Financial Accounting Standards Board

To: Board Members

From: Beneficial Interests Team (Hamilton, ext. 330)

Subject: Minutes of the July 27, 2004 Board Meeting **Date:** August 3, 2004

cc: Bielstein, L. Smith, Petrone, Wilkins, Lott, Eric Smith, Laurenzano, Hamilton, Thompson, Gabriele, Sutay, FASB Intranet

Topics:	Accounting for Beneficial Interests in Securitized Financial Assets
Basis for Discussion:	Board memorandum dated July 13
Length of Discussion:	1:20 p.m. to 2:00 p.m.
Attendance:	
Board members present:	Herz, Batavick, Crooch, Schieneman, Schipper, Seidman, Trott
IASB Board/Staff present:	Leisenring
Board members absent:	None
Staff in charge of topics:	E. Smith
Other Staff at Board table:	L. Smith, Wilkins, Lott, Laurenzano, Hamilton
Outside Participants:	None

Summary of Decisions Reached:

The Board affirmed that interests retained by transferors in asset transfers accounted for as a sale under FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, should be initially measured at fair value. Further, the Board decided to require interests retained after transfers creating guaranteed mortgage securitizations (as defined in Statement 140) to be initially measured at fair value even though such transfers may not qualify as sales under Statement 140. The Board also decided against separately recognizing credit enhancement or subordination embedded in beneficial interests resulting from a transfer of assets accounted for as a sale under Statement 140.

Objective of the Meeting:

The objectives of the meeting were to (1) determine if there are circumstances in which an interest held after an asset transfer accounted for as a sale under Statement 140 should not be measured at fair value at the time of the transfer, (2) determine if credit enhancement inherent in a subordinated retained interest should be recognized as a liability separate from the retained interests and (3) reaffirm the project scope and project plan.

Matters Discussed:

INITIAL MEASUREMENT

Mr. E. Smith reported that at its June 16, 2004 meeting, the Board voted to initially measure transferor's interests in transferred assets at fair value if the transfer is accounted for as a sale under Statement 140 (referred to as "the June 16 decision" for the purposes of the minutes). The Board asked the staff to evaluate circumstances in which that might not be appropriate, for example, because the transferor retains such a large interest.

The staff presented the following example of an asset transfer that is not accounted for as a sale under Statement 140 but that the staff believed represented an event that should result in fair value measurement:

Mortgage Loan Transfer

A bank securitizes a group of its originated mortgage loans using a qualified special-purpose entity (QSPE), and a substantive guarantor assumes the credit risk of the loans (through a guarantee) in exchange for a portion of the interest cash flows (typically 35 basis points). The bank takes back 100 percent of the beneficial interests in the QSPE in the form of securities as defined in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, and classifies them in accordance with the terms of that Statement. This transaction is neither accounted for as a sale nor as a financing under Statement 140. However, the transformation of loans into securities is recognized. This is a recognition event that does not have associated with it an initial measurement. (There will be subsequent measurement and related gain or loss recognition if the loans are classified as either trading or available-for-sale.)

Mr. E. Smith stated that the phrase, *a transfer accounted for as a sale under Statement 140*, is important to the measurement of retained beneficial interests. If fair value measurement was not limited to *a transfer accounted for as a sale under Statement 140*, an entity could take a loan portfolio, securitize the portfolio, retain the entire portfolio, recognize in earnings a gain or loss, and then classify the securities retained under Statement 115 as trading, available-for-sale, or held-to-maturity. He proposed that, in this situation, some would argue that the cash flows, risks, and rights had not changed and therefore this was a transaction structured merely to achieve gain or loss recognition, while others would argue that the rights in the retained interests are different from those embodied in the original loans merely due to the "securitization," or transformation, of the loans into security form—embodied in the increased liquidity of a security versus a loan—and therefore represents an event that calls for fair value measurement by the transferor.[1]

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[1] The clause *a transaction accounted for as a sale under Statement 140* is of no consequence to the third-party purchaser of either the transferred assets or of a beneficial interest in the securitized financial assets. For the purchaser this event is an initial recognition event regardless of whether the transaction is accounted for as a sale or a financing by the transferor. That is, the purchaser will initially recognize the financial asset acquired at fair value (presumptively, the price paid) whether the purchaser obtains a direct interest in a financial asset originated by another entity or a new financial asset that represents an indirect interest in financial assets originated by another entity.

Mr. E. Smith stated that the staff believes that when assets are transferred in exchange for beneficial interests in the entity holding the assets, new assets with different cash flows, risks, or rights are obtained. New assets should be measured at fair value regardless of whether the transfer is accounted for as a sale under Statement 140. Ms. Seidman noted that, in her opinion, the first sentence in paragraph 9 of Statement 140[2] would have to be amended if these types of transfers were to be accounted for as a sale.

Mr. Trott asked the staff whether mortgage loan transfers where 100 percent of the assets are retained and a substantive guarantee is purchased by the transferor, as provided in the example, are accounted for as sales in practice. Mr. E. Smith responded that these types of asset transfers do not qualify as sales under Statement 140, and the transferor's interests are not remeasured, although they are reclassified as securities and measured under Statement 115. Mr. Lott pointed out that mortgage loan transfers have special accounting guidance in Statement 140.[3]

Mr. Trott was concerned that the staff's recommendation as presented in the Board memorandum (remeasurement of retained interests after asset transfers accounted for as sales) was different from the recommendation being discussed with the Board (remeasurement for retained interests in securitization transactions in which cash flows, risks, or rights with regard to the original assets had changed). He stated that he believes that, in the guaranteed mortgage loan securitization example provided, an event has occurred, but a sale has not. He stated that this type of transfer would result in fair value measurement based on what the staff was verbally recommending but would not result in fair value measurement based on the staff's written recommendation.

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[2]That sentence states, "A transfer of financial assets (or all or a portion of a financial asset) in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than **beneficial interests** in the transferred assets is received in exchange."

[3] Paragraph 174 of Statement 140 states, "Sometimes financial assets, especially mortgage loans, are securitized and the transferor retains all of the beneficial interests in the qualifying SPE as securities. The objective is to increase financial flexibility because securities are more liquid and can more readily be sold or pledged as collateral to secure borrowings. In some cases, securitization may reduce regulatory capital requirements. The Board concluded that transfers of financial assets to a qualifying SPE, including securitizations, should qualify as sales only to the extent that consideration other than beneficial interests in the transferred assets is received."

Ms. Schipper stated that if mortgage loan transfers are included in the scope of the Board's June 16 decision, a necessary and sufficient test would be required to determine if an event had occurred. She pointed out that, using the staff's logic, asset transfers accounted for as sales would necessarily require initial fair value measurement for retained interests, but transfers not accounted for as sales would have to be evaluated for sufficiency (as to changes in cash flows, risks, or rights) to determine whether they qualified as an event resulting in fair value measurement.

Ms. Schipper asked the staff to define the class of events that, in addition to transfers accounted for as sales under Statement 140, would cause assets to change sufficiently to justify fair value measurement. She asked the staff whether all arrangements in which an item (asset or liability) is transformed into a security should qualify for fair value measurement. She expressed concerned about potential unintended consequences of broadening the Board's June 16 decision to include interests retained after asset transfers that are not accounted for as sales.

Ms. Schipper also asked how one would account for a securitized asset that is "unsecuritized" and whether the Board's decision on whether to broaden the scope of its June 16 decision could impact measurement for assets that are unsecuritized.

Mr. Leisenring agreed with the staff recommendation to expand the scope of the Board's June 16 decision to include all transferor's interests in securitized assets, regardless of whether they are accounted for as a sale under Statement 140. He stated that he believes securitization constitutes a remeasurement event and that assets securitized in transfers that are not accounted for as sales can subsequently be measured under the guidance provided in Statement 115 at fair value. He believes that because Statement 115 provides that interests retained after securitizations are subsequently treated like securities, accounting for those interests should be the same as the accounting for a newly acquired security.

Ms. Schipper also agreed with the staff recommendation to expand the Board's June 16 decision to include all transferor's interests in transferred assets, including those not accounted for as sales under Statement 140, because she believes that securitization of assets constitutes a remeasurement event.

Mr. Trott proposed expanding the Board’s June 16 decision to include initially measuring transferor’s interests in transferred assets accounted for as sales under Statement 140 and guaranteed mortgage securitizations at fair value.

Mr. Crooch agreed that interests retained by transferors in transfers accounted for as sales should be measured at fair value. He was uncomfortable with treating securitizations not accounted for as a sale as an event requiring fair value measurement. He was unsure whether a change in the form of the assets received by the transferor in a transfer is sufficient to require remeasurement.

Mr. Schieneman agreed with the staff recommendation and observed that disclosures related to these types of transactions must be robust in order to facilitate financial statement users’ understanding of securitization transactions.

Ms. Seidman renewed her objection to measuring retained interests in asset transfers accounted for as sales under Statement 140 at fair value regardless of the accounting for the transfer. Ms. Seidman reiterated her concerns from the June 16 Board meeting:

> Ms. Seidman stated that she does not believe the scope of this project should include remeasuring retained interests at fair value. She said that implementing that approach would have the effect of recognizing 100 percent of the gain or loss on the transferred assets, regardless of whether the transaction was only a partial sale. She views that result as inconsistent with the control principle underlying paragraphs 265–275 of Statement 140 and believes that it could produce undesirable accounting results.
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> Ms. Seidman also objected to the staff’s recommendation on the grounds that she believes the recommendation would require a change to the provision in paragraph 9 of Statement 140 that a transfer of financial assets be accounted for as a sale only to the extent that consideration other than beneficial interests is received in the exchange. She stated that if the staff recommendation were accepted, the Board would have to determine how to characterize gains and losses associated with a securitization and whether gains and losses would be recognized differently depending on whether they were related to retained or purchased beneficial interests. She also believes that all of the examples

> in Statement 140, the definition of proceeds, and several Q&A's would be have to be altered if the staff recommendation is accepted.
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> Ms. Seidman stated that there are a number of specific practice issues that involve transactions where there are different accounting standards being applied to the instruments being securitized, some of which were brought to the EITF by the SEC (for example, Statement 140 Q&A numbers 60–63). She cautioned that the Board could face substantial implementation challenges if it accepts the staff recommendation [Minutes from the June 16, 2004 Board meeting]

Ms. Seidman observed that, in other standards that address exchanges of items, guidance requires some type of commercial substance test for the items received to qualify for fair value measurement. Ms. Seidman observed that Statement 140 is indirectly a form of a revenue recognition model. She was concerned with lowering the initial recognition threshold in Statement 140 to allow recognition of gains (losses) for retained beneficial interests. She stated that comments to this effect have been received from constituents in regard to the Exposure Draft, *Exchanges of Productive Assets*.

Ms. Seidman reiterated her objection to initially measuring at fair value transferor's interests in transferred assets whether accounted for as sales under Statement 140 or not.

The Board decided to expand the scope of the Board's June 16 decision to include initially measuring at fair value transferor's interests in transferred assets accounted for as sales under Statement 140 and guaranteed mortgage securitizations. [Five Board members did not object; two objected: Crooch (because of the inclusion of guaranteed mortgage securitizations) and Seidman. Schipper and Schieneman preferred to measure transferor's interests at fair value regardless of the accounting for the transfer.]

SEPARATE RECOGNITION OF CREDIT ENHANCEMENT/SUBORDINATION

Mr. E. Smith stated that the proper recognition and measurement of credit enhancement embedded in subordinated beneficial interests in transferred assets has been questioned. One Board member proposed that the measurement of this credit enhancement would be more reliable if it was separately recognized as an embedded credit derivative rather than being subsumed by the beneficial interest.

Mr. E. Smith stated that under Statement 140, credit enhancement provided to the transferee in the form of cash collateral or a subordinated tranche is neither separately recognized as a liability nor measured at fair value. Instead, credit enhancement is considered in determining the fair value of interests retained by allocating a portion of the carrying value of the transferred assets retained.

Mr. E. Smith also pointed out that, under Statement 140, credit enhancement is recognized as a liability only when performance of the obligation is accomplished through the obligor by writing a check to the guaranteed party. If the transfer is reported as a sale, this obligation is recognized as a liability and is considered a reduction of the proceeds in calculating the gain or loss on the transfer.

Mr. E. Smith commented that FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, covers recognition and initial measurement of guarantees but specifically excludes credit enhancement in financial asset transfers. He also noted that Interpretation 45 includes a "make a payment" concept very similar to the "write a check" concept in Statement 140.

Mr. E. Smith questioned whether the liability that would be separately recognized by grossing up the balance sheet for credit enhancements embedded in beneficial interests meets the definition of a liability under FASB Concepts Statement No. 6, *Elements of Financial Statements*.

Mr. E. Smith indicated that the staff believes that the separate recognition of credit enhancement in a subordinated beneficial interest would not necessarily increase the reliability of the valuation of such "guarantee" obligations. Additionally, the staff believes the broader questions raised by addressing subordination in transferred assets to all subordinated instruments preclude addressing separate recognition as a liability as it relates to this narrow topic. Therefore, the staff recommended against separate reporting of credit enhancement embedded in subordinated beneficial interests.

Mr. Trott reiterated his belief that the a holder of subordinated interests is, in effect, getting paid by receiving a premium resulting from the holder's subordination to other interest holders that could be subject to separate accounting guidance. He believes that financial reporting would be improved if this credit subordination or enhancement were separately recognized.

Ms. Schipper stated that she supports the staff recommendation but not the staff justification for its recommendation. She said her justification focuses on the performance obligation of the guarantor as being the criteria on which a liability should be recognized. She stated that, if credit risk is retained in a subordinated tranche, the holder of the subordinated tranche has already performed its obligation to absorb losses to the extent of its subordination; the credit quality of the holder does not impact the value of the subordinated tranche. She went on to state that if a party were to instead write a guarantee related to the credit risk in securitized loans, the party that has written the guarantee has an obligation to deliver assets at some point in the future, and the credit quality of that party impacts the value of that guarantee.

The Board, with the exception of Mr. Trott, decided not to require separate recognition of credit enhancement embedded in subordinated beneficial interests.

PROJECT SCOPE AND PROJECT PLAN

Mr. E. Smith summarized the expansion of the project scope from its initial adoption in January, 2004 (to include consideration of the proper measurement attribute of retained interests). He noted that the major decisions yet to be addressed had been included in the memorandum to the Board and asked the Board to reaffirm the project scope and project plan.

Ms. Seidman asked the staff for additional clarification on the potential impact of this project on EITF Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets." Mr. E. Smith clarified that nullification of Issue 99-20 is a codification issue; the staff will recommend whether guidance in Issue 99-20 should be incorporated into any proposed amendment to Statement 140 or remain as a separate EITF consensus. He pointed out that the staff has no intent to broaden the scope of or nullify decisions reached in Issue 99-20.

Mr. Herz asked if there were any objections to the project scope and plan. No Board members objected

Follow-up Items:
None

General Announcements:
Mr. E. Smith announced that the staff is composing memorandums on (1) bifurcation of embedded derivatives in securitized financial assets and (2) potential impacts of this project on QSPEs.