

MINUTES



To: Board Members

From: Donoghue (ext. 374), Lusniak (ext. 214), Detling (ext. 354)

Subject: Minutes of the October 18, 2006 Board Meeting (Transfers of Financial Assets—Redeliberations) **Date:** October 27, 2006

cc: L. Smith, MacDonald, R. Golden, Bielstein, Leisenring, 140 Project Team, Polley, Carney, Gabriele, Allen, Sutay, Jacobs, Cowan, FASB Intranet

The Board meeting minutes are provided for the information and convenience of constituents who want to follow the Board's deliberations. All of the conclusions reported are tentative and may be changed at future Board meetings. Decisions become final only after a formal written ballot to issue a final Statement, Interpretation, or FASB Staff Position.

Topic: Transfers of Financial Assets—Redeliberations

Basis for Discussion: Memoranda 66 and 67, dated October 3, 2006, and October 13, 2006, respectively

Length of Discussion: 10:30 a.m. to 11:15 a.m

Attendance:

Board members present: Herz, Batavick, Crooch (by phone), Linsmeier, Seidman, Trott, Young

Board members absent: none

Staff in charge of topic: Donoghue

Other staff at Board table: L. Smith, R. Golden, Lusniak, Detling

Outside participants: Leisenring (IASB)

Summary of Decisions Reached:

The Board continued redeliberations on the August 2005 revised Exposure Draft, *Accounting for Transfers of Financial Assets*, and discussed whether and how to amend the isolation guidance in FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

The Board decided to amend the isolation criteria in paragraph 9(a) of Statement 140 for consolidated financial statements that include a transferor by requiring that the legal analysis treat all of the involvements in the transferred financial assets by any entity that is included in the consolidated financial statements being presented as if those involvements were made by the transferor. In order for a parent entity of a transferor to meet the isolation requirement, an isolation analysis must conclude that the transferred financial assets would be beyond the reach of all of the entities (and their creditors) included in the financial statements being presented, using the assumption that all of the involvements of the entities were made by the transferor.

Objective of Meeting:

The objective of this meeting was to determine how the isolation guidance in Statement 140 needs to be amended. The objective of the meeting was met.

Matters Discussed and Decisions Reached:

1. Ms. Donoghue began the discussion by explaining that the isolation guidance in Statement 140 needs to be addressed because many constituents and Board members have expressed concern that the guidance is unclear or that it is not being applied consistently. The staff prepared an analysis of three alternative approaches to amend the isolation guidance for discussion at today's meeting.

2. Ms. Donoghue noted that the isolation analysis would be the same under all three alternatives for the stand-alone financial statements of a transferor. The alternatives differ, however, in how the isolation analysis would be performed for the consolidated financial statements of a parent entity that consolidates a transferor when multiple entities have involvements with the transferred financial assets.

3. Ms. Donoghue then explained the alternatives and asked the Board to decide which alternative it preferred:

a. **Alternative A** would amend Statement 140 to clarify that a transferor must perform a legal analysis to determine that the isolation criteria have been met and that the same legal analysis must consider the involvements of all entities that are included in the consolidated financial statements of the transferor. This alternative allows current practice to continue, but clarifies that the involvements of all the affiliates included in the transferor's consolidated financial statements must be considered in the isolation analysis. Ms. Donoghue explained that the proponents of this alternative argue either that (1) the existing isolation guidance is adequate or (2) the Board should not amend Statement 140 and should instead conduct a major project to supersede Statement 140 entirely.

b. **Alternative B** would amend Statement 140 to clarify that an isolation analysis must consider the legal effect of the involvements of all of the entities that are consolidated in the financial statements being presented, such as a parent entity that consolidates a transferor. In the stand-alone financial statements of a transferor, an isolation analysis must be performed as described in Alternative A. However, Alternative B would specifically address how a parent entity that consolidates a transferor should perform an isolation analysis. When a parent company's financial statements are presented and include an entity involved in a transfer of financial assets, the isolation analysis must conclude that the transferred

financial assets are beyond the reach of all of the entities (and their creditors) that are included in the financial statements being presented. This approach continues to rely on a legal concept of isolation and consolidation.

- c. **Alternative C** would amend Statement 140 by requiring that a legal analysis be performed that treats all of the involvements in the transferred financial assets by the entities that are included in the consolidated financial statements being presented as if each involvement were made by the transferor. In the stand-alone financial statements of a transferor, an isolation analysis must be performed as described in Alternative A. However, for a parent entity of a transferor to meet the isolation requirement, the isolation analysis must conclude that the transferred financial assets would be beyond the reach of all of the entities (and their creditors) included in the financial statements being presented, using the assumption that all of the involvements of the entities were made by the transferor. If multiple entities are involved in the transfer, an isolation analysis of a parent entity under that alternative may result in a different conclusion than under Alternative B if several entities are involved with the transferred financial assets, because Alternative C uses an accounting concept of consolidation rather than the legal concept of consolidation as required under Alternative B.

4. The Board decided that Alternative C should be used to amend the isolation guidance in Statement 140. Five Board members (RHH, GMC, TJL, EWT, DMY) voted for Alternative C and two Board members (LFS, GJB) voted for Alternative B. Although Mr. Herz voted to support Alternative C, he did so with some reservations as noted below.

5. Mr. Trott believes Alternative B is required currently under Statement 140. That guidance already explains that the isolation analysis should consider whether the transferred assets would be isolated from any affiliate of the

transferor—that is, any other entity that is included in the consolidated financial statements being presented.

6. Mr. Trott disagrees with using Alternatives A or B because isolation is more than just the literal event of whether assets will be consolidated back in bankruptcy. Alternative B relies on the legal notion of chain of title and honors the corporate shields within a reporting entity. Use of Alternative B would result in true sale opinions that support isolation even if the continuing involvements from affiliates included in the financial statements being presented would not be acceptable in the isolation analysis if affiliate involvements were collapsed into one entity. The legal determination of isolation is based on an evaluation of the level of continuing involvement by the transferor; it is not a bright line and focuses principally on the retention of credit risk.

7. Mr. Trott strongly supports Alternative C, recognizing it is not a clarification, but rather, an amendment of Statement 140. The issue is whether the level of continuing involvements should prohibit derecognition. He believes that if the corporate shield issue had been raised in the deliberations of FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, and Statement 140, an approach similar to Alternative C would have been required by those Statements.

8. Mr. Trott stated that the Board has already agreed to improve Statement 140 without starting over again. Alternative C addresses that objective. He said that it does not seem to be outside of the Statement 140 approach because it still relies on the performance of a legal analysis. He also said that Alternative C is more consistent with an accounting notion of consolidation because it views the involvements from the perspective of the reporting entity (not just from the perspective of the legal entity that is transferring financial assets). He stated that recognition in the consolidated financial statements of assets and liabilities held by a subsidiary does not consider the existence of corporate shields within the reporting entity.

9. Mr. Linsmeier stated that a model that continues to rely on legal opinions from attorneys will not work in the long term. He stated that although a new model is needed to address the issues arising from Statement 140, it will likely

take a long time to develop. He also believes that in the deliberations for Statements 125 and 140, the Board did not contemplate that corporate veils would have the significance they currently do to determine the accounting result from the isolation analysis. He agreed that Alternative C might not represent exactly what would happen in the event of bankruptcy. He also agreed with Mr. Trott in that when Statements 125 and 140 were developed, the focus was on the reporting entity. Mr. Linsmeier stated that the best solution in the interim is Alternative C.

10. Mr. Crooch stated that the overriding reason for the transactions addressed by Statement 140 is to make sure that the assets are not recorded in the statement of financial position by the transferor. Statement 140 requires a lot of steps to ensure that occurs. He believes that the accounting concept of consolidation should prevail regardless of the legal concepts used in isolation opinions. He was surprised to learn that the result of the legal isolation opinion would be altered by which legal entity has continuing involvements within a consolidated group of entities. He believes that consolidation is an important aspect of accounting and should be considered in the isolation opinions. Mr. Crooch supports Alternative C.

11. Mr. Young agrees that a new model is needed. He stated that the existing guidance needs to be improved immediately because there is a big problem with the current model and it will likely take a long time for a new model to be developed. He contends that users do not agree with the current model in Statement 140 and that they often treat transfers of financial assets as borrowings in their analyses. He also stated that Alternative C will help to resolve these issues better than Alternative B, although Alternative C is not perfect. He stated that Alternative C seems to be closer to the correct answer and is the best alternative directionally. He believes that related parties also should be included in the analysis. As a result, Mr. Young supports Alternative C.

12. Ms. Seidman stated that this issue comes down to whether the Board wants to continue to use the legal analysis concept or to change the model now. She stated that the Board seems to have decided to do a short-term fix rather than

drop the transfers project to develop a new model. Because the Board has decided to temporarily keep the current Statement 140 model, which relies on a legal analysis applied to the actual facts and circumstances of the transfer, she believes that Alternative C is too significant a change and is inconsistent with the legal isolation concept. A legal analysis must rely on what would happen in bankruptcy—that is, if the transferor or an affiliate were to enter into bankruptcy, whether a bankruptcy court or other receiver could revoke the transfer. Alternative C seems inappropriate because it changes the assumptions in the legal analysis. Alternative C is a “what if” analysis that involves reassigning the involvements as if the transferor had entered into the involvements itself. Consequently, the legal analysis under Alternative C no longer reflects what would happen in bankruptcy. Alternative B would better reflect what would occur in the event of bankruptcy. Therefore, she supports Alternative B in the context of amending Statement 140, but wants to reconsider the entire model as a whole.

13. Mr. Trott questioned whether any level of collective involvement by affiliates would cause Ms. Seidman to change her view. Ms. Seidman responded that first, all of the forms of involvement would be reported in the consolidated financial statements, for example, as recourse obligations. Second, she observed that if a bankruptcy court would conclude that, notwithstanding the various forms of involvement, the transferred assets would not come back to any part of the consolidated group, that would seem to have substance and the best financial reporting would be to report the collective forms of support, not the assets themselves.

14. Mr. Batavick stated that he is unable to determine exactly what was contemplated when Statement 140 was issued and that he cannot conclude that Alternative C is what the Board would have required had they known what would happen in practice. Statement 140 relies on a model based on legal isolation, and the Board has already agreed to temporarily keep and improve it. He stated that were constituents required to move from Alternative A to Alternative B, it would be an improvement. He agreed with Ms. Seidman that Alternative C would not represent what would actually occur in bankruptcy and that he does not believe that Alternative C is what the Board originally intended when Statement

140 was developed. Consequently, he supports Alternative B. He stated that he also would like to see a major project added to the agenda that would create a new derecognition model.

15. Mr. Herz stated that this issue is extremely vexatious. He believes that Statement 140 currently requires Alternative B and he does not understand how readers could have misinterpreted it to mean Alternative A given the definition of *consolidated affiliate of the transferor* in Statement 140 and the implementation guidance in that standard. He believes that Alternative B is what was originally intended and it is what is in the current standard. He agrees with Ms. Seidman that Alternative B represents the actual legal effect of the isolation analysis. He also agrees with supporters of Alternative C that even though transferred assets might be legally isolated, a reasoned review of certain current transactions that are treated as sales would find that there is too much continuing involvement and that those assets should not be considered isolated or be derecognized. Mr. Herz stated that he could have supported either Alternative B or C. He stated that he would not object to Alternative C. He believes that Alternative C will provide the directionally better result (as Mr. Young stated) and it will provide better representation of transactions addressed by Statement 140 in financial statements.

16. Ms. Seidman said that she would dissent to Alternative C. Mr. Batavick said that he would not necessarily dissent to Alternative C. He said that he would make a decision about whether to dissent only after the alternative is exposed.

17. Ms. Donoghue then asked the Board whether it would want to make any refinements or modifications to Alternative C. She noted that Mr. Young had already stated that he would like to expand Alternative C to not only consider involvements of consolidated entities but also related parties of the reporting entity. She stated that adding this aspect to Alternative C would require a considerable amount of time. She warned that getting into the issue of entities under common control and related parties is not a simple exercise and has been troublesome in several other projects.

18. The Board decided that Alternative C should not be modified to include related parties. Five Board members (RHH, GJB, GMC, LFS, EWT) did not support adding related parties. Two Board members (TJL, DMY) supported adding related parties.

19. Mr. Linsmeier stated that he would like the related party issue to be explored. He explained that if Alternative C simply moves the line for structuring transactions from consolidated entities to related parties, then the Board should at least contemplate whether that potential structuring opportunity could be eliminated in a simple fashion. Mr. Young also supported considering adding related parties to Alternative C.

20. Mr. Golden stated that if one looks at any related party (which is a broad view), that the real concern is over implicit guarantees provided by a consolidated entity. He said that one potential problem is that a parent entity could encourage a nonconsolidated related party to provide a guarantee of transferred assets and could promise to make the related party whole in the event the guarantee had to be used. This would be an implicit guarantee because the parent entity would be providing a guarantee that in essence is acting as a guarantee of the transferred assets. He proposed that the Board use the concepts in FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*, and consider applying the guidance about implicit guarantees in Interpretation 46(R) to Alternative C. He believes the issue is not about related parties, but rather whether a reporting entity can provide an implicit guarantee. He suggested that an implicit guarantee is the same as an explicit guarantee. He stated that because constituents have been so used to a very literal interpretation and have concentrated on the pure form of transactions in Statement 140, any amendment should specifically state that an implicit guarantee is the same as an explicit guarantee for purposes of applying the isolation guidance.

21. Mr. Herz believes that Interpretation 46(R) would possibly prevent or substantially mitigate restructuring of transactions by moving involvements to related parties. He also stated that he is uncertain about how an attorney would be able to opine on implicit guarantees.

22. Mr. Smith stated that some of these issues with involvements or guarantees provided by related parties might be addressed by the Emerging Issues Task Force next year. The model in Statement 140 is already very complex. The Board has been dealing with isolation issues for so long and they may need to move on with the fundamental issue of how involvements of consolidated entities should be treated first before addressing related parties.

23. Mr. Trott felt that while adding related parties could strengthen Alternative C, the alternative could be issued quickly in the form of an FASB Staff Position (FSP) without the related party issue. He stated that the proposed amendments have already been exposed and that there is currently very little guidance on related party involvements, and that this would be a very large and complicated undertaking. The other members of the Board agreed that the staff should not consider modifying Alternative C to include related parties; however, Ms. Seidman stated that Alternative C is clearly an amendment of Statement 140 that would need to be exposed for comment. .

24. Ms. Donoghue then reviewed the issuance plan for amendments to Statement 140. She stated that currently the project has several legs to it, including the following:

- a. Permitted activities of a qualified special-purpose entity (QSPE) (including servicer discretion)
- b. Isolation
- c. Initial measurement
- d. Other isolation issues (such as the requirement to use a QSPE).

She stated that currently her thinking is that all of these issues should be included in one project that would result in one document that would be issued as an Exposure Draft in the second quarter of 2007 and as a final document in the fourth quarter of 2007. She stated that she does not know whether the Board would like to decouple servicer discretion or permitted activities of a QSPE. She does not know whether the Board would come to conclusions on all of those issues that would be suitable for an FSP. She stated that she was concerned that if multiple documents were issued, inconsistencies would result and could cause confusion in the market by requiring companies to restructure transactions

numerous times. She stated that it is difficult to know how best to issue guidance because all of the decisions have not yet been made.

25. Mr. Trott stated that he believes that an FSP on isolation could be issued because it doesn't relate to servicer discretion. He stated that the Board needs to decide which issues can be addressed through an FSP (because the issues have already been exposed) and which issues needs to be exposed in an exposure document.

Follow-up Items:

None.

General Announcements:

None.