

PROPOSED FASB STAFF POSITION

No. FAS 140-c

Title: Clarification of the Application of Paragraphs 40(b) and 40(c) of FASB Statement No. 140

Comment Deadline: August 22, 2005

Issue

1. The Board directed the FASB staff to issue this FASB Staff Position (FSP) to clarify the application of paragraphs 40(b) and 40(c) of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

Background and Scope

2. Paragraph 35 of Statement 140 provides conditions that must be met for a trust or other legal entity to be considered a qualifying special-purpose entity (qualifying SPE). One such condition is that a qualifying SPE may hold only passive derivative financial instruments that pertain to beneficial interests issued or sold to parties other than the transferor, its affiliates, or its agents.

3. Paragraph 40 of Statement 140 specifies criteria that must be met for a derivative financial instrument to pertain to beneficial interests issued:

A derivative financial instrument pertains to beneficial interests (other than another derivative financial instrument) issued only if it:

- a. Is entered into (1) when the beneficial interests are issued by the qualifying SPE to parties other than the transferor, its affiliates, or its agents or sold to such other parties after being issued by the qualifying SPE to the transferor, its affiliates, or its agents or (2) when a passive derivative financial instrument needs to be replaced upon occurrence of an event or circumstance (specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds) outside the control of the transferor, its affiliates,

or its agents, for example, when the counterparty to the derivative defaults or is downgraded below a specified threshold

- b. Has a notional amount that does not initially exceed the amount of those beneficial interests and is not expected to exceed them subsequently
- c. Has characteristics that relate to, and partly or fully but not excessively counteract, some risk associated with those beneficial interests or the related transferred assets.

4. The Board decided to limit the notional amount of the derivatives in a qualifying SPE to the amount of beneficial interests held by parties other than the transferor, its affiliates, or its agents (outside parties), to prevent a transferor from avoiding the requirements of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, by transferring derivatives to a qualifying SPE that relate to its own beneficial interests in the qualifying SPE. Paragraph 187 of Statement 140 states, “The Board noted that if the transferor wanted to enter into derivative instruments pertaining to the beneficial interests it holds, it could accomplish that by entering into such derivative instruments on its own behalf, which would be accounted for under Statement 133.” Paragraph 188 of Statement 140 explains that the basis for requiring that the derivatives not excessively counteract the risks associated with the beneficial interests held by parties other than the transferor or its affiliates (the paragraph 40(c) requirement) was to preclude a qualifying SPE from holding a derivative that does not pertain to the beneficial interests held by outside parties.

5. Constituents have raised questions about whether paragraphs 40(b) and 40(c) would require a qualifying SPE to become disqualified if the amount of beneficial interests held by outside parties is reduced to less than the total notional amount of the related derivative financial instruments because of events that were not anticipated at the inception of the qualifying SPE. At the inception of a qualifying SPE, a transferor typically obtains a notional amount of derivatives to mitigate risks for the term of the underlying financial assets based upon a comprehensive analysis of the future payment scenarios at inception (including an estimate of the timing and amounts of prepayments) and the amount of beneficial interests that the transferor expects to be outstanding to outside parties over time. A prepayment that was not contemplated

in the comprehensive analysis (an “unexpected prepayment”) may cause the notional amount of the derivatives held by the qualifying SPE to exceed the amount of the beneficial interests held by parties other than the transferor, its affiliates, and agents. Unexpected prepayment of the qualifying SPE’s assets may cause the derivative notional amount to exceed the beneficial interests held by outside parties as the proceeds from the prepayment of the assets are used to pay down beneficial interests at a faster rate than the amortization, if any, of the derivative.

6. Constituents also have raised questions about whether purchases of beneficial interests by the transferor, its affiliates, or its agents in connection with market-making or trading activities would disqualify a qualifying SPE. For example, a large financial institution may be expected to make a market in the beneficial interests issued by qualifying SPEs that it sponsors. This may result in the transferor, its affiliates, or its agents owning, for a short period of time, some of the beneficial interests issued to outside parties. Alternatively, a large financial institution may have multiple trading desks throughout the world entering into transactions/positions for short periods of time. As the trading desk employees are not prohibited from purchasing beneficial interests issued by qualifying SPE’s sponsored by these institutions because such interests are typically highly rated, the transferor, its affiliates, or its agents may own such interests for a short period of time.

7. Both unexpected prepayments and market-making or trading activities may cause the amount of beneficial interests held by outside parties to be less than the notional amount of the derivative entered into by the qualifying SPE. Some have questioned whether this will cause the disqualification of the qualifying SPE because of paragraph 40(b), as well as paragraph 40(c). This question arises because if the notional amount of the derivative exceeds the amount of beneficial interests held by outside parties, the derivative will excessively counteract the risks associated with the outside party beneficial interests.

8. The soon-to-be-issued Exposure Draft related to qualifying SPEs that would amend Statement 140 is expected to address the issue of whether the notional amount of derivative financial instruments held by a qualifying SPE should be limited to the *total* amount of beneficial interests, including those held by a transferor, its affiliates, and its agents. The purpose of this

FSP is to address the issue of whether unexpected events that occur after the inception of the qualifying SPE that result in the notional amounts of passive derivatives exceeding the amount of beneficial interests held by outside parties should cause an SPE to fail to meet the conditions of a qualifying SPE under the current requirements of Statement 140.

FASB Staff Position

9. The Board believes that the requirements of paragraphs 40(b) and 40(c) must be met when the beneficial interests are issued by the qualifying SPE or when a passive derivative financial instrument needs to be replaced upon the occurrence of a specified event outside of the control of the transferor, its affiliates, or its agents. However, unexpected subsequent events such as prepayment of assets of the qualifying SPE that were not contemplated by a comprehensive analysis of the expected future prepayment scenarios when the beneficial interests of the qualifying SPE were issued would not impair the qualified status of the qualifying SPE.

10. In addition, the Board believes that purchases of beneficial interests through market-making or trading activities must be evaluated as part of a comprehensive analysis of whether, at the time the beneficial interests of the qualifying SPE are issued, the notional amounts of the derivatives are *not expected to exceed the amount of beneficial interests outside the control of the transferor, its affiliates, or agents subsequently*. This comprehensive analysis should anticipate a level of purchases of beneficial interests by the transferor, its affiliates, or its agents in connection with market-making or trading activity that is consistent with the level of outside ownership required by paragraph 36 of Statement 140. Unexpected subsequent events such as unusually high levels of sales by outside parties during a short period of time that were not contemplated by a comprehensive analysis of purchases in connection with market-making or trading activity would not impair the qualified status of the qualifying SPE as long as the level of outside ownership is consistent with the requirements of paragraph 36 of Statement 140.

11. In response to the unexpected prepayment of the qualifying SPE's assets, or purchases of beneficial interests through market-making or trading activities, although the qualifying SPE would not have a change in its qualified status, the Board observes that any remedial action taken

by the qualifying SPE to “rebalance” the derivative amount with the amount of beneficial interests held by parties other than the transferor, its affiliates, or its agents must be taken in accordance with the terms and activities specified in the governing documents of the qualifying SPE at the time it was originally established. That is, all activities¹ must continue to meet the permitted activities limitations of paragraph 35(b) of Statement 140.

Effective Date and Transition

12. The guidance in this FSP shall be applied prospectively to the evaluation of the qualified status of new and existing SPEs after the date the FSP is finalized.

¹ Such activities include, but are not limited to, the selection of a derivative counterparty, the determination of the notional amount, and the timing of the amortization of the notional amount and must be consistent with the activities specified in the legal documents that established the SPE.