commitments and obligations to purchase assets) that it is not otherwise contractually required to provide.

#### Servicing exception

Paragraph E8 of *Appendix E - Background Information and Basis for Conclusions* to the proposed FSP states "Footnote 10 to paragraph 17(i)(4) of Statement 140 provides an exception from the disclosures required by that paragraph if a transferor's only continuing involvement is servicing the transferred financial assets. Based on constituent feedback about the difficulty of providing a definition of servicing that would be consistently applied, the Board concluded that the disclosure exemption in footnote 10 to paragraph 17(i)(4) should be removed for this proposed FSP." We do not believe the related disclosures would be meaningful in situations in which typical servicing is the only continuing involvement as those disclosures may imply risks to the transaction that do not represent the transferor/servicer's ongoing economic exposure. While we acknowledge the difficulty

in appropriately defining servicing that should qualify for an exemption and agree consistency is important, we do not believe the Board has provided a sufficient basis to support the elimination of this exemption in its entirety. We also note the Board has acknowledged such servicing can be treated differently in some circumstances, such as in the Exposure Draft, in which it is carved out in determining the appropriate treatment for participation interests.

We recommend that the Board develop parameters to describe when the exemption would be appropriate. That exemption would apply when the servicer is receiving fair compensation for its services and is not subject to significant risks and rewards of changes in the fair value or cash flows of the servicing assets (other than reductions in servicing fees because of reductions in the number of underlying services assets). For example, arrangements in which all or part of the fee is subordinated to the cash flows of other beneficial interest holders in the structure or in which the fee is contractually dependent on asset performance (other than simply being a set dollar amount or percentage of the overall balance of assets being serviced) would not qualify. Additionally, collateral or portfolio management arrangements in which the manager shares in a portion of the increase or decrease in the fair value of the assets or in realized gains or losses would not be considered the type of servicing that would qualify for the exemption.

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We would be pleased to discuss our comments with the Board members or the FASB staff at your convenience.

Very truly yours,

*Ernst & Young LLP*