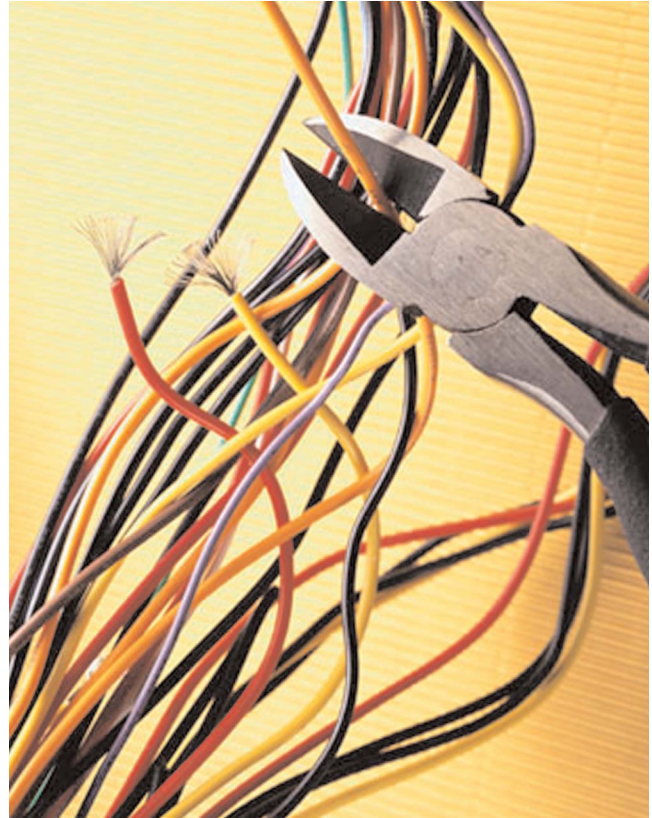


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## Proposal to Limit “QSPE” Off-Balance-Sheet Structures

The FASB is moving to redefine what entities are passive, pass-through financing structures commonly referred to as QSPEs. These securitization structures are exempt from consolidation under the new rules on variable interest entities.<sup>1</sup> The redefinition in a recent exposure draft<sup>2</sup> would require most companies that transfer financial assets to QSPEs to closely examine whether the structures meet the qualifying criteria set out in Statement 140.<sup>3</sup> The proposal’s effective-date and limited grandfathering provisions would leave little time to align structures with the amended definition of a QSPE. The FASB stated that one of its purposes in amending Statement 140 is to prevent companies from extending the concept of a QSPE to avoid consolidation.

Narrowing the definition of a QSPE would affect many companies because QSPEs are commonly used in off-balance-sheet securitization structures. They are often found in transactions that create asset-backed securities. Financial institutions employ QSPEs in the sale of mortgage, credit-card, and auto loans. Finance companies often use them in the sale of leases and consumer loans. For these reasons, rules affecting QSPEs typically bring financial institutions to mind, but the potential effect of the new proposal is wider than that.

Comments on the exposure draft are due by July 31.

(1) FASB Interpretation No. 46, Consolidation of Variable Interest Entities, January 2003.  
 (2) Exposure Draft, Proposed Statement of Financial Accounting Standards, Qualifying Special-Purpose Entities and Isolation of Transferred Assets: an amendment of FASB Statement No. 140, available at [www.FASB.org](http://www.FASB.org).  
 (3) FASB Statement of Financial Accounting No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, September 2000.

## THE NEW CRITERIA

The exposure draft would add to the criteria an entity must meet in order to be a QSPE. The additions are predominantly designed to disqualify an entity from being a QSPE if the transferor has decision-making power over the entity or obligations to it. The proposed requirements seem to be intended to limit QSPEs to passive, pass-through entities, legally distinct and outside the control of the transferor. The criteria already in Statement 140 are similarly designed, but less restrictive than they would be with the additions.

There would be four additional criteria.

(1) An entity would not be a QSPE if the company that transfers assets to it (the transferor) enters into a commitment to provide additional cash or other assets to fulfill the SPE's obligations to beneficial interest holders (the funding entities that invest in the QSPE). This criterion would *preclude* QSPE treatment if the transferor (or its affiliates or agents) entered into any of the following arrangements:

- A derivative financial instrument with the entity (such as an interest rate swap or interest rate cap) that requires the transferor to deliver additional financial assets;
- An agreement (such as a guarantee or liquidity agreement) that requires the transferor to deliver additional cash or other assets to the entity or its beneficial interest holders; or
- A commitment to purchase outstanding beneficial interests directly or indirectly from beneficial interest holders or to otherwise settle beneficial interests with their holders.

(2) Entities that can reissue beneficial interests cannot be QSPEs if any involved party:

- Commits to deliver additional cash or assets to fulfill the entity's obligation to its beneficial interest holders, if the commitment has a fair value of more than half the aggregate fair value of all such commitments to the entity;

- Can make decisions about reissuing beneficial interests and either (a) enters a commitment to deliver additional cash or financial assets to fulfill the SPE's obligation to its beneficial interest holders or (b) holds beneficial interests other than the most senior in priority; or

- Holds beneficial interests other than the most senior in priority and enters into a commitment to deliver additional cash or assets to fulfill the SPE's obligation to its beneficial interest holders.

(3) Entities are not QSPEs unless the transferred assets are isolated from all entities in the consolidated group, "except for certain bankruptcy-remote entities." This is a clarification of a criterion already in Statement 140.

(4) Entities are not QSPEs if they hold equity instruments, including partnership interests as well as equity securities.

The proposed Statement would also clarify that the method and time of the disposition of a QSPE's financial assets that will survive its termination must be specified at the inception of the QSPE.

**Revolving-Period Securitizations.** The FASB noted that the amendment is not intended to cover forward contracts in revolving-period-securitization structures, such as credit-card-securitization structures. However, these structures are likely to run afoul of the proposed amendment for other reasons, such as the ability to reissue beneficial interests, the transferor's involvement in that process, and interest rate swaps or credit guarantees provided by the transferor.

**Two-Step Transfers.** So-called "two-step transfers" are generally used by financial institutions and commercial entities to monetize financial assets and to isolate the assets legally from the transferor. The two steps are, first, the transfer of assets to one entity (e.g., a wholly owned consolidated subsidiary of the transferor), and, second, a follow-on transfer of the same assets to a purchaser, say, a commercial paper

conduit. The original transferor recognizes a sale on the transfer of the assets. Under the proposed requirements, the transferor cannot recognize a sale if the transfer results in the issuance of beneficial interests unless the second transferee is a QSPE.

The proposed change will likely lead many transferors to consider injecting a QSPE into the arrangement to achieve the sale, thereby changing the common two-step transfer into a three-step transfer. The complications and additional costs of injecting the additional structure are unclear at this point.

## EFFECT ON CURRENT ARRANGEMENTS

The proposed redefinition of a QSPE is likely to significantly affect how financial institutions and other companies manage the interest, credit, and liquidity risks they retain in a securitization. Any arrangement that transfers risk back to the transferor and requires delivery of cash or assets would have to be carefully evaluated to see whether it disqualifies the SPE from being a QSPE. Making changes to existing QSPE structures may be difficult and costly, particularly if the QSPE has multiple investors whose holdings have varying maturities. Parties involved with entities that are currently considered QSPEs will also have to evaluate whether the nature of their and others' involvement disqualifies the QSPE. This may prove difficult if they do not have the information or access to it. The parties involved with an entity that fails to meet the amended definition of a QSPE would then have to evaluate whether the entity should be consolidated as a variable interest entity in accordance with Interpretation 46.



Amending a QSPE's contractual arrangements to meet the proposed criteria could be difficult and costly. This is because one of the requirements to be a QSPE is that its governing

documents can be significantly changed only with the approval of the holders of at least a majority of the beneficial interests held by entities other than any transferor, its affiliates, and its agents.

Transferors to QSPE securitization structures would have to critically evaluate all arrangements they have with QSPEs to identify those that fail to meet the criteria in the

proposed Statement. It appears that "normal servicing" arrangements are likely to survive the criteria that disqualify QSPE treatment in arrangements that transfer any form of risk back to the transferor and require cash or assets to be delivered to the SPE, but arrangements with the latter characteristics would have to be scrutinized carefully even if they are part of a standard servicing agreement.

## EFFECTIVE DATE AND TRANSITION

The FASB intends to issue a final Statement in the fourth quarter of 2003. Public companies would have to apply the proposed requirements prospectively to transfers occurring after the beginning of the first quarter after the final Statement is issued (that is, on January 1, 2004). Private companies would apply the Statement prospectively to transfers occurring after the beginning of the first annual period after the final Statement is issued.



The effective date is put in perspective by the proposal's grandfathering provision. A structure that qualified as a QSPE prior to the amendment of Statement 140 would continue to qualify under the old requirements unless the QSPE issues new beneficial interests after the effective date and receives assets other than those it was committed to receive. Thus, only static structures would be grandfathered. The proposal would therefore likely apply to many existing arrangements, leaving little or no time for adjustments to the structures.

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Because of the popularity of QSPEs, the proposal will affect many of the FASB's constituents. Interested parties should provide their comments to the FASB before the July 31 deadline.

The descriptive and summary statements in this presentation pertain to an exposure draft still under consideration by the FASB. Nothing is intended to indicate how to comply with the yet-to-be-issued FASB Statement. Companies addressing the provisions of the finally adopted Statement should base their accounting on the requirements applicable at the time they report and consultation with accounting and legal advisors.

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