Financial Accounting Standards Board

To: Board Members

From: Beneficial Interests in Securitized Financial Assets (Hamilton, ext. 330)

Subject: Minutes of the May 19, 2004 Board Meeting

Date: June 7, 2004

cc: Bielstein, L. Smith, Petrone, Wilkins, Lott, E. Smith, Laurenzano, Hamilton, Thompson, Gabriele, Sutay, FASB Intranet

Topics: Accounting for Beneficial Interests in Securitized Financial Assets

Basis for Discussion: Board memorandum dated May 7.

Length of Discussion: 8:30 a.m. to 9:00 a.m.

Attendance:

Board members present: Herz, Batavick, Crooch, Schieneman, Schipper, Seidman, Trott (by phone)

IASB Board/Staff present: None

Board members absent: None

Staff in charge of topics: E. Smith

Other Staff at Board table: L. Smith, Lott, Wilkins, Laurenzano, Hamilton

Outside Participants: None

Summary of Decisions Reached:

The Board decided that beneficial interests in securitized financial assets should be accounted for at the holder's election:

1. At fair value with changes recognized in earnings, or
2. Through the application of existing accounting literature (without the exemption provided to beneficial interests in Statement 133 Implementation Issue No. D-1, "Application of Statement 133 to Beneficial Interests in Securitized Financial Assets"), with additional guidance to be provided as to how embedded derivatives would be identified.

The Board also outlined issues to be discussed at future meetings on the project, including:

1. Guidance on identification of an embedded derivative
2. Guidance on application of the bifurcation option
3. Impact on the status of qualifying special-purpose entities
4. Subsequent measurement issues and their impact on existing accounting guidance, specifically EITF Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets."

Objective of the Meeting:

The objective of the meeting was for the Board to recommend one of the alternatives identified at the March 31 Board meeting to account for beneficial interests in securitized financial assets.

Matters Discussed:

The staff introduced the Board-recommended options to account for beneficial interests in securitized financial assets.

Alternative A: Fair Value

Account for all beneficial interests at fair value with changes recognized in earnings in the period in which they occur.

Alternative B: Fair Value with a Current Accounting Framework Option

At the holder's election, account for beneficial interests at fair value with changes recognized in earnings, or apply existing accounting literature (without the exemption provided to beneficial interests in Implementation Issue D-1, with additional guidance to be provided as to how embedded derivatives would be identified.

The staff outlined the benefits of Alternative A and Alternative B.

Benefits of Alternative A:

- Conceptually appealing to those who believe fair value is the most relevant attribute for all financial instruments
- Most consistent with the Board's announced intention to require reporting all financial instruments at fair value with changes recognized in earnings
- Simple
- Consistent accounting treatment for all beneficial interests.

Benefits of Alternative B:

- Represents a less significant change from existing GAAP
- Results in similar transactions being accounted for similarly (assuming the bifurcation option is elected) regardless of the form of the transaction
- Considers management's intent in measurement
- More internationally convergent.

The staff stated that, regardless of which alternative is selected, the Board will have to define what constitutes a beneficial interest. The staff further stated that the Board should assess whether the decisions made in this project should apply to all hybrid financial instruments (i.e., whether paragraph 16 of Statement 133 should be amended).

The staff stated that if the Board selects Alternative B, additional steps would need to be taken, including:

- Developing standards on how to evaluate contractual terms to identify embedded derivatives requiring bifurcation for purchased beneficial interests and cash flows for retained beneficial interests
- Developing standards for bifurcation including identification and classification of the host contract
- Addressing issues of how to apply the election embodied in Alternative B (asset by asset, asset type by asset type, entity by entity, etc.)
- Determining whether or not the qualified status of special-purpose entities (SPEs) would be affected by the identification of derivatives in beneficial interests and, if so, whether FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, should be amended to allow previously qualifying SPEs to continue to qualify.
- Determining whether to amend paragraph 14 of Statement 140 to recognize retained beneficial interests as new assets and therefore proceeds (which includes the beneficial interests) from the transfer initially recognized at fair value instead of at original carrying value allocated based on relative fair value of assets sold versus assets retained
- Determining whether to amend paragraph 14 of Statement 140 to recognize credit support as a liability initially and subsequently measured at fair value.

The staff member in charge of the project recommended Alternative B because it incorporates the intent of management into the determination of how to measure beneficial interests.

Mr. Schieneman asked the staff what impact this project may have on the Board's project on mortgage servicing rights (MSRs). The staff stated that while MSRs are a type of beneficial interest, an argument could be made to provide separate guidance for MSRs due to the fact that they are not financial instruments and due to the fact that they contain performance obligations.

Ms. Seidman stated she supports the staff recommendation (Alternative B). She stated that the intent of Implementation Issue D-1 was to provide a temporary exemption for beneficial interests from applying guidance in Statement 140. Ms. Seidman expressed concern that while Alternative A would provide consistency in accounting for beneficial interests, it would not provide consistency in accounting for similar financial instruments. She also viewed Alternative A as an unnecessary broadening of the scope of the project.

Ms. Schipper stated that "management intent" is not discussed anywhere in the conceptual framework. She does not believe that management intent should be considered a determinative factor in determining how to account for financial instruments. She expressed concern with inconsistencies created by the application of Alternative B and specifically referred to divergent methods employed by entities purchasing beneficial interests and entities retaining beneficial interests when determining whether an embedded derivative exists in a beneficial interest[1]. Ms. Schipper believes that constituents would require additional application guidance if Alternative B is selected.

Ms. Schipper maintained that even if management intent was a determinative factor in accounting for beneficial interests, the vast majority of beneficial interests would be accounted for at fair value, whether classified as trading or available-for-sale. Ms. Schipper cited information provided by the staff regarding the current classification of beneficial interests in practice.

Mr. Trott cautioned that he believes that there is a material amount of senior level beneficial interests that have minimal prepayment and credit risk that could be accounted for as held-to-maturity investments.

[1]Under the Board recommended option, p*urchased beneficial interest* holders look to the contractual terms of the interest itself whereas *retained beneficial interest* holders look to the cash flows of the assets securitized and any other assets in the securitization transaction.

Mr. Trott stated that he supports Alternative B. He stated that he believes the Board should spend substantial time and effort addressing issues related to disclosure. He believes the original intent of Statement 140 was to have beneficial interests bifurcated.

Mr. Batavick stated that he supports Alternative B for the reasons outlined by Ms. Seidman and because it is more internationally convergent than Alternative A.

Mr. Schieneman stated that while he prefers the relative simplicity of applying Alternative A, he supports Alternative B.

Mr. Crooch stated that he supports Alternative A because he believes that fair value is the most representative measurement attribute for financial instruments.

Mr. Herz stated that he supports Alternative B because, while fair value is the most relevant measurement attribute for financial instruments, he believes additional progress will need to be made on performance reporting before fair value of financial instruments can be required.

The Board approved Alternative B as the appropriate method to account for beneficial interests. [Five Board members agreed; two did not: KAS, GMC.]

Follow-up Items:

The objective of the meeting was met.

General Announcements:

None