

Capital Markets
Accounting Developments
Advisory 2004-05

April 23, 2004

**Accounting for
Beneficial Interests in Securitized Financial Assets**

Background

Beneficial interests in securitized financial assets (“BIs”) may be a stand-alone derivative. Alternatively, BIs may be in the form of a hybrid instrument containing an embedded derivative. Under current GAAP, the embedded element usually is not measured at fair value with changes in fair value recognized in earnings.

DIG Issue D1, *Recognition and Measurement of Derivatives: Application of Statement 133 to Beneficial Interests in Securitized Financial Assets*, currently exempts BIs from the scope of Statement of Financial Accounting Standards (“SFAS”) No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

BIs are currently subject to paragraph 14 of SFAS 140, *Accounting for Transfers of and Servicing of Financial Assets and Extinguishments of Liabilities*, where the investor may not “recover substantially all of its recorded investment” due to prepayment or other factors. SFAS 140 requires that these interests be reported as either trading or available-for-sale securities (i.e., fair value) under SFAS 115, *Accounting for Certain Investments in Debt and Equity Securities*.

BIs that are not subject to loss except for credit risk may be classified as held-to-maturity under SFAS 115.

In 2001, the Financial Accounting Standards Board (“FASB” or “Board”) attempted to clarify the application of SFAS 133 to BIs in proposed DIG Issue D2, *Recognition and Measurement of Derivatives: Applying Statement 133 to Beneficial Interests in Securitized Financial Assets (a Resolution of the Issues Raised in Implementation Issue D1)*.

The approach in Issue D2 would have required bifurcation of embedded derivatives in hybrid BIs in accordance with SFAS 133. Many objections from constituents, combined with the complexity of applying the D2 approach, caused the proposal to be dropped.

In January 2004, the Board added a project to its technical agenda to revisit this matter.

Current Developments

In its March meeting, the FASB discussed how an investor (including a transferor) might account for a purchased (or retained) BI in securitized financial interests. The FASB staff presented various alternatives to the Board (see Attachment A).

To expedite the project, the staff asked the Board to identify which of those alternatives the staff should analyze further. The FASB instructed the staff to focus on two approaches:

1. Require an investor in all cases to account for and report BIs “like” a trading security under SFAS 115, or
2. Permit an investor to choose between reporting a BI as (i) trading or (ii) an investment to be analyzed and accounted for as follows:
 - Purchased BIs: based on an analysis of the terms (cash flows) of the BI itself, account for any identified derivative(s) in accordance with SFAS 133, and account for the host contract under SFAS 115.
 - Retained BIs: based on an analysis of the cash flows of the underlying securitized assets, account for any identified derivative(s) in accordance with SFAS 133, and account for the host contract (and any other retained assets) in accordance with other GAAP. (See Attachment B.)

The Board also directed the to staff explore the following related subissues as part of the project:

- Amending SFAS 140 to require transferors to **initially** record any retained interest in a transferred financial asset at its fair value (vs the allocated carryover basis currently called for under SFAS 140); and

- Requiring transferors to recognize at the transfer date a **separate** liability for the implicit (or explicit) credit guarantee arising from the transferor's retention of a residual or subordinate interest in the securitization vehicle.

The FASB staff will identify and evaluate the implications of the two recommended approaches and the foregoing subissues. The staff did not indicate when it next expected to discuss matters with the Board.

SFG Observation: *Articulating a technically robust and operationally feasible framework to guide investors on how to account for retained or purchased BIs in securitized financial assets has not been an easy road for the FASB.*

The vexsome issue has been to identify under what circumstances a BI should be deemed to contain an implicit embedded derivative element (based on the structure of the securitization vehicle, the character of the underlying assets, and/or the economics of the BIs issued) that should be bifurcated and separately accounted for by a BIH.

DIG Issue D1, issued in June 2000, explicitly acknowledged that its guidance was largely a "placeholder," pending the FASB staff's further consideration of SFAS 133 and, possibly, SFAS 125 (SFAS 140's predecessor).

The approach set forth in draft DIG Issue D2 and in the proposed revisions to DIG Issue B12 (which addresses BIs issued by qualifying special-purpose entities as defined by SFAS 140) required an investor to consider both the terms of the BI and the character of the underlying securitized assets when evaluating whether the BI contained an embedded derivative requiring separate accounting. This approach would have required investors in certain cases to recognize an embedded derivative in their purchased or retained BIs. However, that proposed guidance raised numerous implementation issues, leading to the initiative being temporarily shelved.

At the March meeting, both the staff and various Board members acknowledged that the approach mandating "trading-like" accounting for BIs was "not perfect" and represented an expedient response to the problem.

The Board member who supported the two sub-issues indicated that his recommendation stemmed from a concern that retained interests are sometimes "overstated" on a transferor's books because the transferor fails to fully consider the credit risk concentrated in the retained subordinate tranche. He stated that a requirement to record this exposure separately, coupled with remeasuring the obligation at fair value in subsequent reporting periods, might help remedy this problem.

Several Board members expressed concern that a separate carve-out/mark-to-market approach for the credit support element would not necessarily lead to improved financial reporting. In their view, improper carrying values usually result from inappropriate assumptions or modeling, rather than from faulty accounting mechanics.

Next Steps

Stay tuned. The outcome of this project could significantly affect how investors report their purchased interest in certain structured products, and how transferors account for retained residual interests.

Depending on the final decisions reached, the Board may also find it necessary to amend certain parts of SFAS 140, including paragraphs 14, 35 (the criteria for a QSPE) and 56 through 60.

Questions

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EXCERPTS FROM BOARD HANDOUT FOR ITS MARCH 31 MEETING

Three questions are applicable to the alternatives to be considered. The Board's answers to these questions will help in narrowing the number of acceptable alternatives. The questions are:

Question 1: Are there conceptual or other reasons BIs should be excluded from the scope of Statement 133?

Question 2: Should there be a common standard for accounting for retained BIs and purchased BIs or could different standards be applied to the two types of interests?

Question 3: Should the inclusion of BIs in securitized financial assets in the scope of Statement 133 impact the qualified status of an SPE?

ALTERNATIVES

Alternative 1: Permanent Exemption

Specify that BIs in securitized financial assets are excluded from the scope of Statement 133.

Alternative 2: Create a Framework to Identify When BIs Are within the Scope of Statement 133.

Alternative 2a: Create a framework that would look through to the cash flows of the securitized assets.

Alternative 2b: Create a framework that would look to the cash flows of the BIs.

Alternative 2c: Create a framework under with 2a or 2b above that would then allow the election to account for hybrid instruments as trading assets rather than require bifurcation of embedded derivatives.

Alternative 2d: Create framework that would:

- look through to the cash flows of the securitized assets for retained BIs, and
- look to the cash flows of the BIs for purchased BIs.

Alternative 3: Require Statement 115 Trading or Available-for-Sale Classification.

Alternative 3a: Require this treatment for all BIs.

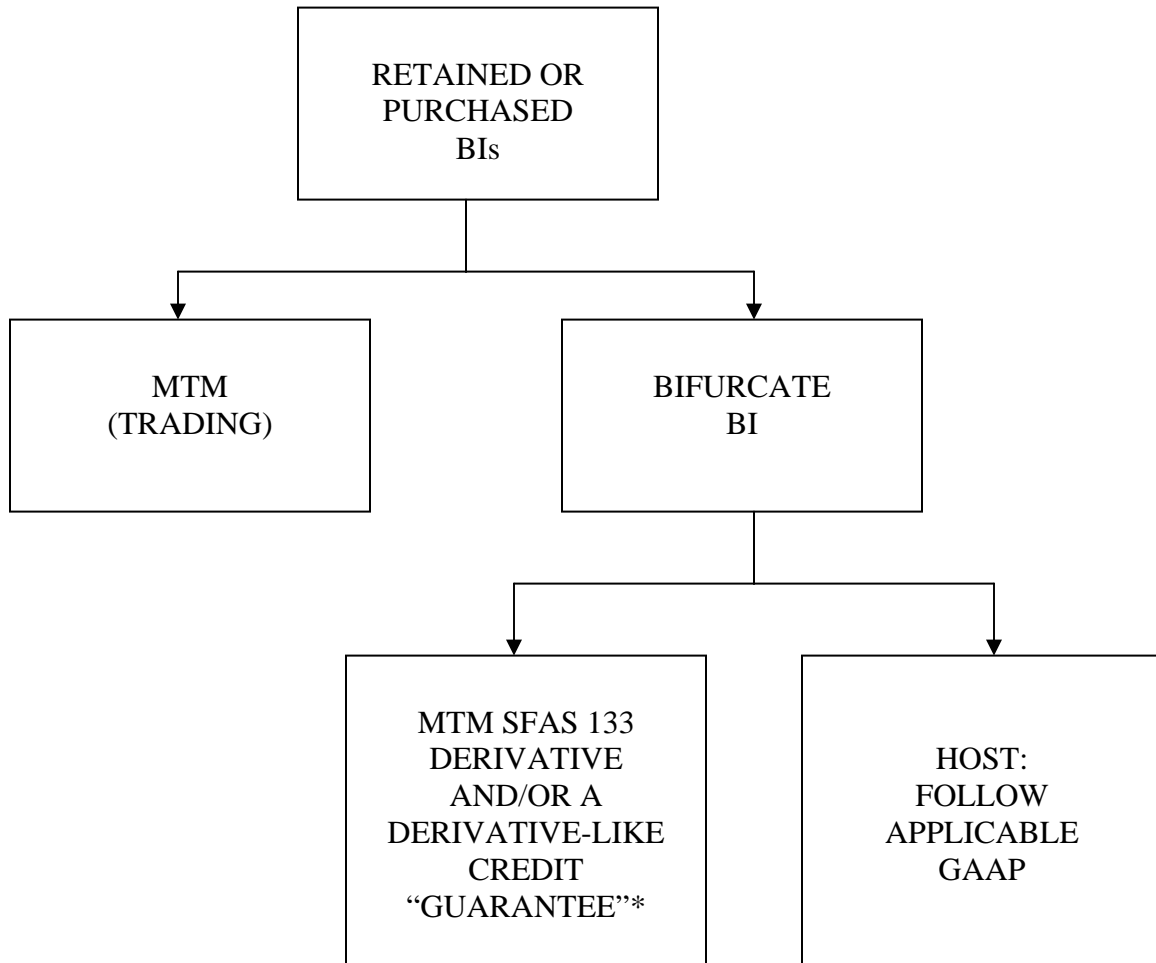
Alternative 3b: Require this treatment for retained BIs.

Alternative 4: Require Statement 115 Trading Classification.

Alternative 4a: Require this treatment for all BIs.

Alternative 4b: Require this treatment for retained BIs.

Potential Decision Tree: Reporting Beneficial Interests in Securitized Assets



*Bifurcation process may focus on the character of the assets/structure of the securitization vehicle and/or the terms of the BIs when assessing whether the terms of the derivative should be considered clearly and closely related to the host contract.