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SFAS 140—Six Years Later: When Will a Final Amendment be Issued?

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Background

Many entities engage in transactions involving the transfer of financial assets, such as securitizations of receivables or loans, sales of loan participations, repurchase agreements, securities lending and factoring arrangements. In the United States, the provisions of Statement of Financial Accounting Standards No.140, “Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities” (SFAS 140), issued in September 2000, generally dictate whether these transactions qualify for sales accounting (“derecognition” of the transferred asset) or must instead be reported as “on balance sheet” financing arrangements.

In January 2003, the Financial Accounting Standards Board (FASB) added a project to re-examine certain provisions in SFAS 140. At the time, it was widely anticipated that this initiative would lead to a relatively narrow, “quick-fix” amendment to the standard. However, this has not proven to be the case—instead, this effort has morphed into a project having a much broader scope. To date, the project has resulted in two new pronouncements (SFAS 155 and 156) that amend certain aspects of SFAS 140. However, the anticipated principal amendment to SFAS 140 (sometimes referred to as the “transfer project”) has yet to be finalized and issued, the release of two exposure drafts in June 2003 and August 2005 notwithstanding. This article describes—and offers perspectives on—certain issues with which the FASB continues to wrestle as it recently deliberated how best to proceed with the transfer project.

Recent Board Meetings

On June 7th, 2006, the FASB revisited the SFAS 140 transfer project as proposed in the August 11th, 2005 Exposure Draft (revised) (ED). At the June meeting, the Board reached decisions whether to re-deliberate, reaffirm previous decisions or drop from consideration a number of issues identified from the comment letter process.

At its July 26th meeting, the Board continued to discuss certain open issues related to the project, including:

- Permitted activities of a qualifying special purpose entity (QSPE);
- Rollovers of beneficial interests;
- Participating interests; and
- Transferability requirements.

Permitted Activities of a QSPE

In December 2005, the Board added to its agenda a project to provide interpretive guidance regarding the permitted activities (and related discretion) that a servicer can exercise on behalf of a so-called QSPE. (QSPEs are non-consolidated “auto-pilot” or “brain dead” SPEs that meet the stringent requirements set forth in paragraph 35 of SFAS 140.) Evaluating whether (or to what extent) a QSPE may “rollover” beneficial interests and whether a QSPE’s servicer may permissibly engage in certain servicing activities involving discretion must be considered in light of paragraph 35(b), which directs that the activities of a QSPE be “significantly limited” and “entirely specified”. The FASB staff recommended that the Board address these issues pertaining to the permitted activities of QSPE jointly for efficiency and to ensure that consistent guidance is provided for those related issues.

The Board agreed to combine the servicer discretion project into the transfers project and deliberate all matters related to the permitted activities and investments of a QSPE under this one project.

The FASB staff identified the following issues relating to permitted activities and permissible investments that they expect to address in this part of the combined project:

- Rollovers of beneficial interests (see below);
- Equity investments held by a QSPE;
- Limitations on derivatives held by a QSPE; and
- Servicer discretion in
 - a) waiving a due-on-sale provision;
 - b) substituting collateral with respect to a loan held by a QSPE; and
 - c) connection with the potential foreclosure and sale of related estate temporarily held by a QSPE.

Rollovers of Beneficial Interests

The FASB staff recommended, and the Board agreed, to redeliberate the proposed guidance on rollovers of beneficial interests and to determine whether to:

- Disallow rollovers.
- Clarify the meaning of “more-than-trivial incremental benefit.”
- Provide examples of acceptable and unacceptable combinations of involvements by a single party; and
- Clarify the guidance for beneficial interests issued by a master trust.
- Consider other alternatives.

PwC’s Structured Finance Group’s Observation

The ED’s proposed amendments to SFAS 140 relate to QSPEs that reissue or “rollover” beneficial interests. Specifically, the ED defined “reissuance of beneficial interests”, clarified that issuances from master trusts would not be considered the reissuance of beneficial interests, and concluded that an SPE would not be qualifying if any party to the transaction had more than one involvement with the entity and was able to obtain a “more-than-trivial incremental benefit” by virtue of the combination of those involvements.

Numerous comment letters objected to the ED’s proposed guidance. Some considered the concept unoperational (i.e., how should a “more-than-trivial incremental benefit” be assessed?); others asserted that a “benefit”-based test is inconsistent with the control-based approach that undergirds the SFAS 140 model.

Derivatives Held by a QSPE and Initial Measurement of a Transferred Interest

An earlier decision by the Board in the transfers project would have eliminated the present restriction in SFAS 140 that proscribes a QSPE from holding passive derivative financial instruments deemed to “pertain to” beneficial inter-

ests held by the transferor. The revised ED incorporated this change—one of the few provisions in the proposal endorsed by virtually all constituents who commented.

At the June 7th meeting, the Board decided to delete this change from the proposed statement—thus leaving the present restriction intact. However, after receiving a number of comment letters expressing concern over this decision, the FASB staff recommended and the Board agreed to continue discussions on the use of derivatives in QSPEs.

PwC's Structured Finance Group's Observation

The Board devoted little time to deliberating this matter at the June 7th meeting before agreeing to delete the proposed relief—an outcome that caught many observers by surprise. The decision to reconsider that action is a welcome one.

The Board also decided to redeliberate how a transferor should initially measure its retained interest in a transferred asset (allocated carrying value vs. fair value), as various Board members believe that the limitations on passive derivatives and initial measurement should be evaluated together.

Participating Interests and Transferability Requirements

These two issues relate to transfers of assets (or transfers of interests in those assets) that involve multiple steps and/or a QSPE as the ultimate transferee, and related issues of derecognition. The current ED prescribes conditions more stringent than current practice for a transferor to achieve sales accounting. The FASB staff recommended that the Board defer making a decision about whether to retain these new de-recognition requirements in the final standard until the Board completed its redeliberations regarding (1) permitted activities of a QSPE and (2) the effects of a transferor's continuing involvement with a transferred asset relative to the isolation evaluation. The Board agreed and will make a decision regarding the participating interests and transferability requirements after these deliberations have been completed.

PwC's Structured Finance Group's Observation

In its deliberations leading up to the new ED, the Board devoted significant time to discussing under what circumstances de-recognition is appropriate for transfers involving a partial interest in a financial asset (referred to currently as an undivided interest). Currently, transfers of such interests may qualify for derecognition, although no QSPE is involved. The ED provides a new definition and guidance for transfers of portions of a financial asset, referred to as participating interests, which are significantly more restrictive than current practice.

Next Step

The FASB staff indicated that they expect to report back to the Board in September on the results of their research relating to a QSPE's permitted activities/investments and to make further recommendations for the Board's consideration.

The Board currently anticipates issuing a final amendment relating to the transfer project during the second quarter of 2007. We look forward to updating you with the latest developments as they become available.

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