

*Capital Markets  
Accounting Developments  
Advisory 2003-12*

*August 25, 2003*

**FAS 140 Amendment ED  
(Issued on June 2003)**

The Proposed Amendment

On June 10, 2003, The FASB issued an Exposure Draft (ED) of a proposed amendment to FAS 140 entitled, *Qualifying Special-Purpose Entities and Isolation of Transferred Assets, an amendment of FASB Statement No. 140*, with a comment period that ended on July 31, 2003.

The FASB will hold a public roundtable discussion on August 28, 2003 to obtain information from and views of interested individuals and organizations about the ED.

Participants will be limited to those individuals or organizations that had notified the FASB of their interest via email at [director@fasb.org](mailto:director@fasb.org) on or before August 7, 2003 and submitted a position paper or a comment letter addressing the provisions of the proposed Statement by the end of the comment period .

Overview

The ED addresses:

- the ongoing involvement by the transferor in a securitization transaction,
- the ability of a qualifying SPE to hold equity securities or securitize assets without a contractual maturity,
- the use of two-step transfers in a securitization transaction,
- the requirement to achieve legal isolation, and
- the ability to make decisions about reissuing beneficial interests (“BIs”).

The changes and clarifications in the ED will:

- Preclude derecognition by transferors when maintaining effective control of the transferred assets by providing financial support other than a subordinated retained interest or making decisions about re-issuance of BIs,
- Not permit SPEs to qualify for the exception provided by FIN 46 if any party involved is in a position to enhance or protect the value of its own subordinated interest by providing support or making decisions about reissuing BIs.

**SFG Observation:** *The FASB project began with a focus on entities that reissue BIs. The project has now proposed significant changes to the fundamental financial components approach which underlies FAS 140 which was established upon the primary foundations of its predecessor, FAS 125. These proposed changes will fundamentally affect many, if not most, financial asset backed securitization structures.*

### **Support to a QSPE**

For a QSPE to be able to reissue BIs, the FASB has placed a number of constraints on the type of involvement certain parties can have with the QSPE.

**SFG Observation:** *The term reissuance is not defined or fully explained in the ED. The FASB discussions focused primarily on BIs that legally matured and the issuance of new BIs.*

*Questions have arisen on structures that have BIs that have terms that adjust, or are remarketed. This issue's affect on master trust structures is also not clear.*

- A QSPE may **not** hold a commitment from the transferor, its affiliates, or agents **to provide additional cash or assets** to make or support the contracted payments to the BIHs.

**SFG Observation:** *The term commitment is used very broadly. Literally it would preclude reps and warranties that address the validity of the assets transferred (good title, legal obligation, etc.).*

- A party other than the transferor, its affiliates or agents **may** provide such a commitment, within the constraints described below.
- Examples of commitments include:
  - derivative contracts,
  - liquidity commitments,
  - financial guarantees of the beneficial interests,
  - total return swaps,

- written options, and
- commitments to purchase assets or BIs
- The limitations on commitments apply to commitments that are conditional or contingent
- No single party (including affiliates or agents) can be obligated to provide more than 50% of any additional cash or assets to the QSPE.

**SFG Observation:** *The maximum level of support provided under a commitment is capped at 50% by any party.*

*The concept of support is used very broadly.*

*Any obligation to provide cash or other assets under any type of contractual agreement must be analyzed. The substance of the contractual agreement will be the determining factor.*

*The 50% cap seems to be based on the notion that a single party should not provide a majority of the support to a QSPE. This criterion is similar to FIN 46.*

*This language is much broader than earlier versions, and is inconsistent with the basic historical provisions in FAS 140 that use a financial components approach.*

*Transferors, decision makers, or residual interest holders cannot provide any type of commitment that guarantees payments to BIHs (broadly referred to as “liquidity”). Certain servicing advances are permissible. (Refer to footnote to paragraph 35e).*

### **SPEs That Reissue Beneficial Interests**

The ED would limit the support that can be provided to a QSPE when it must periodically reissue BIs.

- No party will provide more than 50% of commitments to provide cash or other assets to a QSPE.
- Any party (including affiliates or agents) that is obligated to provide additional cash or assets cannot make decisions about reissuing beneficial interests.
- Any party (including affiliates or agents) obligated to provide additional cash or assets can only hold BIs that are not the most senior in priority.
- No party (including affiliates or agents) that holds BIs, other than the most senior BIs in the SPE, can be responsible for making decisions about reissuing BIs.

**SFG Observation:** *The amendment will:*

- *limit the size of the liquidity that a single entity can provide,*
- *limit a liquidity provider from having a residual or subordinate interest, and*
- *prohibit any entity that makes decisions about reissuing the beneficial interests from providing liquidity or other support.*

### **Derivative Contracts**

Subparagraph 35(c)(2) is amended to explicitly state that a QSPE may not hold any derivative instruments that transfers risk between the transferor and the SPE.

**SFG Observation:** *The protection provided to BIHs by a transferor's subordinated BI depends on the credit quality of the transferred financial assets. The support is not based on the credit worthiness of the transferor. Subordinate BIs are generally not derivatives and would continue to be permissible.*

*The ED would preclude an affiliate from providing a derivative contract to the QSPE. The proposed limitation will require the transferor to involve more external parties in many of their structures.*

### **Equity Instruments**

A qualifying SPE would not be able to hold equity instruments or assets with contractual maturities extending beyond the end of the planned life of the entity **unless** the governing documents include a pre-specified date of sale and means of disposition within the entity's planned life.

**SFG Observation:** *The Board concluded that equity securities cannot be held by a QSPE. Initially, the Board discussed the limitation on equity securities in the context of FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities (FAS 115).*

*The discussion of equity securities in the ED may apply to equity securities beyond those discussed in FAS 115.*

*The ED uses the term equity securities broadly, therefore the term equity securities needs to be clarified in order to understand whether it is the FASB's intent to apply this prohibition to equity securities as defined in FAS 115 or as defined more broadly in FASB Statement 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity.(FAS 150)*

*Long-term fixed income assets with lives beyond the maturity of the BIs can be held so long as there are explicit wind up provisions.*

## **Legal Isolation**

Paragraph 9(a) and 35(a) of Statement 140 will be amended to clarify that de-recognition of transferred assets is appropriate only if:

- the assets would be beyond the reach of a bankruptcy trustee or other receiver for the transferor, and
- any other **consolidated** affiliate of the transferor that is **not** an SPE designed to make remote the possibility that it would enter bankruptcy or other receivership.

**SFG Observation:** *We understand that the Board's intent is that the transferred assets must be isolated from the **entire consolidated reporting group** of which the transferor is a part (downstream and upstream) as discussed in A16.*

*The Board discussed the ability to obtain legal assurance for transactions with certain attributes, such as affiliate guarantees and derivative contracts. The new language would clarify the requirements for obtaining legal assurance that the assets have been isolated. Refer to Attachment Table 6.*

The ED also proposes certain changes to paragraphs 80 through 84 that will broaden the scope of these paragraphs by

- replacing all of the current references to securitizations with references to “transactions resulting in the issuance of beneficial interests” or simply “transactions” and
- including undivided interest within the scope of beneficial interests as that term is referred to in paragraphs 80 through 84

An additional sentence added to the end of paragraph 83 would also mandate that the second step in a two-step transfer (as described in paragraph 83(b)) be to a qualifying SPE in order for that transfer to meet the requirements in paragraph 9(b) that the transferee has the right to pledge or exchange the transferred assets.

**SFG Observation:** *While we understand that generally the Board's intent with these changes was aimed at stopping transfers that resulted in the transferor providing additional support to a securitization accounted for as a sale outside of a QSPE structure, the addition of the words in paragraphs 80-84 could be interpreted as impacting a broad spectrum of transactions, including loan participations, which are typically sold as an undivided interest in the whole loan and do not require the use of an SPE to achieve legal isolation. Refer to Attachment Table 6.*

## **Effective Dates**

For public entities, the amendment will be effective at the beginning of the **first fiscal quarter after** the final Statement is issued.

For private entities, the amendment will be effective at the end of the first **fiscal year** after the final Statement is issued.

### **Transition Provisions**

*The proposed transition provisions are similar to the transition provisions in paragraph 25 in FASB Statement No. 140 (FAS 140), Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.*

**SFG Observation:** *The transition provisions preserve QSPEs on a grandfathered basis, provided there are no new issuances of BIs or previously uncommitted transfers of financial assets to the QSPE.*

### **Questions**

Questions related to this Advisory should be addressed to:

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Kay Gustafson (646-471-2658)	Todd Sauer (202-414-1473)	Woody Wallace (646-471-2850)

**Changes to the Activities of a QSPE**

- A QSPE cannot hold an asset that requires a cash payment (Note 1) by the transferor (Note 2)
  - Liquidity
  - Guarantees
  - Credit Support
- A QSPE cannot hold a derivative issued by a transferor:
  - Interest rate swap (“IRS”)
  - Options
  - Total return swap (“TRS”)
  - Puts
- A QSPE cannot hold any type of equity securities (FAS 115 and FAS 150?)
- A QSPE cannot hold securities with contractual maturity dates which exceed life of the BI unless:
  - The date, and
  - Process for disposition is specified in the documents

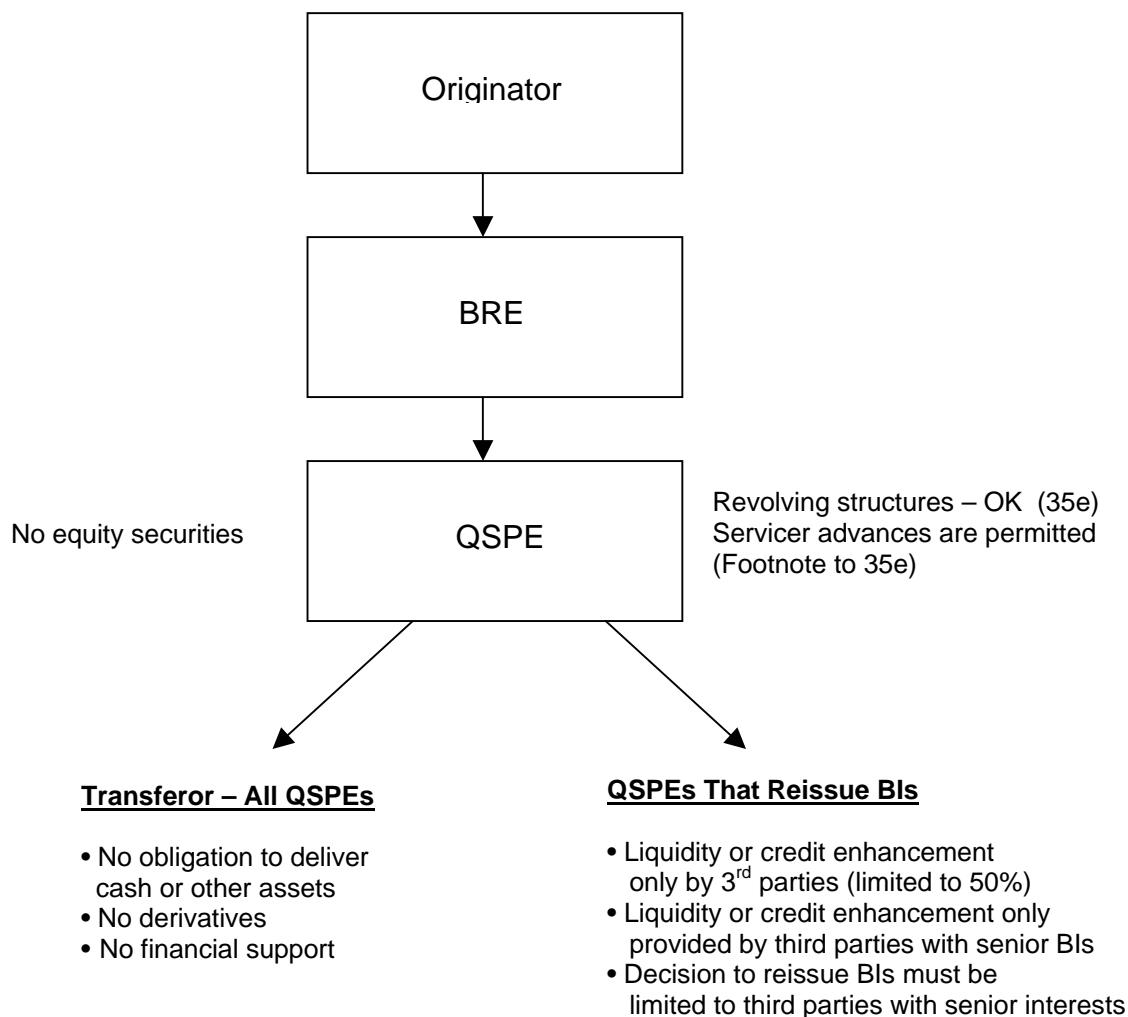
**Notes**

1. The term cash is intended to refer to cash and other assets.
  
2. The term transferor includes affiliates and agents.

**QSPEs That Reissue BIs**

- All liquidity or guarantees are limited to 50% of the assets by a single party
- A party that can make decisions about the reissuance of BIs cannot provide liquidity or guarantees
- A party that makes decisions about the reissuance of BIs can only hold the most senior interests in a SPE
- A transferor cannot provide liquidity or guarantees (paragraph 35e)
- A party providing liquidity or a guarantee can only hold senior interests in the QSPE but not make decisions about the reissuance of BIs

## A Typical Securitization Transaction



### Notes

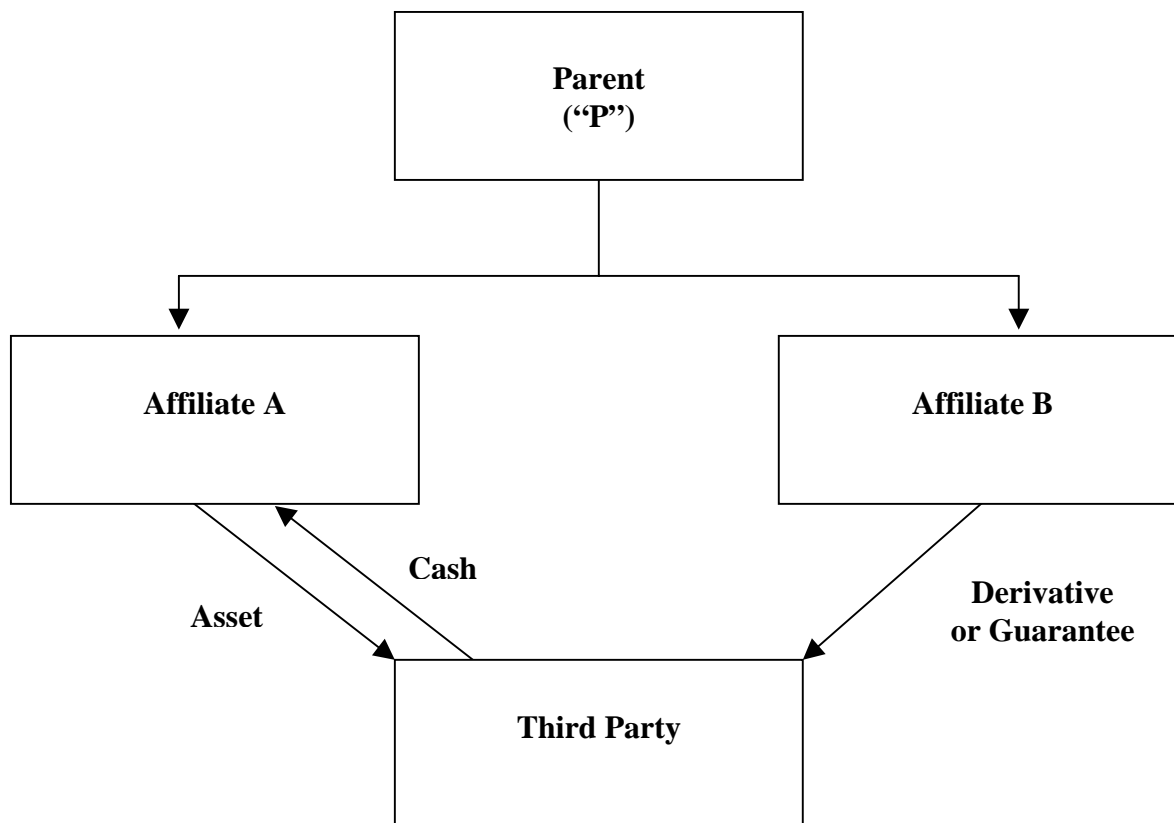
1. Transferor includes affiliates and agents

**Table 4**

	<b>Transferor</b>	<b>Affiliates and Agents</b>	<b>Third Parties</b>
Derivatives (35c2)	Not Permitted	Not Permitted	Permitted - subject to limitations
Forward contract for revolver	Permitted	Permitted	N/A
Liquidity	Not Permitted	Not Permitted	Permitted (Note 1+2)
Financial guarantees	Not Permitted	Not Permitted	Permitted (Note 1+2)
Written options and puts	Not Permitted	Not Permitted	Permitted (Note 1+2)

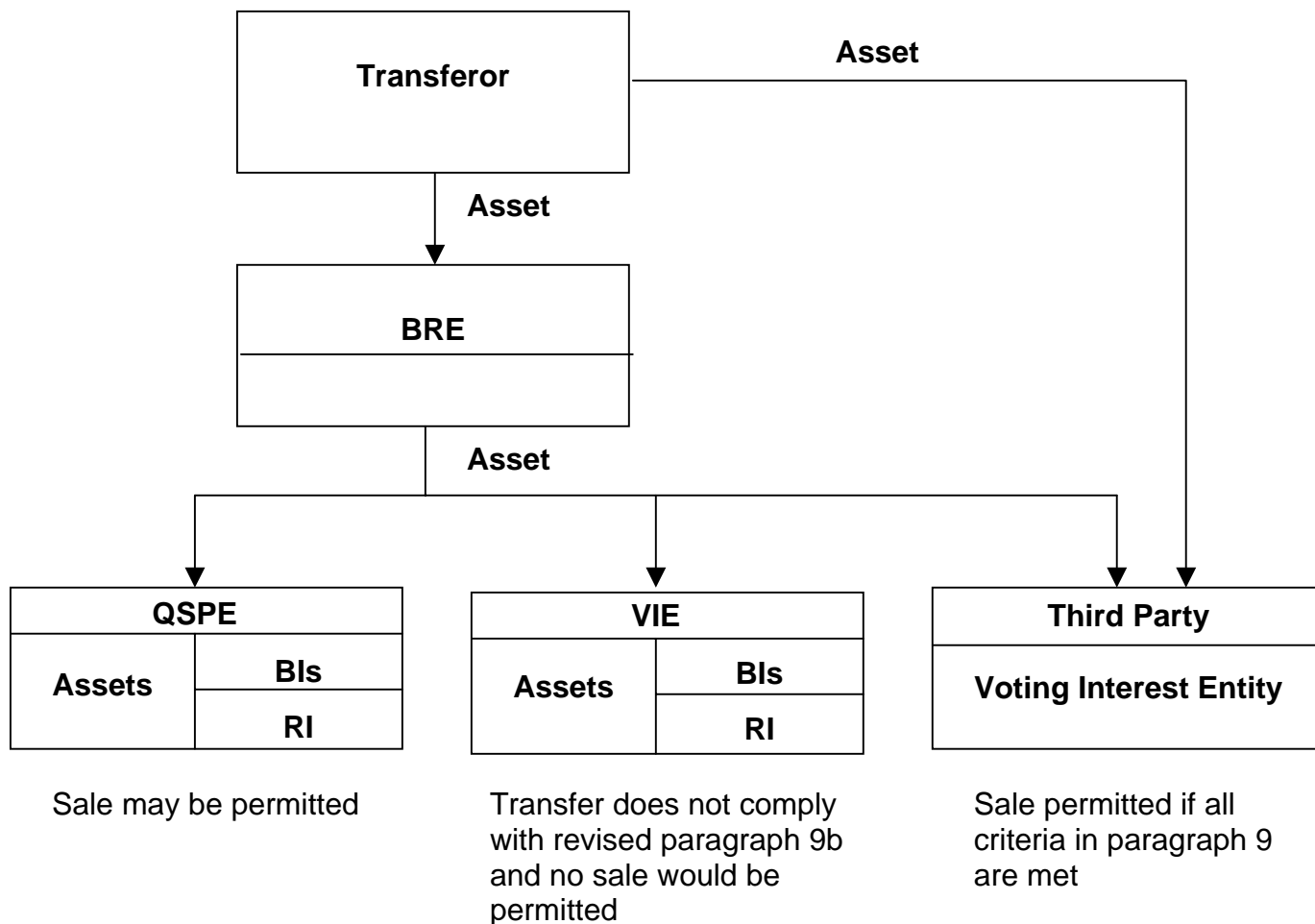
**Notes**

1. Limited to 50% of the fair value of all commitments when the QSPE reissues Bls.
2. Provider can only hold senior beneficial interests.

Illustration of Legal Isolation

**SFG Observation:** The legal analysis should address whether the asset would be considered part of the estate of A, B, and P (which includes A and B) in a bankruptcy or similar proceeding.

**Impact of Revisions to Paragraphs 80 to 84**



**Notes**

1. Transferor provides credit support to BIs by a retained interest ("RI") or other support.
2. The revisions of paragraphs 80 to 84 would include undivided interests as a beneficial interest and require the second step in a financial asset transfer to involve a QSPE. The Board has not provided a clear rationale for the proposed modifications.