

Ernst & Young's On-Call Advisory Alert

June 5, 2008

Accounting Alert

FASB May 28 and June 4, 2008 FIN 46(R)¹ Amendment Education Sessions

Note: Decisions are not made at Education Sessions. Staff recommendations at Education Sessions can change before being voted on at FASB Meetings.

It appears the Board will vote on the matters discussed at the Education Sessions (summarized below) at the June 11 Board Meeting.

PB Determination Principal:

The Staff summarized the following alternatives for determining a “variable interest entity’s” (“VIE”) Primary Beneficiary (“PB,” the party who consolidates the VIE):

View A: PB is the party (if any) qualitatively determined to have a controlling financial interest in a VIE and a VI in the VIE providing more than insignificant VIE risks or benefits. Control is substantive decision-making power through VIs, other interests, or other persuasive characteristics.

If it can't be qualitatively determined whether there is, or is not, a PB, the PB is the party (if any) quantitatively determined to have > 50% of VIE expected loss or residual return (current FIN 46(R) analysis).

View B: PB is the party (if any) with the right to use VIE assets in the same manner it would if they were its own assets (the “Pure Control Model”).

View C: PB is the party (if any) quantitatively determined to absorb > 50% of VIE expected loss or residual return.

Select On-Call Advisory Services Group members:

Lisa D. Filomia-Aktas (212) 773-2833
Hee Lee (212) 773-8605
Timothy Kane (212) 773-3648
Peter Hornecker (212) 773-0227
Kenneth Wilchfort (212) 773-3414
David Thrope (212) 773-0930
Jim Medeiros (212) 773-1884
Mandy Sagar (703) 747-0660
Betty Davis (202) 327-5631
Jennifer Weiner (617) 859-6047

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There did not appear to be Board support for changing the prior Board vote for View A.

The Staff described the following alternatives for determining risks and rewards considered under Views A and C:

Approach 1: Only consider risks created by, or differentially allocated by, the VIE and passed to VI holders; do not consider VIE asset risks passed through to only one VI class.

Approach 2: Consider only risks from VIE net assets that are, by design, passed to VIs (consistent with FSP FIN 46(R)-6).

One Board member appeared to support Approach 1 as a basis for excluding interest rate risk in some cases.

Most Board members appeared to support Approach 2 and for excluding interest rate risk from VIE analyses when consistent with FSP FIN 46(R)-6.

Illustrations:

The Staff described the application of these Views and Approaches to the following transactions, based on the indicated “facts”:

Transaction 1: Single Class GSE Guaranteed RMBS:

- Loan originator transfers loans to GSE,
- GSE transfers the loans to VIE, and
- VIE issues one class of GSE Guaranteed VIs (i.e., the RMBS).

View A: There is no PB as no one controls VIE as it is assumed neither RMBS holders nor GSE can unilaterally change VIE activities. Quantitative analysis is not required.

The Staff indicated some may require quantitative analysis in this case. One Board member indicated such analysis is not required, nor permitted, as no one controls the VIE. He asked that the Amendment be clear in this regard.

Another Board member disagreed with the Staff’s conclusion and indicated GSE is PB as:

- GSE controls VIE by establishing its program parameters and GSE’s ability to purchase defaulted VIE loans, and
- GSE’s guarantee fee and credit loss exposure are VIs under Approach 2 with more than insignificant risks and rewards.

Other Board members appeared to agree with that Board member’s logic, but indicated they were uncomfortable with the conclusion that GSE is PB.

View B: There is no PB as no one can use VIE assets as its own.

View C, Approach 1: A holder (if any) of > 50% of the RMBS is the PB as only GSE credit risk is relevant.

View C Approach 2: GSE or a holder (if any) of > 50% of the RMBS is PB, depending upon the relative magnitude of loan credit risk (absorbed by GSE) and interest/prepayment risk

(absorbed by RMBS holders).

Transaction 2: Multi-Seller Asset Backed Commercial Paper Conduit:

- Conduit is a VIE,
- Conduit's assets are trade receivables,
- The sellers of receivables to Conduit provide over-collateralization that absorbs substantially all receivable credit and Conduit interest rate risk,
- No seller's receivables are > 50% of Conduit assets, and
- Bank is Conduit's administrator and provides Conduit with credit and liquidity support for fixed fees.

View A: (the only View discussed) There is no PB as Bank controls Conduit but does not have a VI with more than insignificant risks and rewards.

It appears this conclusion is based on the Staff's view that:

- Bank's fees are fixed,
- Bank's credit and interest exposure is insignificant relative to the exposure absorbed by receivable seller provided over-collateralization, and
- FIN 46(R) paragraph 12 (interests in assets < 50% of the fair value of all VIE assets are not VIs) does not apply.

Transaction 3: Multi-Class CMBS:

- Commercial loans are transferred to a VIE,
- VIE issues multiple classes of Certificates,
- VIE is match-funded in that both its assets and Certificates have either fixed or floating interest rates,
- Loan transferor is VIE's Servicer,
- VIE's one Residual Certificate holder is, or has the ability to appoint, VIE's Special Servicer,
- VIE's Special Servicer resolves delinquent and defaulted VIE loans, and
- There is little or no VIE loan prepayment risk.

View A: Residual Certificate holder is PB as:

- Residual Certificate holder is, or controls, VIE Special Servicer appointment,
- Special Servicer controls VIE's "problem" loans, giving it power over VIE's principal (i.e., credit) risk, and
- Residual Certificate holder has a VI with more than insignificant risk and reward.

View B: There is no PB as no party can use VIE assets as its own; Special Servicer only controls loans if/when there is a credit event and even then, control only exists over the specific asset.

View C: Residual Certificate holder is PB as it is absorb > 50% of expected loss and residual return.

Transaction 4: Collateralized Debt Obligation (“CDO”):

- Financial assets are transferred to a VIE,
- VIE issues multiple classes of Debt and one class of Equity,
- CDO’s Investment Manager manages CDO assets, subject to Indenture constraints,
- CDO Investment Manager receives a fixed Senior Fee and a Performance Fee (upside participation after CDO Equity achieves a specified rate of return), and
- Investment Manager owns < 50% of CDO Equity that, when combined with its Senior and Performance Fees, does not absorb > 50% of CDO expected loss or residual return.

View A:

No Investment Manager Kickout Rights	Investment Manager is PB as it: <ul style="list-style-type: none"> • Controls CDO and • Has VIs providing more than insignificant VIE risks and rewards.
With Substantive Investment Manager Kickout Rights	Investment Manager is not PB as it does not control CDO.

Two Board members indicated Investment Manager should consolidate in both cases, as they do

not believe Kickout Rights (until exercised) overcome Investment Manager’s control.

The Staff noted the view of those two Board members is inconsistent with non-VIE GAAP, by which a party with majority votes does not consolidate when the minority has “substantive participation rights.” The Staff noted this could affect determination of whether an entity is, or is not a VIE².

While another Board member appeared sympathetic with the view of those two Board members, they asked the Staff to prepare a complete analysis of the application of Kickout Rights for Board consideration.

View B: There is no PB as no party can use VIE assets as its own.

View C: Investment Manager is not PB as it does not absorb > 50% of expected loss or residual return.

Quantitative analysis is necessary to determine if any VI holder is PB.

Transaction 5: Structured Investment Vehicle (“SIV”):

- SIV is a VIE,
- SIV’s assets are high credit quality assets,
- SIV is capitalized with short term Commercial Paper and Capital Notes,
- SIV is managed by Investment Manager, whose fee includes participation in SIV results,
- Investment Manager owns < 50% of SIV’s Capital

Notes that, when combined with its Fees, do not absorb > 50% of expected loss or residual return, and

- If SIV cannot roll over its commercial paper, SIV is to sell all or a portion of its assets to generate cash needed to repay maturing Commercial Paper.

2. The Amendment apply to existing VIEs at the start of the first fiscal year beginning after November 15, 2009, and
3. When the Amendment is first applied, there may be cumulative effect income statement recognition; prior financials would not be restated.

View A:

<p>No Investment Manager Kickout Rights</p>	<p>Investment Manager is PB as it:</p> <ul style="list-style-type: none"> • Controls SIV and • Has VIs with more than insignificant VIE risks and rewards.
<p>With Substantive Investment Manager Kickout Rights</p>	<p>Investment Manager is not PB as it does not control SIV</p>

One Board member suggested the FIN 46(R) Reconsideration Event³ and Disclosure changes (not discussed at the Education Session) be effective as recommended by the Staff, but that all other FIN 46(R) changes be effective as of the start of the first fiscal year beginning after November 15, 2009. This Board member indicated he believes it would be confusing for users of financial statements to have existing structures accounted for under the current guidance and new structures accounted for under the amended guidance during the one year transition period.

Another Board Member indicated he did not believe it would be acceptable to allow new QSPEs during a one year transition period.

View B: There is no PB as no party can use VIE assets as its own.

View C: Investment Manager is not PB as it does not absorb > 50% expected loss or residual return.

Quantitative analysis is required to determine if any VI holder is PB.

Transition and Effective Date:

While not fully discussed, it appeared the Staff recommended:

1. The Amendment apply to new VIEs and new transfers at the start of the first fiscal year beginning after November 15, 2008,

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- ¹ “Consolidation of Variable Interest Entities, an interpretation of ARB No. 51.”
- ² An entity controlled by a Manager with a non-substantive equity investment who is subject to Substantive Kickout Rights (as defined) held by equity holders with a substantive equity investment would likely not be a VIE under FIN 46(R) ¶5(b)(1) as the equity holders have the ability to make decisions having a significant effect on entity success. If Kickout Right are not relevant, such an entity would likely be a VIE under ¶5(b)(1) as its substantive equity would not have the ability to make decisions having a significant effect on entity success.
- ³ The Board previously decided all FIN 46(R) evaluations will be reconsidered each time financials are prepared (i.e., quarterly).