

## MINUTES



**To:** Board Members

**From:** Statement 140 Amendment Team  
(Gagon, Ext. 322)

**Subject:** Minutes of the July 27, 2004 Board Meeting      **Date:** August 3, 2004

**cc:** Bielstein, Smith, Petrone, Leisenring, Project Team, Mahoney, Thompson, Vincent, Sutay, Gabriele, Swift, Polley, FASB Intranet (e-mail)

Topic: Qualifying Special-Purpose Entities:  
Legal Isolation and Setoff Rights

Basis for Discussion: Memorandum 32  
dated July 14, 2004

Length of Discussion: 2:25 p.m. to 3:50 p.m.

Attendance:

Board members present:	Herz, Trott, Schipper, Batavick, Crooch, Seidman, and Schieneman
Board members absent:	None
Staff in charge of topic:	Donoghue
Other staff at Board table:	Smith, Lott, Lusniak, and Gagon
Outside participants:	Leisenring (IASB)

**Summary of Decisions Reached:**

The Board discussed a summary of the information about loan participations and setoff rights gathered at the public roundtables and from the letters received in response to the Staff Request for Information. The Board did not make any decisions pending further investigation of possible criteria for consideration of setoff rights. The Board requested that the staff further research whether to:

- a. Require that the transferor waive its setoff rights
- b. Require that the existence of setoff rights by either the transferor or obligor be remote
- c. Require that the risk that setoff rights be exercised by the transferor or the obligor be remote
- d. Require that setoff rights be evaluated like a conditional call that does not disqualify the transfer from being accounted for as a sale until the condition is met.

**Objective of the Board Meeting**

The objectives of the Board meeting were as follows:

1. To discuss a summary of the information about loan participations and setoff rights gathered at the public roundtables and from the letters received in response to the Staff Request for Information.
2. To provide information to Board members about other conditions that may have effects similar to setoff (referred to as dilution by securitization industry participants).
3. To discuss the potential effects of setoff and other dilution risks on accounting for transfers of financial assets.
4. To decide whether to interpret or amend the isolation criterion in paragraph 9(a) of Statement 140.

Objectives 1–3 were met. Objective 4 will be considered again at a Board meeting in August.

**Matters Discussed and Decisions Reached:**

Ms. Donoghue began the meeting by stating that paragraph 9(a) as currently written and interpreted by the Board, would prohibit transfers of assets that are subject to setoff rights from being accounted for as sales. She stated that the Board needs to determine whether paragraph 9(a) or 27 should be amended or clarified to address the issue of setoff. Ms. Donoghue provided the following approaches for the Board's consideration:

- **Approach 1**—Make the current working interpretation of *isolation* official.
- **Approach 2**—Amend paragraph 9(a) or 27 to clarify that transferred assets are isolated if the transfer is judged to be a true sale at law. Do not make the current working definition of isolation official.
- **Approach 3**—Adopt Approach 2 with an additional requirement that the risk that setoff or dilution will have a significant effect on the transferee must be remote.
- a. **Approach 4**—Make the current working interpretation of isolation official but provide an exception for bank loan participations and other types of transfers of financial assets that contain setoff or dilutive rights.

Mr. Trott stated that he believes that Approach 1 explains isolation in a manner consistent with paragraph 9(a). He believes that setoff rights cannot be ignored and that a waiver of all setoff rights should be made by both parties because when either party continues to have setoff rights, the transferor has not relinquished control over the asset and isolation has not been achieved. Mr. Trott favors an approach which requires setoff rights to be eliminated except in those circumstances where he believes it is not feasible to do so, for example, consumer transactions and transactions involving institutions under the jurisdiction of the FDIC.

Mr. Lott asked Mr. Trott if he would extend the requirement for waivers to other dilutive rights such as the right of a purchaser to return goods after the related receivable has been sold. Mr. Trott stated that he would not extend the waiver requirement to other dilutive rights. Mr. Trott stated that he agrees that a true

sale opinion is necessary, but he does not feel that it is sufficient to determine if an asset has been isolated per paragraph 9(a).

Ms. Seidman stated that she supports the staff's recommendation but recommends that the requirement for true sale analysis include consideration of any affiliate recourse as if it had been provided by the transferor and a non-consolidation analysis. Ms. Seidman stated that when attorneys determine whether a transaction constitutes a sale, they assess whether the transferred asset would be consolidated as part of the estate of the seller in bankruptcy or receivership and would be available to satisfy creditors' claims generally. Setoff rights do not result in the asset being included in the seller's estate. Ms. Seidman views setoff and other dilutive rights to be inherent in the asset being transferred. She believes it affects the value of the asset to subsequent holders but does not affect whether the asset has been sold. She stated that purchasers of these assets should be aware of dilutive rights, including setoff, and consider the related risks in setting the price of the assets.

Ms. Seidman further recommended that the banking industry develop a master participation agreement that has all the attributes of a "true participation" to improve consistency in applying the isolation requirement.

Ms. Schipper stated that taking setoff rights and other dilutive rights into consideration in pricing an asset is a good thing, but it is not enough. She stated that her first preference is Approach 1 but realizes that Approach 1 is not likely to get sufficient support. Ms. Schipper believes that pressure should be put on the contracting parties to exercise all possible contractual remedies to make the existence of mutuality as remote as possible.

Mr. Batavick stated that he firmly supports the staff recommendation. He stated that he originally favored Approach 3, but he is convinced that Approach 3 would be very difficult to implement. He stated that Approach 2 is the most practical solution and that sale accounting should not be precluded for an extremely remote risk such as setoff. Furthermore, he believes there is precedent in other accounting literature to rely on legal opinions to determine recognition or

derecognition of assets and liabilities (for example, derecognition of a liability when there is legal release from being the primary obligor). He agrees with Ms. Seidman that these types of risk are factored into the valuation of the asset by the purchaser of the asset.

Mr. Schieneman stated that he believes it is more representationally faithful to account for transactions that are subject to setoff rights as sales, if they can otherwise meet the criteria in paragraph 9. He believes the market already accounts for these as sales and supports the staff's recommendation.

Mr. Crooch stated that his first choice would be to leave the document as is and let the circumstances dictate the answer. However, he is also willing to support Approach 2 with the constraints advocated by Mr. Trott and Ms. Schipper.

Mr. Herz stated that he believes that a true sale opinion is necessary, but not sufficient, for the isolation criteria in paragraph 9(a) as it exists. He has concerns with the approach supported by Messrs. Trott and Crooch and Ms. Schipper because it requires exceptions for the certain transactions (involving consumer trade receivables and the FDIC). He feels that there are only two approaches to consider—Approach 1 or Approach 2. He stated that he would be willing to go with Approach 2 as elaborated by Ms. Seidman. He also stated that he is sympathetic to Messrs. Trott and Crooch and Ms. Schipper's view and would like to explore their approaches further. However, he believes that it is more important that the risk that setoff would be exercised be remote than that the possibility of mutuality be remote.

Mr. Herz asked if transferor setoff rights could be a 9(c) issue. Ms. Donoghue stated that she believed it could be a 9(c) issue and added that the FASB could amend paragraph 9(c) to require that the transferor waive its setoff rights to give up control of the asset. Ms. Seidman disagreed and stated that 9(c) is met when the transferor has the unilateral ability to reclaim the assets; setoff rights do not give the transferor the unilateral ability to reclaim the assets, those rights exist only in bankruptcy or default.

Ms. Seidman recommended an alternative that views setoff rights to be accounted for like a conditional call option because the option (setoff rights) cannot be exercised until a party is in default or bankruptcy. Under Statement 140, transfers with conditional calls are accounted for as sales and when the call condition is met, the transferred assets are brought back onto the books following the guidance in paragraph 55.

The Board did not make any decisions pending further investigation of possible criteria for consideration of setoff rights.

**Follow-up Items:**

The Board requested that the staff further research whether to:

- a. Require that the transferor waive its setoff rights
- b. Require that the existence of setoff rights by either the transferor or obligor be remote
- c. Require that the risk that setoff rights be exercised by the transferor or the obligor be remote
- d. Require that setoff rights be evaluated like a conditional call that does not disqualify the transfer from being accounted for as a sale until the condition is met (the setoff is exercisable).

**General Announcements:**

None.