MINUTES

Financial Accounting Standards Board

To: Board Members

From: Statement 140 Amendment Team
(Lusniak , Ext 214; Kapko, Ext. 317)

Subject: Minutes of the March 9, 2005 Board Meeting (QSPE's)   **Date:** March 14, 2005

cc: Bielstein, Smith, Petrone, Leisenring, Project Team, Mahoney, Thompson, Vincent, Sutay, Gabriele, Swift, Polley, Getz, FASB Intranet (e-mail)

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 or Interpretation.

Topic: Initial Measurement of a Transferor's Interest in a Financial Asset and Setoff Rights

Basis for Discussion: Memorandum 39, dated February 17, 2005; Memorandum 40, dated February 25, 2005; Memorandum 41, dated March 7, 2005; and Memorandum 42, dated March 8, 2005

Length of Discussion: 9:00 a.m. to 10:40 a.m.

Attendance:

Board members present: Herz, Schipper, Batavick, Crooch, Young, and Seidman

Board members absent: Trott

Staff in charge of topic: Donoghue

Other staff at Board table: L.Smith, E. Smith, Lott, Lusniak, Kapko, Varian, and Bergstrom

Outside participants: Leisenring

Summary of Decisions Reached

Qualifying special-purpose entities and isolation of transferred assets. The Board focused on two issues: (1) whether a transferor's participating interest that results from a transfer of a portion of a financial asset that does not utilize a qualifying special-purpose entity (QSPE) should be remeasured at fair value and (2) whether its decision to require that a transferor pass through a share of any benefits it receives from a setoff event to transferees to achieve sale accounting should be reconsidered.

The Board discussed four alternatives to address the issue of whether a transferor's participating interest in a financial asset should be considered a new asset that would be initially measured at fair value. A *participating interest* conveys pro rata but equal ownership rights to the cash flows and other assets generated by an original financial asset to each participating interest holder, including the transferor to the extent the transferor has retained a participating interest, and does not involve any recourse to or subordination by any participating interest holder. The Board had tentatively decided that all transferors' interests should be initially measured at fair value in conjunction with the projects that address the measurement of beneficial interests and servicing rights.

The Board did not reach a decision at this meeting; however, it narrowed down the alternatives to two. Both alternatives require that a transferor's participating interest be initially measured at allocated carry-over basis, but one alternative would only allow a transferor's interest to be measured at allocated carry-over basis if a QSPE had not been used. The Board asked the staff to provide additional analysis of the characteristics of those two alternatives.

In addition, the Board reconsidered its decision to require that in all circumstances, a transferor agree to pass through to transferees-investors a share of any benefits received from exercising setoff involving transferred financial assets in order to achieve sale accounting. The Board did not reach a decision on this issue. The Board deferred consideration of this issue until it has time to consider additional materials. The Board expects to discuss both issues at the March 23, 2005 Board meeting.

Objectives of the Board Meeting

The objectives of the meeting were for the Board to decide (1) whether a transferor's participating interest in a financial asset should be considered a new asset that would be initially measured at fair value and (2) whether to require that in all circumstances, a transferor agree to pass through their share of any benefits received from exercising setoff in order to achieve sale accounting. The objectives of this meeting were not met.

Matters Discussed and Decisions Reached:

The following paragraphs summarize the Board's views on the major issues discussed at the meeting. The views and matters presented in these minutes may not be in the specific order in which they were discussed at the meeting.

1. Ms. Donoghue opened the meeting with a description of the first issue, the initial measurement of a transferor's interest in a financial asset. She explained that the issue could be broken down into two components: (a) a participating interest that does not involve the transfer of an asset to a QSPE and (b) the issuance of beneficial interests from assets that have already been transferred into a QSPE. She noted that the Board may want to consider whether or not the transferor's participating interest in a financial asset should be considered a new asset and initially measured at fair value. This decision depends upon whether or not the Board believes that a participating interest is sufficiently different from the original asset to require remeasurement and whether or not the Board would be comfortable having different accounting for transferor's participating interests and transferor's beneficial interests.

2. Ms. Donoghue presented the staff's four alternatives for initially measuring a transferor's participating interest in a financial asset. The four alternatives are:

a. Initially measure all transferor's participating interests and transferor's beneficial interests at fair value if there is a minimum percentage transferred to third parties.

b. Initially measure all transferor's interests, whether participating or beneficial, at fair value regardless of what percentage of interests is sold to third parties.

c. Require that a transferor's participating interest continue to be initially measured at allocated carry-over basis.

d. Require that a transferor's interest be initially measured at fair value only if a QSPE is required and the interest is a beneficial interest.

3. Ms. Donoghue stated that the staff recommends Alternative C but noted that the staff's recommendation was not unanimous. She said that most of the staff believes that a transferor's participating interest should be initially measured at allocated carry-over basis because a participating interest is not sufficiently different from the original financial asset to be considered a new asset, and a transfer of the original financial asset to a QSPE should be considered differently than transfers that do not use a QSPE because the Board has opined that a QSPE has significance. Ms. Donoghue pointed out that the staff is asking the Board to draw a very fine line between what may be similar transactions and notes that the staff recognizes that the fair value option has its supporters among Board members. She expressed concern over choosing Alternative D because of the Board's previous decision that a QSPE has significance and substance.

4. Ms. Donoghue responded to a Board request to provide additional information on the impact that a QSPE had on a transaction and to compare and contrast transactions with and without a QSPE. She noted that the staff found that in some cases a participation contract was more stringent than a QSPE. She mentioned that the QSPE was developed specifically to reduce the inconsistencies between transactions and has accounting significance because it was originally derived from an SPE that was used to achieve legal segregation of the financial assets from the transferor's estate.

5. Ms. Donoghue stated that the Board's objective in amending Statement 140 is to simplify the standard and to clarify when a QSPE is required and when it is

not. Ms. Donoghue noted that the staff is trying to determine where the Board wants to draw the line for initial measurement of different types of transferor's interests at fair value. Ms. Donoghue pointed out that the pro rata rule is absolute and that any time there is a line drawn there will be some white noise around that line. She suggested that if the cash flows change, then an event has taken place that warrants remeasurement.

6. Ms. Seidman stated that in a mixed attribute model, derecognition has the same effect as answering the question of when it is appropriate to recognize gain or loss through earnings on an asset that is not being remeasured through earnings. She expressed concerns about a conclusion that would overlay a remeasurement attribute on a standard that would have otherwise concluded that there was not a sale of some or all of that asset and, therefore, no gain or loss on the transaction to be recognized. Ms. Seidman stated that her preference is not among the alternatives provided by the staff and that she would prefer that the Board not revisit the remeasurement issue. In expressing her position, she reiterated Neil Foster's dissent in Statement 125. Specifically, she noted that that dissent states that it is appropriate to remeasure all retained interests at fair value because the original asset has been sufficiently changed to merit fair value, and that is true even in a loan participation because you no longer have rights to all the cash flows (there is reduced marketability of the asset held). She stated that she did not necessarily agree with that rationale but is concerned is that there is no conceptual base for any of the alternatives presented by the staff. She further expressed her desire to make the Statement as practical and operational as possible. While her first preference is not to amend the initial measurement of retained interests, among the alternatives presented, she could support Alternative C based on the fact that the Board has already said that there are two models in this standard, one when a QSPE is used and one when a QSPE is not used. When a QSPE is not used the interest that the transferor holds should not be remeasured. While she believes that Alternative D has more conceptual merit, it is too complex and inconsistent with the Board's decision in

the beneficial interests project to look at the terms of the beneficial interest instead of looking into the structure.

7. Mr. Herz stated that he was not sure that he agreed with any of the proposed alternatives and that he agreed most with Ms. Seidman's comments that the guidance in Statement 140 should not change, interests retained by the transferor should be measured using allocated carry-over basis. He also expressed concern that Board members may not have had a chance to read and fully comprehend the supplemental memorandums that the staff prepared for today's discussion. He stated that Alternatives A and B introduce a notion of remeasurement that is inappropriate with the sale of a portion of an asset. Therefore, among the alternatives provided, his choice would be Alternative D. He stated that the reason that he chose Alternative D was that it was the most consistent with prior decisions that the Board has made. Mr. Herz then indicated that Mr. Trott, who was absent from the meeting, left instructions that his preference was dependent on the supplemental information provided by the staff relating to the significance of a QSPE. Mr. Trott had not been able to review that information; therefore, he left no clear indication of his preference.

8. Mr. Crooch commented that the Board has tried to define participations in such a way that they are distinct from other transactions. He also commented that the Board has been trying to define the characteristics of a participation in such a way that for accounting purposes, the transaction is viewed as a sale. The question is, once the Board decides that there can be a sale of a portion of a loan, how is the piece the transferor holds measured? He would argue that a pro rata share of the original asset has been sold but not the piece that is held by the transferor. He stated that he favors Alternative C, because he believes that using a QSPE has significance. He believes that if a QSPE has substance, and there is a sale of a portion of the financial asset using a QSPE, then there has been a transfer of the original asset to another entity and the interest issued by the QSPE, which is held by the transferor, should be remeasured at fair value.

9. Ms. Schipper clarified that she believes the difference between Alternative A and C is where the remeasurement line is drawn. In Alternative C, the line is drawn at the presence of a QSPE, while in Alternative A, the line is drawn at sale treatment plus 10 percent of the interest transferred to outside parties. She stated that she supports Alternative A. She believes that Alternative B, which remeasures the transferor's interest regardless of what is transferred, would violate the 10 percent rule for a QSPE currently in Statement 140. In addition, she believes that Alternative C creates a treatment alternative in which sale accounting is achieved in both cases, but remeasurement occurs only for a transferor's beneficial interest. She also believes that Alternative D is inconsistent with the Board's previous decision that you do not have to analyze the assets that are held inside the QSPE. She also stated that Alternative D requires you to analyze the structure and its cash flows over and over again to verify that nothing has changed. Consequently, she stated that the choice between Alternatives A and C hinge on whether the Board thinks that sale accounting is always an event that warrants remeasurement.

10. Ms. Schipper indicated that she agrees with Neil Foster's dissent in Statements 125 and 140. She noted that pro rata cash flows (participating interest) receive special treatment as a result of the Board's decision to move away from the use of a custodian; however, she believes that a participating interest held by a transferor is a new asset that should be measured at fair value if 10 percent of the participating interests are sold to third parties. As a result, Ms. Schipper stated that she favors Alternative A with a 10 percent minimum requirement.

11. Mr. Batavick questioned what the drawbacks of Alternative D are. He stated that he was originally drawn to Alternative D because it seemed conceptually sound, but had come to realize that it was too complex and would require a number of new paragraphs to explain how it should be implemented. He then stated that he supports Alternative C because it is simpler and more operational.

12. Mr. Young stated that he would be most comfortable with Alternative D but did not object to Alternative C.

13. Mr. L. Smith stated that he supported Alternative D because the attributes of a participation are such that the cash flows are not being reconfigured, rather, only a portion of the pro rata cash flows are being sold, and he would like to see consistency in treatment whether the transfer utilizes a QSPE or not. He did not think that a participating interest held by the transferor should be measured at fair value. Further, he stated that he did not believe the achievement of sale treatment for accounting purposes is a remeasurement event. He is concerned that someone can set up a QSPE in such a way that they achieve the identical transaction that they would have achieved through a participation but that it allows them to choose which measurement alternative they want. He does not support Alternative A because he feels that in a participation, one has sold only part of a loan, and the part of the original asset retained should not be remeasured. He supports Alternative D because there has been a recharacterization of the cash flows that creates a new asset that should be remeasured.

14. Mr. Lott asked if the staff could eliminate bringing back the options that have the least support in order to facilitate the Board's discussions at the next meeting. He stated that he did not support Alternative A because he feels that the 10 percent rule for a QSPE has a different effect than the 10 percent requirement in that alternative for a participation transaction. The 10 percent requirement for a QSPE is there to ensure that the entity is demonstrably distinct from the transferor; in a participation, that is not an issue. He points out that when a QSPE does not sell 10 percent of its interest to outside parties, the result is a borrowing. When a participation does not sell 10 percent of its interest, the result is a sale with the interest held by the transferor being measured at allocated costs. He does not believe that that is internally consistent.

15. Mr. Herz indicated that the Board was not ready to decide on this issue. He asked Board members what their leanings were. Ms. Seidman and Mr. Herz

indicated that they preferred to keep the measurement guidance in Statement 140 for retained interests. Messrs. Crooch and Batavick supported Alternative C. Ms. Schipper supported Alternative A. Mr. Young was supportive of Alternative D but could support Alternative C. Mr. Trott (who provided input in writing to Mr. Herz) was between Alternatives C and D. Mr. Leisenring suggested that the staff provide additional analysis of Alternatives C and D and bring that analysis back to the Board. No Board members objected to that request.

Setoff and Other Dilutive Rights

16. Ms. Donoghue stated that the second issue is whether the Board would like to redeliberate its decision to require that a transferor be required to pass through any benefits it receives from exercising its right to setoff involving a transferred financial asset as an effective control requirement. She indicated that the staff believes that treating this requirement as an effective control issue would require that the Board also address other dilutive rights, which the Board has previously declined to do.

17. Ms. Donoghue discussed the following alternatives for addressing setoff:

- **Alternative A**—Reverse the decision to require that a transferor pass through setoff benefits.
- **Alternative B**—Require a pass through of setoff benefits only for participating interests that do not use a QSPE.
- **Alternative C**—Retain the pass through requirement as a stand-alone exception in paragraph 9.
- **Alternative D**—Extend the setoff decision to all dilutive rights.

18. Ms. Donoghue said that the staff recommends Alternative A because it believes that it is not necessary to require that a transferor pass through setoff benefits because setoff is either addressed in the transaction documents or reflected in the transaction's pricing. It can also be compensated for through overcollateralization. She noted that the courts are likely to require that setoff benefits be passed through.

19. As a fallback, she said that the staff recommends Alternative B, to include this requirement as a stand-alone exception for participating interest transactions. She said that the staff rejects extending this to other dilutive rights and therefore rejects Alternatives C and D because current practice for the most part already considers setoff when determining if there is a sale.

20. Ms. Schipper questioned whether the Board's previous decision at the September 22, 2004 Board meeting, to include as implementation guidance a list of conditions that an attorney would require in order to issue a true sale at law opinion, would include setoff as one of its conditions. She also questioned whether a participating bank that acts as a custodian would be required to share the benefits of setoff. Ms. Seidman stated that she does not know enough about what it means to be a custodian to answer that question but that she recalls from the roundtables with the attorneys that they indicated that the potential for setoff has no impact on whether they will give a true sale at law opinion. She noted that most participation contracts explicitly address setoff to avoid litigation and that her concerns about addressing setoff as an isolation issue is that the Board would be including setoff in the isolation evaluation, and it is not part of that evaluation.

21. Ms. Donoghue explained that the reason why lawyers are not concerned about the right of setoff is that they assume that the courts would require that the benefit from setoff be passed through to the other interest holders based on the revised Uniform Commercial Code. Mr. Herz stated that he assumes that the market factors in setoff and dilution when pricing the security. Ms. Donoghue responded that the right of setoff would either be factored into the pricing or dealt with through overcollateralization.

22. Ms. Schipper stated that in discussions with attorneys and in the public roundtable, the fact that dilution and setoff were considered in pricing came up repeatedly. She said that sale treatment is a zero or one indicator, that is, either there is a sale or there is not a sale. Ms. Schipper stated that there is a difference between a secured borrowing and a sale on the balance sheet and,

therefore, it is not enough to let the pricing reflect the risk of setoff. She also stated that there are two different issues: recognition and measurement.

23. Ms. Seidman stated that she was comfortable with letting the pricing reflect the risk of setoff and that she would prefer Alternative A. Mr. Crooch said that from an accounting perspective, the buyer must have the right to the benefits of a setoff and that he would like to see an accounting requirement in the standard. He also stated that he was uncomfortable with attorneys saying that setoff is not an issue without the support of at least one court case. He asked why the requirement should not be included in the guidance as Ms. Schipper suggested.

24. Ms. Donoghue clarified that the reason why there are no court cases is because the issue is not that difficult to resolve and therefore has not been brought to court under current statutes. In response to Mr. Crooch's question on whether or not to include the requirement in the guidance on a true sale, she said that it would not be appropriate to say that attorneys need to look for setoff to be passed on when in reality they do not.

25. Ms. Seidman stated that she does not consider the issue of setoff to be an effective control issue because the transferor does not have unilateral control until the borrower fails to pay and that if it were analyzed as an effective control issue, it would be considered conditional, which does not prevent sale accounting. Ms. Seidman noted that she does not consider setoff to be an issue just for participations.

26. Mr. Batavick stated that the Board should not legislate this issue (make it part of the accounting literature) and, therefore, he supports Alternative A.

27. Mr. Lott stated that he supports Alternative A and that he would not support Ms. Schipper's alternative to include setoff in the list of things that an attorney would look at because attorneys have already told the staff that they do not consider setoff in rendering an opinion. He would, however, support the Board making it an accounting requirement for sale treatment and including in the basis

for conclusions that the Board believes it is important that the benefits from setoff rights are passed through.

28. Mr. Herz asked for the Board's vote. He indicated that his preference is Alternative A. Mr. Young stated that he would prefer to be conservative and supports Alternative C. Ms. Schipper stated that she would not be able to vote until she had had more time to reflect on the issue. Mr. Crooch suggested that the Board defer the final vote on this issue until the Board has more time to read the supplemental memos that were received at the beginning of the week.

29. Ms. Seidman said that she does not agree that setoff is only an issue for participations and that if the staff wants to argue that it is, they need to elaborate on the issue. She also noted that it would be conceptually inconsistent to address setoff and ignore dilutive rights since they both have the same economic impact, and dilutive rights are more common.

30. The Board decided to defer a decision on the matter of setoff until it has more time to review the supplemental memos. Mr. Herz asked the staff to look into whether there is another way (other than Alternative A) to deal with setoff.

Follow-up Items:

The staff will provide the Board with additional analysis of Alternatives C and D, which address whether a transferor's participating interest in a financial asset should be considered a new asset that is initially measured at fair value. In addition, the staff will bring back to the Board for its consideration the issue of whether to require that a transferor pass through its share of any benefits it receives from a setoff to a transferee.

General Announcements:

None.