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June 4, 2008 FASB Board Meeting and Education Session on FAS 140 and FIN 46(R)

OVERVIEW

On June 4, 2008, the Financial Accounting Standards Board ("FASB" or "the Board") held a Board meeting and an education session on FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* ("FAS 140"), and FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities* ("FIN 46(R)), in connection with its projects to amend both standards.

Summary of Board Decisions related to FAS 140

The Board was asked to decide (1) whether to require a minimum third party investment in transferred financial assets as a condition to achieve sale accounting and (2) whether to continue the guaranteed mortgage securitization (GMS) exception that requires the reclassification of mortgage loans to securities and the recognition of related servicing assets and liabilities when a transferor classifies the securities as trading or available-for-sale and the underlying transfer of loans does not meet the requirements for sale accounting.

A majority of the Board members tentatively supported the elimination of the minimum threshold for third party investment in transferred financial assets in

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order to derecognize assets under FAS 140. However, a formal vote was not taken as the Board members wanted to wait until after the discussions on the possible amendments to FIN 46(R) before concluding on this issue.

The Board decided that it did not want to continue to provide the GMS exception. Rather, transfers formerly subject to that exception are to be treated in the same manner as any other transfer.

The Board also decided to eliminate the exception for GMS transactions that requires a transferor to recognize a servicing asset under FASB Statement No. 156, *Accounting for Servicing of Financial Assets an amendment of FASB Statement No. 140* ("FAS 156"), if the securities are classified as trading or available-for-sale even if the transfer does not qualify for sale accounting.

Summary of Board Decisions related to FAS 140 and FIN 46(R) Disclosures

The Board discussed enhancements to the existing disclosure requirements relating to transfers of financial assets within the scope of FAS 140 and variable interest entities within the scope of FIN 46(R).

Generally, the Board agreed with the staff recommendations for providing additional disclosures. The Board meeting handout provided a limited description of the proposed disclosures. The draft requirements were provided to the Board in an appendix, but were not provided publicly for the meeting. The Board instructed the staff to provide the draft disclosure requirements in the public minutes of the Board meeting so that the recommended disclosures could be viewed in context. The specific disclosures discussed are presented later in this Advisory.

FICG Observation: One of the more significant decisions reached was that the Board decided to include VIE sponsors in the scope of the FIN 46(R) disclosure requirements, even if the sponsor has no significant explicit variable interest in the VIE.

The Board also instructed the staff that the amendments to FIN 46(R) should emphasize that reputational risk and implicit guarantees by sponsors and other entities need to be considered in the consolidation analysis and disclosures.

Summary of Education Session on FIN 46(R) and FAS 140

The FASB held an education session to determine whether the Board members had enough information to take a formal vote on an approach to determining the

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primary beneficiary under an amendment to FIN 46(R) at the next Board meeting.

Generally, the Board expressed divergent views regarding the application of the various alternatives to an amendment of FIN 46(R). In addition, the Board did not state definitively that it is ready to vote on specific amendments at next week's Board meeting.

BOARD MEETING AND EDUCATION SESSION DISCUSSIONS

FAS 140 Discussion at the Board Meeting

Issue 1: Minimum Third Party Investment in a Transferred Financial Asset

With respect to minimum third party investments in transferred financial assets, the Board meeting handout explained that:

> In the 2005 FASB Exposure Draft, *Accounting for Transfers of Financial Assets,* the Board decided to remove the requirement in paragraph 9 of Statement 140 in which consideration other than beneficial interests in the transferred financial assets must be received in exchange to account for the transfer as a sale. This change was consistent with the view that a transfer of an entire financial asset, which meets the criteria in paragraphs 9(a)–9(c), is a sale of the entire financial asset and that any interest received by the transferor would be proceeds of the sale. However, these decisions were based on the assumption that transactions that issue beneficial interests are either (1) affected through the use of a qualifying special-purpose entity (QSPE), which requires that at least 10 percent of the beneficial interests should be issued to third parties and is exempt from consolidation, or (2) that the transaction must be to a third party.
>
> With the Board's recent decision to eliminate the QSPE, transferees that are variable interest entities would now be subject to consolidation under FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*. As a result, the requirement that at least 10 percent of the beneficial interests should be held by parties that are not consolidated by the transferor will be eliminated.

The staff asked the Board whether FAS 140 should have a rule that sets a minimum amount of beneficial interests that must be held by parties other than

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the transferor and its consolidated affiliates for a transferor to account for a transfer as a sale.

FICG Observation: The staff believes that retaining a minimum threshold probably will not have a material impact in practice. The staff expressed its view that, with the elimination of the QSPE concept, a transferor that retains a high percentage of beneficial interests will be unlikely to avoid consolidation and/or meet the derecognition criteria under FAS 140.

Most Board members supported not having a threshold in FAS 140. After the Board members have concluded on the decisions regarding the possible amendments to FIN 46(R), they will confirm whether the threshold should be eliminated.

FICG Observation: During the deliberations, some Board members expressed concerns that FIN 46(R) and the other criteria in FAS 140 might not be effective in stemming potentially abusive transactions. One Board member suggested that a threshold of 50% be established to derecognize transferred assets (i.e., at least 50% of the beneficial interests in transferred assets would have to be held by third parties in order for the transferor to derecognize the transferred assets). As a result, the Board decided to wait until the new FIN 46(R) consolidation criteria were established before deciding whether a threshold should be required.

Issue 2: Guaranteed Mortgage Securitization Exception

With respect to guaranteed mortgage securitizations, the Board meeting handout explained that:

> A guarantee mortgage securitization (GMS) is a securitization of mortgage loans that includes a substantive third party guarantee. In many GMSs, a transferor transfers loans to a QSPE, a guarantee is provided to the QSPE by a third party, and the transferor receives 100 percent of the beneficial interests in the QSPE. If the transferor reclassifies the loans as securities in accordance with FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, and classifies those securities as trading or available-for-sale in accordance with FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, the transferor is required to recognize a servicing asset or liability initially at fair value pursuant to Statement 140, as amended by FASB Statement No. 156, *Accounting for Servicing of Financial Assets*. The transferor usually sells some or all of the resulting securities over time to third parties.

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In Statement 156, the Board continued to permit the recognition of a servicing asset or liability for a GMS if the GMS is affected through a QSPE and the resulting securities are classified as trading or available-for-sale, even though the transferor receives 100 percent of the beneficial interests in the securitized loans and the transaction does not meet the requirements for sale accounting. However, Statement 156 also changed the initial measurement methodology for servicing assets from an allocation of a previous carrying amount to fair value that often results in reporting a gain on sale based upon the creation of a marketable servicing asset.

With the Board's recent decision to eliminate the QSPE, the accounting for GMS also must be reconsidered; that is, whether the reclassification of loans to securities and the recognition of a servicing asset or liability should be permitted, regardless of the results of the consolidation analysis or whether or not to permit that accounting only if the GMS trust is not consolidated by the transferor.

FICG Observation: The staff suggested that the elimination of this exception would prevent entities from managing the timing of gain recognition from GMS transactions. The staff stated that the exception had resulted in diversity in practice, as some entities have analogized to the guidance for GMS transactions and thus have recognized securities for transfers involving assets other than mortgages that have not met the requirements for sale accounting.

During the deliberations, one Board member stated that the implication of the elimination of the exception for GMS is that if (1) the transferee SPE is consolidated by the transferor under FIN 46(R) or (2) the derecognition criteria under FAS 140 are not met, the loans would continue to be recognized as loans (rather than recognized as securities).

The staff observed that, to recognize gains on mortgage loans that will eventually be securitized in a GMS that will not meet the derecognition criteria, the reporting entity could elect to report the loans at fair value under FASB Statement No.159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115*, when the loans are initially recognized (originated or purchased).

The Board decided that it did not want to continue to provide the GMS exception. Rather, transfers formerly subject to that exception are to be treated in the same manner as any other transfer.

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The Board also decided to eliminate the exception for GMS transactions that requires a transferor to recognize a servicing asset or liability under FAS 140, as amended by FAS 156, if the securities are classified as trading or available-for-sale, even if the transfer does not qualify as a sale.

Discussion of FIN 46(R) and FAS 140 Disclosures at the Board Meeting

The Board meeting handout explained that:

> The staff prepared a summary of suggested disclosure enhancements based on input received from financial statement users (including representatives of Investors Technical Advisory Committee (ITAC)) and its review of existing SEC disclosure requirements, existing or contemplated disclosure requirements of other standard setters (including the IASB), Senator Reed's letter to the FASB, and various other studies and articles on the topic of perceived gaps in the disclosure requirements in general. The staff compared the suggested disclosure enhancements to the relevant existing disclosure requirement(s) in U.S. GAAP, if any. As a result of that analysis, the staff identified areas where the Board should consider enhancements to the disclosures relating to transfers of financial assets and variable interest entities.

FICG Observation: During the meeting, the staff explained that it had given greatest consideration to suggestions from users of financial statements.

The Board meeting handout provided a limited description of the proposed disclosures. The draft requirements were provided to the Board in an appendix, but were not provided publicly for the meeting. The Board instructed the staff to provide the draft disclosure requirements in the public minutes of the Board meeting so that the recommended disclosures could be viewed in context.

Issue 1: Disclosure Objectives

The Board decided that the disclosure requirements in both FAS 140 and FIN 46(R) should begin with a statement as to the overall objectives of the disclosure requirements.

FICG Observation: During deliberations, the staff explained that even though the disclosure requirements of the standards are prescriptive, citing the underlying objectives of the requirements would help reporting entities address and respond to changing circumstances in the future. In addition, the Board

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views the specific disclosures as a minimum required. One Board member suggested that the guidance state that to meet the objective the reporting entity should provide disclosures that include, but are not limited to, the specific disclosures prescribed.

Issue 2: Aggregation of Similar Transfers and Similar Variable Interests

The Board decided that an aggregation principle should be given that provides guidance as to whether and how to aggregate disclosures for similar transfers and similar variable interests for the purposes of applying the disclosure requirements in FAS 140 and FIN 46(R).

Issue 3: Amendments to the FAS 140 Disclosure Requirements

The Board meeting handout explained that:

> The staff recommends that the amendments to the disclosures required in Statement 140 should include the following:
>
> 1. Additional information about the calculation of the gain or loss recognized as a result of a transfer of financial assets that has been accounted for as a sale
> 2. Additional information about the transferor's continuing involvement, regardless of whether the transfer was accounted for as a sale or as a secured borrowing and regardless of when the initial transfer occurred
> 3. Qualitative and quantitative information about liquidity, guarantee, and other commitments provided by third parties related to the transferred financial assets
> 4. Certain other amendments to Statement 140.

The Board agreed with the staff recommendations and decided that Item 1 should be limited to transfers to an SPE.

Issue 4: Definition of Continuing Involvement

The Board meeting handout explained that:

> The staff believes that the term *continuing involvement* should be explicitly defined in the glossary to Statement 140 in order to clarify the proposed requirements to disclose information related to a transferor's continuing involvement with transferred financial assets. The staff proposes the following definition:

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> Any further involvement of any kind with transferred financial assets, other than standard representations and warranties that the transferred financial assets met the delivery requirements under the arrangements. Examples of continuing involvement include, but are not limited to, servicing arrangements, recourse or guarantee obligations, agreements to repurchase or redeem, derivative instruments, pledges of collateral, participation in future cash flows, retained subordinated interests, and restrictions on interests that continue to be held by the transferor.

The Board generally agreed with the staff recommendation. However, members suggested that the definition be revised to suggest that standard representations and warranties should only relate to the state of the assets at the point of transfer. In addition, they suggested that additional clarification be provided regarding how derivative instruments should be considered in the analysis. The staff will refine the definition based on the Board's comments.

FICG Observation: Certain Board members were concerned that some might interpret the definition to mean that any derivative could be deemed a form of "continuing involvement" even if it was entered into by the transferor after the transfer and was completely unrelated to the transferred assets (for example, an interest rate swap entered into by the transferor with a third party subsequent to the transfer would not be considered continuing involvement with the transferred assets even though there is interest rate risk in the transferred assets).

Issue 5: Paragraph 17 of FAS 140

The Board meeting handout explained that:

> Paragraph 17(c) of Statement 140 currently contains the phrase "after the effective date of Statement 125." The staff understands that this disclosure, which was carried over from FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, was primarily written to address the restrictions on assets that were set aside in an in-substance defeasance. The staff believes that this disclosure should be applied broadly to all assets within the scope of Statement 140 that are set aside solely for satisfying a specific obligation (for example, transfers that are accounted for as secured borrowings).

The Board agreed with the staff's recommendation to clarify that the disclosure required in paragraph 17(c) of FAS 140 applies to all transfers of financial assets

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accounted for as secured borrowings and not just to assets set aside in an in-substance defeasance.

Issue 6: Methodology Used in Determining Fair Value

The Board meeting handout explained that:

> Paragraphs 17(h)(1) and 17(i)(1) of Statement 140 currently provide examples of the methodology by which an interest that continues to be held by the transferor is measured at fair value: "…(whether quoted market price, prices based on sales of similar assets and liabilities, or prices based on valuation techniques)." The staff does not believe this methodology is necessary following the issuance of FASB Statement No. 157, *Fair Value Measurements.*

The Board decided to eliminate these references as they are redundant with FAS 157.

Issue 7: Footnote 10 of FAS 140 Exception for Servicing

The Board meeting handout explained that: "Footnote 10 of Statement 140 currently provides an exception from the disclosures required by paragraph 17(i)(4) if the transferor's only continuing involvement is servicing. Based on constituent feedback and the difficulty in defining servicing, the staff proposes that footnote 10 be deleted from the Statement." The Board agreed.

Issue 8: Amendments to the FIN 46(R) Disclosure Requirements

The Board meeting handout explained that:

> The staff recommends that the amendments to the disclosures required in Interpretation 46(R) should include the following:
>
> 1. The enterprises methodology and process for applying the Interpretation, including information about significant judgments, factors, and assumptions
> 2. The primary factors considered that cause a change in how a variable interest entity is reported by the enterprise and the impact to the enterprise's financial statements between periods
> 3. Whether the enterprise has provided financial or other support to the variable interest entity that it was not

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contractually required to provide, including the type and amount of financial support and the primary reasons for providing the voluntary support
4. The significant risks of the variable interest entity
5. The terms of arrangements that could require the enterprise to provide financial support to the variable interest entity, including events or circumstances that could expose the enterprise to a loss
6. The carrying amount and classification of the assets and liabilities relating to the variable interests recognized in the statement of financial position, including the nature of any restrictions on the ability of the enterprise to use assets it has recognized
7. Qualitative and quantitative information about liquidity, guarantee, and other commitments to the variable interest entity by third parties
8. The fair value of the variable interest entity's financial assets and liabilities that are consolidated
9. Information about how the maximum exposure to loss is determined
10. Disclosure of the enterprise's expected loss and how it is determined
11. To encourage, but not require, disclosures to be provided in a tabular format
12. Certain other amendments to Interpretation 46(R).

The Board agreed with the recommended disclosures and clarified that Item 10 does not mean disclosure of the detailed calculations of FIN 46(R).

The Board also decided that these disclosures should be required for sponsors of VIEs and suggested that the staff clarify that a sponsor presumptively has reputational risk and therefore should provide the FIN 46(R) disclosures, even if it does not otherwise have a significant variable interest.

FICG Observation: As a result of the Board's decision to include sponsors in the scope of the FIN 46(R) disclosure requirements, the disclosures will be required for an entity that is the primary beneficiary of, has significant variable interests in, or is a sponsor of a VIE. The staff suggested that a definition of sponsor could be created by leveraging other GAAP.

The Board also instructed the staff that the amendments to FIN 46(R) should emphasize that reputational risk and implicit guarantees by sponsors and other entities need to be considered.

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Issue 9: Significant Variable Interest Entities

The Board meeting handout explained that:

> The staff believes there is diversity in practice about how to assess whether an enterprise has a significant variable interest. Some companies assess whether the variable interest is significant by evaluating whether the (1) variable interest is significant to the variable interest entity, (2) variable interest is significant to the enterprise, or (3) both. The staff believes that an enterprise should provide the disclosures required for a significant variable interest entity under both scenarios. Accordingly, the staff recommends clarifying this in paragraph 6 of Interpretation 46(R).

The Board agreed with the staff's recommendation to clarify that the disclosures for a significant variable interest should be made when the variable interest is significant to the variable interest entity ***or*** when the variable interest is significant to the enterprise. The Board also decided that the consideration of significance should include an evaluation of not only the expected loss but also whether the maximum possible loss would be significant.

Issue 10: Exception to the FIN 46(R) Disclosures for Enterprises that also hold a Majority Voting Interest

The Board meeting handout explained that: "Paragraph 23 of Interpretation 46(R) currently states that a primary beneficiary that holds a majority voting interest in the variable interest entity, as described in footnote 17, is not required to provide the required disclosures for a primary beneficiary." The Board decided to remove the exception from providing the disclosures required by paragraph 23 of FIN 46(R) if the primary beneficiary also holds a majority voting interest.

Issue 11: When a Significant Variable Interest Holder's Involvement Begins with a Variable Interest Entity

The Board meeting handout explained that: "Paragraph 24(a) of Interpretation 46(R) currently requires an enterprise with a significant variable interest in a variable interest entity to disclose when its involvement with the variable interest entity began. The staff does not believe this disclosure requirement currently provides meaningful information to users and thus proposes deleting it." The Board decided to remove the requirement for significant variable interest holders to disclose when their involvement began with the variable interest entity.

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Education Session on FIN 46(R) and FAS 140

The FASB held an education session to determine whether members had enough information to take a formal vote on an approach for determining the primary beneficiary under FIN 46(R) at the Board meeting next week. Education sessions are not decision-making meetings. Therefore, the discussions during the education session do not reflect Board decisions and are subject to change or re-interpretation by the Board. In addition, it is possible that some of the Board's preliminary views have been captured incorrectly below. The summary below reflects our understanding of the Board's deliberations on the proposed amendments to FAS 140 and FIN 46(R) as of June 4, 2008.

Generally, the Board expressed divergent views regarding the application of the various alternatives to an amendment of FIN 46(R). In addition, the Board did not state definitively that it is ready to take a formal vote on specific amendments at its Board meeting next week. The FASB staff plan to prepare a handout for the Board by Friday that captures what they believe are the alternative views of the Board related to certain areas in order to help the Board decide whether they are ready for a vote next week.

Analysis of Example Structures under Alternative Views

The Board continued its discussion of the application of the three alternative views to five example structures (see Capital Markets Accounting Development Advisory 2008-5 for a more detailed discussion of the three views and structures). The three views are:

- View A - the proposed qualitative assessment model to determine the primary beneficiary with a quantitative analysis performed in the event that the primary beneficiary is not clear from the qualitative analysis;
- View B - an entirely control-based view; and
- View C - the current FIN 46(R) approach with added disclosures and reconsideration event changes

CMBS Example

The Board discussed a CMBS structure example. This is the third example structure; the first two examples (an agency mortgage securitization and an asset backed commercial paper ("ABCP") conduit) were discussed at the previous education session. In the staff's example, under views A and C, an entity that is a special servicer and holds a residual interest would be the primary beneficiary. Under View B no one would be the primary beneficiary in this example.

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The Board discussed that the qualitative assessment under View A would include an assessment of the powers and benefits of the variable interest holder, and whether the concept of power should be considered differently based on whether it was current or contingent (i.e., based upon a triggering event). The Board also discussed whether the entity created and passed along both credit and interest rate risk or just credit risk.

CDO Example

The fourth example was a CDO structure. In the example, the manager held an equity tranche and earned a base fee and performance fee. The staff presented two variations of this example. In the first, the manager was subject to substantive kick-out rights. In the second, substantive kick-out rights did not exist.

The Board discussed whether kick-out rights should be considered in the qualitative analysis called for under view A. In the example presented, the staff explained that if kick-out rights are considered then the manager would not be the primary beneficiary, whereas if they are not considered then the manager would be the primary beneficiary.

As a result of that discussion, a View A' was developed in which the qualitative assessment would not consider substantive kick-out rights when evaluating the power of a variable interest holder subject to the kick-out rights. This alternative would be a current control model (that is, kick-out rights would not be relevant in determining the primary beneficiary at inception). However, if the kick-out rights were invoked, a reconsideration would be needed.

FICG Observation: Certain board members and staff indicated that there was a potential conflict between the View A' alternative, which ignores kick-out rights, with EITF Issue No. 04-05, *Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights* and the guidance in FIN 46(R) and the related FASB Staff Positions. The staff will evaluate this issue when they draft their understanding of the alternatives of View A.

SIV Example

The fifth example discussed was a SIV structure. In the example, the advisor was also the investment manager and funding manager and could only be removed in the event of a material breach. The advisor receives a management fee, performance fee, and fixed fee. Under View A, the advisor would be the primary beneficiary as it has power and the right to receive benefits. Under View

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B, no party would be considered to control the vehicle. Under View C, the capital note holder would be the primary beneficiary in the staff's example because it absorbs the majority of expected losses.

Agency Mortgage Securitization Example

The Board revisited the agency mortgage securitization structure and discussed whether the guarantor should be considered the primary beneficiary. Some Board members expressed a view that the guarantor should be considered a variable interest holder in the same manner as an entity with any other variable interest. In this view, whether or not an interest was a guarantee should not make a difference. These Board members felt that the guarantor was an absorber of risk, not a creator. These Board members disagreed with the view expressed last week that the securitization process makes the guarantor a creator of risk.

FICG Observation: It wasn't clear at the meeting whether there was a consensus about whether the guarantor (such as a GSE) would be viewed as an absorber of risk and therefore would be considered the primary beneficiary.

The Board also discussed other possible alternatives to View A whereby under the qualitative assessment the reporting entity would evaluate who is managing the VIE and who has the economic interests in it, but would look at the risks and benefits when performing the quantitative analysis. Toward the end of the discussion, one Board member suggested that the qualitative assessment should be based on both control and a more than insignificant benefit.

The majority of the Board appears to tentatively be in favor of View A. However, it is not clear which alternative of View A they prefer. Some Board members may support other Views.

Other Issues

The Board also discussed which risks should be considered in determining the primary beneficiary and the impact of the design of the entity. Specifically, the Board discussed whether, under View A, the analysis should only consider risks that the VIE was designed to create and pass through, newly-created risks, or all risks.

FICG Observation: The Board discussed the application of a systematic approach to the qualitative assessment. This approach involved: identifying the risks in the entity, identifying the risks that are created by design, identifying the

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variable interests and holders, using the risks that are created by design in the evaluation of the variable interests, and determining the primary beneficiary.

The Board also discussed possible transition guidance, specifically whether entities should apply the amendments to FAS 140 and FIN 46(R) to new structures after the effective date and to existing QSPE and FIN 46(R) structures one year after the effective date, or whether the new guidance should simply be applied to all structures (both new and those existing prior to the effective date) one year after the effective date. The Board also discussed requiring the additional proposed disclosures and requiring recurring reconsiderations upon the effective date of the amendments (without a one year delay). While no decisions were made, the Board seemed to support having some transition period. The Board also seemed to still be moving forward with a 45-day comment period and an effective date of 2009.

Next Steps

The staff intends to draft its understanding of the alternatives of View A and provide them to the Board on June 6th for review. The staff stated that at the next Board meeting it intends to ask the Board for its preference on View A, A', B or C, and whether the amendment should include examples. However, the Board did not indicate definitively that it would be ready to make a decision on which view to adopt by the next Board meeting. In addition, the Board did not indicate whether it believes it can reach a consensus on the other issues raised during the education session.

Questions

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