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***Proposed Amendment to SFAS 140: Potential Change in Applying the Isolation Evaluation Approved by Board***

**Summary**

At its October 18th meeting, the Financial Accounting Standards Board (“FASB” or “Board”) agreed to a staff proposal that would alter the legal analysis required to support the assertion that transferred financial assets have met the sales accounting-related isolation test under Statement of Financial Accounting Standards 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities* (SFAS 140).

Depending on the underlying transaction structure, this change may make it more difficult for certain transfers to meet the isolation requirement (and thus qualify for sales accounting) -- particularly if the consolidated financial statements include both the transferor and affiliated companies, with latter having some form of continuing involvement with the transferred assets.

**Background**

To facilitate discussion at the meeting, the FASB staff stipulated the following securitization transaction (see attached schematic):

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- Transferor Co. transfers loans to a QSPE in a typical two-step securitization transaction. The QSPE issues notes to third-party investors. Transferor Co. receives cash and, via the BRE, retains a subordinate interest in the loans. Transferor Co. also enters into (writes) a limited (5%) credit-loss guarantee with the QSPE.
- The Parent Co. of Transferor Co., as well as another subsidiary of Parent Co. (Sister Co.), each enter into a limited (5%) credit guarantee with the QSPE, thereby providing it with additional subordinated financial support. The details of these three guarantees were not clarified by the staff (in terms of relative seniority, etc.).

Parent Co. will issue consolidated financial statements that report the transfer of the loans to the QSPE as a sale.

Using the example, the Board was asked to clarify how it believed counsel should approach the related isolation evaluation under SFAS 140. The ensuing discussion focused on two of the three choices presented by the staff (Alternative A was not seriously considered):

- *Alternative B:* when formulating its "true sale" and substantive non-consolidation opinions, counsel must consider the legal effect of the involvements of all the entities in the transferred assets -- Transferor Co., Parent Co. and Sister Co. in the example -- that are included in Parent Co.'s consolidated financial statements. (Certain Board members are of the view that this approach is currently called for in paragraphs 9(a) and 27 of SFAS 140.)
- *Alternative C:* same as Alternative B, except that, solely for purposes of the legal isolation analysis, any forms of involvement on the part of consolidated affiliates should be attributed to the transferor entity. (Thus, in the example, the guarantees written by Parent Co. and Sister Co. would be analyzed by counsel "as if" they had been written by Transferor Co. directly to the QSPE -- in effect, requiring counsel to perform a "hypothetical" isolation analysis.)

The Board concluded that the proposed amendment to SFAS 140 should require an isolation evaluation along the lines of Alternative C. The most vocal of the proponents of this view indicated that Board members had been "surprised" by weight that the legal analysis attaches to the separateness of legal entities (even when commonly owned) and the extent to which this "corporate shield" affected the legal conclusions reached. This member asserted that, if the Board had

been aware of these considerations, it might have insisted upon Alternative C at the time SFAS 125 (and, subsequently, SFAS 140) was being drafted.

Advocates of Alternative B were of the view that the legal analysis should consider the involvements of consolidated affiliates based on the actual contractual arrangements. They pointed out that, in the event of bankruptcy or receivership of any of the parties involved, a court will consider only those arrangements actually in effect -- not "as if" or "hypothetical" constructs.

***SFG Observations:*** *As the Board and staff have acknowledged, diverse views exist among accountants regarding the appropriate scope and content of legal opinions considered necessary to meet SFAS 140's isolation test. Some of this diversity apparently stems from different interpretations of the term "consolidated affiliate of the transferor" used in paragraph 27. As noted, certain Board members believe that SFAS 140 as currently worded requires the application of Alternative B's approach when evaluating isolation.*

*Several attorneys well-versed in bankruptcy/securitization matters have indicated to us that they cannot (or will not) opine on the legal consequences of a hypothetical transaction. If this view is widely held, and assuming that Alternative C is incorporated into the final amended standard, it is not clear to us whether transferors will find it feasible (or possible) to obtain from counsel the "would level" assurance currently considered necessary to meet paragraph 9(a)'s isolation requirement.*

### **Questions**

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## Securitization Transaction Considered at October 18th Board Meeting

