

# ***FASB Transfers and Servicing***

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## **Respondent information**

### **Type of entity or individual:**

Industry Organization

### **Contact information:**

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## **Questions and responses**

1. This proposed Update would amend the effective control guidance in paragraphs 860-10-40-5(c)(1) and 860-10-40-24 to require that transactions that involve a transfer of a financial asset with an agreement that both entitles and obligates a transferor to repurchase or redeem the transferred asset at the maturity of the transferred financial asset would maintain the transferor's effective control. Therefore, those transactions would be accounted for as a secured borrowing. Do these proposed amendments represent an improvement in financial reporting?

Yes, the proposed amendments represent an improvement but they may also be harmful to the U.S. economy by distorting the capital market mechanism through which the U.S. Department of Treasury and the Government Sponsored Enterprises ("GSEs") finance their operations.

Notes and bonds (collectively "debentures") issued by the U.S. Treasury and GSEs are typically purchased by the primary dealers and the GSE underwriters, respectively, in auctions. Upon successful bidding, these major dealers would sell the debentures to their customers, e.g., money funds, pension funds and corporate treasurers. To minimize the usage of their balance sheets, the dealers may refer their customers to repo dealers to finance the purchases. Repo dealers often also buy the major dealers' unsold inventory and in turn finance their purchases via repo to maturity ("RTM") with third parties, treating each RTM as a sale in accordance with the current control accounting model.

Under the new proposal, these Treasury and GSE RTMs will be treated as secured financing and the repo collateral will be recorded on the balance sheet as trading assets. South Street Securities, as well as many other repo dealers, will have to discontinue its participation in this financing mechanism due to the stringent regulatory capital requirement imposed by the Financial Industry Regulatory Authority ("FINRA") on Treasury and GSE debentures held on balance sheet.

As RTM is a low-margin business, the spread revenue will not be able to cover the cost of capital required under FINRA regulations. Without repo dealers to buy up their unsold inventory, the ability of primary dealers and GSE underwriters to bid in auctions will be impaired and the distribution channel to the investors will be distorted. To compensate for the cost of carrying unsold inventory, the dealers and underwriters will demand higher yields from the Treasury and the GSEs.

That doesn't pose an immediate problem, since the Federal Reserve is providing nearly unlimited

support for securities issued by the Treasury and the GSEs. But when the Fed does decide to end its QE3 strategy, the Treasury and the GSEs could find themselves facing a thinner, more expensive buyer-base for their debts, posing increased risk to the economy.

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2. Do you agree with the limited amendment of the condition for derecognition related to effective control in paragraphs 860-10-40-5(c) and 860-10-40-24? That is, do you agree with the application of secured borrowing accounting to the transactions described in Question 1 and not to other transactions resulting in similar risks and rewards for the transferor (for example, regardless of the form of settlement or whether the settlement date of the repurchase agreement is before, on, or after the maturity date of the transferred financial assets)? If not, what approach for assessing derecognition for transactions that involve transfers of financial assets with agreements that entitle and obligate the transferor to repurchase or redeem the transferred assets would be an improvement to the proposed approach?

No, a limited amendment will not eliminate the opportunities for abusive interpretations of repo sale accounting. An effective approach would be the adoption of a risk-transfer principle. If, and only if, a collateral provider of a repo transaction has effectively transferred the risk of ownership, even in the case of an issuer's default, to the cash provider, such repo transaction can be treated as a sale.

For example, if both parties of a RTM transaction specifically agree to nullify the entitlement and obligation for the collateral provider to substitute or to repurchase the collateral, such RTM shall continue to be treated as a sale since the cash provider has no recourse to the collateral provider and assumes the risk of owning it.

Of course, this type of arrangement will only work for financial obligations of issuers or guarantors with high credit quality, such as the U.S. Treasury and the European Central Bank, because the cash provider can only look to the issuer or the guarantor to repay the repo principal and interest at maturity.

The cash provider of a RTM on lesser quality collateral such as troubled mortgages and European sovereign debts would rely on recourse to the collateral provider and would not accept the underlying collateral as the sole remedy for the repo obligations. As such, sale accounting would not be permitted under those circumstances.

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3. This proposed Update would require that an initial transfer and a repurchase agreement that relates to a previously transferred financial asset between the same counterparties that is entered into contemporaneously with, or in contemplation of, the initial transfer (a repurchase financing) be accounted for separately. Would separate accounting for the initial transfer and repurchase financing reflect the economics of those agreements? Do these proposed amendments represent an improvement in financial reporting?

No, separate accounting neither reflects the economic substance of a repo transaction nor improves the relevance of financial reporting. In fact, it grossly inflates the volume of economic activities and provides misleading information to the users of financial statements.

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4. The Board affirmed that, consistent with existing guidance, effective control would be maintained by a transferor if the transferee returns a financial asset that is “substantially the same” as the initially transferred financial asset. Should the return of financial assets that are substantially-the-same maintain the transferor’s effective control over transferred financial assets? Why or why not?

No. Effective control should be determined based on the transferor's ability to reclaim the same asset, not the transferee's ability to return substantially the same asset. As an example of effective control, a repo on a 5-year Treasury note with the right of substitution provides the repo seller (transferor) with the right to reclaim that 5-year note from the repo buyer (transferee) and substitute it with, say, a 10-year note of the same value. At repo maturity or when the repo seller exercises its right to substitute, the repo buyer must return the same note (i.e. the same CUSIP number). Under a typical repo agreement, the repo Buyer never has the right to return substantially the same asset; it must return the same asset that the repo seller has pledged as collateral. Please refer to paragraph 9 of the 1996 Master Repurchase Agreement (commonly used in the U.S. under New York law) and paragraph 8 of the 2000 Global Master Repurchase Agreement (commonly used in the U.K. under English law).

5. The Board decided that the characteristics that must be satisfied for a financial asset to be substantially the same in paragraph 860-10-40-24A should result in identifying those transactions in which a transferor is in economically the equivalent position with the return of a substantially-the-same asset compared with the return of the identical asset. Do the proposed amendments to the substantially-the-same characteristics help clarify how those characteristics should be applied? If not, what additional clarifications are needed? Does the implementation guidance related to the substantially-the-same characteristics in paragraph 860-10-55-35 provide appropriate clarifications related to the characteristics and their application? Is the implementation guidance operable? If not, what additional guidance is needed?

Please see comment to question 4.

6. The Board decided that for transfers with agreements that both entitle and obligate the transferor to repurchase transferred financial assets that maintain a transferor’s effective control and are accounted for as secured borrowings, the transferor should disclose the gross amount of the total borrowing disaggregated on the basis of the class of financial assets pledged as collateral. Would this proposed disclosure provide decision-useful information? If not, what disclosures, if any, about these transactions should be required and why?

Yes. To the extent that the transferor retains the risk of ownership, the proposed disclosure would provide users of financial reporting relevant information to assess the transferor's risk on the pledged assets.

7. The Board decided that for transfers with agreements that both entitle and obligate a transferor to repurchase transferred financial assets that are accounted for as sales and forward repurchase agreements solely because the asset to be reacquired is not substantially the same as the initially transferred asset, the transferor should disclose the carrying amount of assets derecognized during the reporting period. Would this proposed disclosure provide decision-useful information? If so, should the scope of this proposed disclosure requirement be expanded to explicitly include all transfers of financial assets with agreements to repurchase the transferred assets that are accounted for as sale transactions? What additional information about those transactions, if any, should be disclosed?

Yes, if the transferor retains the risk of ownership. No, if the transferor has effectively transferred all risk of ownership to the repo buyer. The disclosure should focus on the risks retained by the transferor.

8. Do you foresee any significant operability or auditing issues in complying with the proposed disclosures?

No comment.

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9. Do you agree with the transition provisions in this proposed Update? If not, why?

No comment.

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10. Should early adoption be permitted? If not, why? Should this be the case for both public entities and nonpublic entities?

Yes to both questions.

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11. Should the effective date be the same for both public entities and nonpublic entities? If not, why?

Yes.

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Additional comments-updt. Please provide any additional comments on the proposed Update:

None.

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Additional comments-process. Please provide any comments on the electronic feedback process:

Excellent.

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