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Capital Markets
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Advisory 2008 - 5
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FASB EDUCATIONAL SESSIONS ON FAS 140 AND FIN 46R

Background

The Financial Accounting Standards Board ("FASB" or "the Board") recently held educational sessions on Statement on Financial Accounting Standards No. 140 ("FAS 140") and FASB Interpretation No. 46R ("FIN 46R") in connection with their projects to amend both standards. This Advisory reflects our views and understanding of the Board's deliberations on the proposed amendments to FAS 140 and FIN 46R as of May 28, 2008. All matters are subject to change and re-interpretation by the Board. In addition, it is possible that we have incorrectly captured some of the Board's preliminary views. We encourage you to continue to follow the developments of these projects as the Board proceeds with their deliberations.

FIN 46R

The Board appears to support a model requiring an enterprise (including its related parties and de-facto agents) to determine whether it must consolidate a variable interest entity primarily based on a qualitative assessment. If it is determined qualitatively that no primary beneficiary exists or that a primary beneficiary exists and can be identified, no further analysis is performed.

If an enterprise is unable to qualitatively determine whether control exists or does not exist with a single interest holder, a quantitative analysis using the expected losses

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calculation would be performed. That is, the determination of the primary beneficiary would be determined based on which enterprise quantitatively absorbs the majority of the expected losses, receives the majority of the residual returns, or both.

The staff continues to focus on the design of the entity and what risks it was intended to create and pass through to its variable interest holders. In addition, the staff has discussed the need to focus on the control or powers related to those risks.

SFG Observation: *The discussions to date indicate that it is difficult to design a combined control and risks and rewards model.*

There was a discussion about the consideration of interest rate risk in consolidation analyses and the diversity that exists in practice. The FASB staff pointed out that if interest rate risk is included in the analysis it would often dwarf credit risk. The staff proposed excluding the risk free rate on the basis that it was not a risk that an entity was designed to create.

The Board has also discussed guarantees and whether a guarantee is a creator or absorber of variability.

SFG Observation: *There was a general view that guarantees are absorbers of variability whereas a credit default swap ("CDS") is a creator of risk.*

The guarantee fee should equate to the probability of making a payment under the arrangement. A guarantee with power such as a liquidity put should result in consolidation by someone, but a guarantee without any power should not because it does not have any inherent powers or control attributes.

The staff provided the Board with five different structures that were analyzed under three alternative views:

(a) View A - the proposed qualitative assessment model with the quantitative analysis in the event that the primary beneficiary is not clear;

(b) View B - an entirely control based view; and

(c) View C - the current FIN 46R approach with added disclosures and the reconsideration event changes

<u>Structures:</u>

1. Agency mortgage securitization;
2. Asset-backed Commercial Paper ("ABCP") conduit;

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3. Collateralized mortgage-backed securitization ("CMBS");
4. Collateralized Debt Obligation ("CDO"); and
5. Structured Investment Vehicle ("SIV")

The Board discussed the first two examples and focused their conclusions using View A, which focuses on the design of the entity and what new risks were created and passed along.

On the agency mortgage securitization, there was general agreement that the structure created and passed along credit risk in the form of the agency's guarantee. The guarantee was the only change in the structure. Neither the guarantor nor beneficial interest holder ("BIH") could make changes without the other's consent. As a result, neither was considered the primary beneficiary.

SFG Observation: *The guarantee was not viewed as a variable interest. The certificate holders have exposure to the risks and benefits; however, they do not have any power attached to their economic risks. Preliminarily, the conclusion was that no one would consolidate.*

In this example, the agency mortgage securitization process was viewed as a creator of risk, under which the individual borrower default risk was eliminated and credit risk in the form of the agency guarantee was passed along to the beneficial interest holders. Applying the qualitative model to this structure, the Board was of the view that there is no primary beneficiary.

On the second example (the ABCP conduit), there were more diverse views.

In this example, the sponsor provides a liquidity facility and a line of credit. The credit risk is tranched with the first losses absorbed by the overcollateralization ("OC") from the sellers. Credit exposure in excess of the OC would then be absorbed by the expected loss note holders, and then the letter of credit, and finally by the CP holders.

SFG Observation: *There was general agreement that the OC provided by the sellers was not a variable interest in the ABCP conduit.*

In assessing the design and determining the new risks created, the staff identified:

1. The credit risk of the sponsor in the form of the liquidity facility;
2. The credit risk of the sponsor in the line of credit ("LOC");
3. The tenor and interest rate risk between the assets and the commercial paper issued; and
4. Changes in credit risk due to the pooling and tranching of risk

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SFG Observation: *The staff seems to be moving toward distinguishing between the original risks of the assets and how they are modified in the structure. For example, the allocation of credit risk to the equity linked notes ("ELNs"), LOC and CP holders in sequential order (commonly known as tranching) is not a direct pass through of risks.*

Under View A, the expected loss note holders absorb losses but have no powers related to the created risks, and, therefore, would not be the primary beneficiary.

SFG Observation: *The staff discussed whether events such as an inverted yield curve need to be considered and whether a wind-up or liquidation event should be evaluated. The staff agreed to look into the implications of such an event and whether one needs to look at powers that only exist in specific situations.*

There were also views expressed by some Board members that the LOC and guarantee would be both a creator of credit risk and absorber of the other risks created. The Board and FASB staff were unclear about who had voting power, and directed the staff to clarify the extent of the sponsor's powers.

The staff noted that under this model the design of an entity does not change the risks created unless there is a redesign of the entity. The creators and absorbers of risk are not expected to change; however, the staff noted that their powers may change in certain circumstances.

SFG Observation: *The Board asked the staff to incorporate reputational risk into the analysis, which may give rise to an implied arrangement or guarantee in the structure.*

The Board indicated that they were not ready to formally vote on the model (originally planned for Board meeting on June 4, 2008) until they had worked through the remaining examples and clarified points on the first two examples.

FAS 140

The Board agreed that a beneficial interest received by a transferor, in connection with as sale of an entire financial asset to an entity that is not consolidated by the transferor, should be considered proceeds of the sale if the transfer meets the requirements for sale accounting. In addition, the Board also agreed that the beneficial interest received by the transferor as proceeds of a sale should be initially measured at fair value.

SFG Observation: *Recording the beneficial interest at fair value would represent a change in current practice.*

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A participating interest in a financial asset that continues to be held by a transferor should be initially measured at its allocated carrying amount in accordance with the existing measurement guidance in paragraph 10 of FAS 140.

SFG Observation: *The distinction is that a qualifying participation results in a partial sale of the entire asset.*

In previous deliberations, the Board decided that a participating interest may not be an interest in an equity instrument, a derivative financial instrument, or a hybrid financial instrument with an embedded derivative not clearly and closely related to the original financial asset. A participating interest requires that (1) the cash flows received from the assets are divided among the interests in proportion to the share of ownership represented by each, (2) the participating interest holders have no recourse, other than standard representations and warranties, to the transferor or to each other, (3) no interest holder is subordinated to another, and (4) neither the transferor nor any participating interest holder has the right to pledge or exchange the entire financial asset in which it owns a participating interest.

The Board discussed whether to retain the minimum threshold for transfers to third parties in order to achieve sale accounting. Currently, the Standard requires a 10 percent minimum sale to obtain sale accounting. The Board members seemed to favor deletion of the minimum threshold to recognize a sale.

SFG Observation: *Elimination of the 10 percent requirement acknowledges that if the sale criteria are met (legal isolation and no control), a sale should be recorded. The legal analysis should consider all aspects of the transfer when determining if isolation has been achieved.*

The Board discussed the exception for guaranteed mortgage securitizations and seemed to prefer removing the exception and relying on consolidation accounting guidance to assess whether the transferee should consolidate the entity.

The Board briefly discussed a comment period of 45 days for both FAS 140 and FIN 46R exposure drafts. The Board felt it was too early to make a decision on the exposure period, but acknowledged that a period in excess of 45 days would impede the goal of having the standards in place for 2009.

The Board also discussed implementation of the disclosures and reconsideration event changes for 2009, with the changes to FAS 140 and FIN 46R effective a year later. They noted that the proposed transition provisions were complex, since they suggested grandfathering existing qualifying special purpose entities ("QSPEs") for one year to enable records to be obtained while the guidance would be applied to newly formed variable interest entities ("VIEs") from inception.

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Transfers would be accounted for prospectively under the new guidance.

Disclosures:

The staff provided many new proposed disclosures for FAS 140 and FIN 46R that incorporate:

1. The points raised in the Securities and Exchange Commission's ("SEC") "Dear CFO" letter;
2. Input from the Industry Trade Advisory Center ("ITAC") on what users wanted;
3. Gaps in existing requirements; and
4. Linked-presentation type disclosures

Next Steps:

The Board will meet the week of June 3rd to discuss the following FAS 140 matters:

1. The minimum threshold for transfers;
2. The exception for guaranteed mortgage securitizations; and
3. The new disclosures under FIN 46R and FAS 140

A further education session will likely be planned for next Wednesday, June 4th to further discuss FIN 46R.

The Board still intends to issue exposure drafts on the two standards by the end of June.

Questions

Questions regarding this advisory may be directed to:

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