

November 30, 2005
Mr. Lawrence W. Smith
Director—Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856-5116

Re: FSP FIN 46(R)-c, “Determining the Variability to Be Considered In Applying FASB Interpretation No. 46(R)”

Dear Mr. Smith:

The American Securitization Forum (“ASF”), the Commercial Mortgage Securities Association (“CMSA”), the International Swaps and Derivatives Association (“ISDA”), the Securities Industry Association (“SIA”) and The Bond Market Association (“TBMA”) are pleased to offer the following comments in response to the Financial Accounting Standards Board’s (“FASB”) Proposed FASB Staff Position (the “Proposed FSP”) FIN 46(R)-c, “Determining the Variability to Be Considered In Applying FASB Interpretation No. 46(R).”

The comments that follow were developed and are being presented jointly by a working group (the “Joint Industry Working Group”) composed of representatives of the respective accounting policy committees of ASF, CMSA, ISDA, SIA, and TBMA. Collectively, the memberships of these committees have substantial professional expertise and practical experience addressing the accounting policy issues and questions raised by this tentative guidance. A description of our organizations is contained in Attachment I.

The Joint Industry Working Group appreciates the FASB’s efforts to clarify how to determine the variability to consider when applying FASB Interpretation No. 46(R) (“FIN 46(R)”), *Consolidation of Variable Interest Entities*. The Joint Industry Working Group is also supportive of a move to a more qualitative analysis of variable interest entities (“VIEs”) that is inherent in the By-Design Approach and understands the Proposed FSP does not endorse a specific method for determining the primary beneficiary. However, the Joint Industry Working Group believes that the Proposed FSP needs to be modified in order to enhance its usefulness in determining the variability that should be considered when applying FIN 46(R).

We appreciate the examples provided by the FASB in the Proposed FSP, however the rationale for the conclusions in those examples should be clearly articulated and incorporated into the body of the Proposed FSP. The following comments provide our understanding of the principles that we believe the FASB attempted to articulate in the Proposed FSP and how such principles would be applied in each of the examples given the conclusions reached. Overall, we believe that the principles should be more fully and clearly articulated and the application of such principles be clearly demonstrated in each of the examples. Specifically, the example should start with the principle that will be conveyed and the conclusion should reference how the principle was applied to reach the conclusion. In addition, we believe that the approach used to determine the absorbers of the risks designed to be passed along by the entity (identifying the variable interest holders) can be better described.

This comment letter contains the following sections:

1. Diversity in Practice
2. Approach to Determining the Design of the Entity
3. Substantive Subordination as an Indicator of the Design of the Entity
4. Multiple Involvements
5. Foreign Currency Exchange Risk
6. Contracts Which Have Equal and Offsetting Risks Within the Entity
7. Economics Versus Accounting or Legal Form

1. Diversity in Practice

The Proposed FSP indicates that the FASB staff is aware of diversity in practice and at the FASB deliberations a FASB Board member acknowledged that the application of this Proposed FSP could continue to lead to diversity in practice. Since differing conclusions may be reached by different parties reasonably applying this Proposed FSP, we recommend that paragraph 14 of the Proposed FSP be amended with the following language:

“14. Qualitative analyses of the design of the entity, as performed in accordance with the guidance in this FSP and as discussed in Interpretation 46(R), will often be conclusive in determining the variability to consider in applying Interpretation 46(R), determining which interests are variable interests, and ultimately determining which variable interest holder, if any, is the primary beneficiary. Because qualitative analysis often involves subjective judgments as to the relative importance of different types of variability in the design of an entity, different preparers of financial statements may reach different conclusions about similar or even identical structures. While consistency is required within a reporting entity when a preparer is assessing variable interest entities with similar or identical designs, there will often be subjective and qualitative judgments involved in deciding which variable interest entities have similar or identical designs.”

2. Approach to Determining the Design of the Entity

Paragraph 10 describes the types of variability to be considered and paragraph 12 describes the sources that can be used to determine the entity’s design. We suggest the following language be incorporated in paragraph 12 to better clarify the approach to be taken:

- Step 1: Analyze the transaction, including identifying all the risks of the entity
- Step 2: Determine the design of the entity, including which risks in Step 1 should be considered in the FIN46R analysis (the “by-design risks” or “relevant risks”)
- Step 3: Identify the variable interests that absorb the relevant risks identified in Step 2.

In order to determine the design and the relevant risks of an entity in Step 2 consider the following indicators in conjunction with items g-j in paragraph 10 of the Proposed FSP:

- 1) Risks that are absorbed by substantive subordinated interests

2) Neutralized or offsetting risks within the entity (see JIWG's comments on this issue in Section 6)

Explicit acknowledgement that in Step 2 the process of determining the design of the entity and the process of determining the "by-design risks" are interdependent and interrelated would further enhance constituents' understanding of how to apply the Proposed FSP's by-design approach.

We recommend that this approach be followed in the examples so there is a clear indication that all risks identified in Step 1 are not necessarily absorbed by variable interest holders. The determination of the risks the entity was designed to pass along (the "by-design" risks) should be clearly described in each example. For example, in Example 1(b), the explanation for why risk "d" in paragraph in A6 is not a by-design risk should describe that the senior interest rate swap was entered into in order to match the floating rate on the assets to the fixed rate being received by the debt holders, and that the interest rate risk associated with changes in the periodic interest payments was therefore not designed to be passed along to the equity holders.

The Proposed FSP also seems to imply that the FASB believes more weight should be given to risks absorbed by investors who have provided upfront substantive consideration (i.e. cash) to the entity. If this is the case, we recommend the FASB further clarify this point in the Proposed FSP and include the presumption that absent other absorbers of risk, such as a guarantee contract, the risks absorbed by the investors providing the substantive consideration are weighted more heavily in determining the design of the entity. In addition, it would be helpful to explicitly note the application of this principle in the examples.

In addition, practitioners have historically had a view that if a risk was created in an entity, there was an absorber of such risk. The Proposed FSP, along with the accompanying examples, indicates that although certain contracts are creators of risk, there is no corresponding absorber of risk because the entity was not designed to pass along that risk to its variable interest holders. We recommend that the Proposed FSP articulate that even if certain risks are created within an entity, an entity's design may be such that there are no variable interests that absorb such risks.

3. Substantive Subordination as an Indicator of the Design of the Entity

Example 1(b) of the Proposed FSP states that an interest rate swap which is senior in the waterfall is a creator of the entity's variability; however, the analysis provided in the example does not clearly articulate the rationale for the swap being a creator of variability. It appears that the rationale of the swap being a creator of variability is found primarily in paragraph 13 and footnote 5 of paragraph 10 of the Proposed FSP, which state:

"13. For entities that have issued both senior interests and subordinated interests, the determination of what variability should be considered will often be affected by whether the subordination is substantive. If the subordination is substantive, the uncertainty that is absorbed by the subordinated interest is strongly indicated as a variability that is created by the design of the entity." [Footnote omitted]

“⁵In the case of interest rate risk associated with periodic interest payments received or paid by the entity, it may be appropriate to exclude such periodic interest receipts/payments from the variability to consider if the reporting enterprise determines that the entity was not designed to create and pass along interest rate risk associated with such interest receipts/payments to its interest holders. The exclusion of such variability would not eliminate variability caused by interest rate fluctuations that result in variations in cash proceeds received upon anticipated sales of fixed-rate investments in an actively managed portfolio or those held in a static pool that, by-design, will be required to be sold prior to maturity to satisfy obligations of the entity.”

These paragraphs seem to provide the rationale for treating the interest rate swap as a “creator” (defined as discussed in Section 2) of variability. Therefore, the interest rate swap counterparty is not considered a variable interest holder in the FIN 46(R) analysis. We recommend that this principle be more clearly articulated in both Example 1(b) as well as within the body of the Proposed FSP.

Conversely, in Example 2, the swap is embedded in the equity and the conclusions indicate that the entity was designed to pass along both credit and interest rate risk associated with the fixed-rate periodic interest payments from the investments held by the entity. The differentiation between Example 2 and Example 1(b) is that in Example 1(b) the swap is a senior interest, whereas in Example 2 the embedded swap has similar economics to those of a subordinated swap; therefore, the entity in Example 2 is designed to pass along the interest rate variability. We recommend that in Example 2 the FASB clearly articulate the rationale as to why the swap is an absorber of interest rate risk.

Given that this analysis is based on whether the subordination is substantive we also recommend that the Proposed FSP emphasize that the substantive analysis could be determined qualitatively and should not require quantitative analysis.

4. Multiple Involvements

Paragraph A5, footnote 8, of the Proposed FSP reads:

“If the swap counterparty, directly, or through a related party, also held a debt or equity interest in the entity, an analysis of the design of the entity may lead to a conclusion that the swap counterparty was designed to absorb variability that otherwise would have been absorbed by the debt or equity investors, absent the swap transaction.”

In addition, Paragraph A13 of Example 2, states that:

“If the fact pattern were changed such that the entity had entered into an explicit interest rate swap with the equity investor, that interest rate swap would have been considered a variable interest and combined with the equity interest for purposes of determining the entity’s primary beneficiary.”

We do not agree that the design of the entity would change if the swap counterparty held debt or equity in the entity. We understand that all of the variable interests held by a party must be evaluated on a combined basis to determine how much variability they absorb in totality and whether that party is the primary beneficiary. However, we do not believe that the design of the entity would change merely because a party has multiple involvements, and further we do not generally believe that an involvement with an entity that would otherwise not be a variable interest should become a variable interest in the entity just because of the existence of other involvements with the entity. We strongly recommend that the FASB delete the comment in footnote 8 of paragraph A5 or at a minimum clarify that it is intended to be an anti-abuse provision to ensure companies have not embedded the economic characteristics of a subordinated interest in a senior interest rate swap.

5. Foreign Currency Exchange Risk

Example 1(c) of the Proposed FSP indicates that a cross-currency swap is a creator of the entity's variability. The analysis for concluding that the swap is a creator of variability provided in paragraph A10 provides that one of the factors to consider is that the entity was designed for "U.S. debt investors", as opposed to "investors in U.S. debt". The current drafting suggests that the analysis of variability should consider who the investors are and that their functional currency should be taken into consideration. If this consideration is intended, it seems inconsistent with the conclusion reached in Example 1(b), paragraph A7(d), which indicates that the variability caused by the fixed rate debt issued by the entity should not be considered. We would question why the functional currency of the investor is relevant in determining the variability to consider related to the foreign currency exchange risk. We would also question whether the design of the entity should change if non-U.S. entities or multiple investors with different functional currencies were interested in U.S. dollar investments. As discussed in our comments regarding subordination above, we would have thought the conclusion would be based primarily on the fact that the subordinated interest was not designed to absorb the foreign currency risk of the assets.

We recommend that the analysis for foreign exchange variability be similar to that of interest rate variability as described in the Proposed FSP, particularly within paragraphs 10, 12 and 13, inclusive of footnote 5. We request that the FASB clearly articulate this concept for foreign currency exchange variability in the Proposed FSP. We further recommend that the FASB change the wording in Example 1(c) from "U.S. debt investors" to "investors in U.S. dollar denominated debt."

6. Contracts Which Have Equal and Offsetting Risks Within the Entity

Example 6 indicates that in analyzing an entity with a forward contract to sell a commodity and a forward contract to buy the same commodity that was not designed to pass along commodity risk to its investors, an investor would not consider either forward contract as an absorber of risk. While this conclusion that the commodity risk was not designed to be passed along to the debt holders appears consistent with paragraph B12 of FIN 46(R), the associated principle is not fully

articulated in the Proposed FSP; and therefore, when determining the design of the entity, the principle underlying how to analyze contracts that have equal and offsetting risks within an entity is not obvious.

We recommend that the principle that contracts which have equal and offsetting risk within an entity are not variable interests be further specified in the Proposed FSP. The impact of such offsetting contracts is that the risks are neutralized and therefore are not considered in the analysis of the relevant risks. We also recommend that the Proposed FSP further explain that if either of the counterparties to the forward contracts were to default, the debt holders would absorb the risks. This is also consistent with the principle of determining the “by-design risks” by identifying the risks absorbed by the most subordinated interest.

7. Economics Versus Accounting or Legal Form

Paragraph 9 of the Proposed FSP states:

“In all cases, the role of a contract or arrangement in the design of the entity, rather than the legal form or accounting classification of that contract or arrangement, should dictate whether that interest should be treated as creating risk for the entity or absorbing risk from the entity (that is, a variable interest).”

It is not clear whether this paragraph was intended to convey (a) or (b) below:

- a) Accounting classification means whether a contract is classified as an asset, debt, equity or a derivative and that this accounting classification would not impact the design of the entity, OR;
- b) The economics of the contract or arrangement, without regard to the accounting treatment, should drive the determination of the design of the entity.

We recommend that the intended principle be clarified in the body of the Proposed FSP and that the principle’s application be explicitly noted in the Examples. We recommend that Example 5 include a discussion as to whether the variability of the entity is the same whether the entity leases property under an operating lease or financing lease. Similarly, we recommend that Example 4 include a discussion of accounting by the furniture manufacturer for the transaction as a borrowing as well as a sale pursuant to the guidance in Statement No. 49, *Accounting for Product Financing Arrangements*. In addition the conclusion in Example 4 appears to be inconsistent with paragraph B7 of FIN 46(R) that reads, “if the contract with the equity investor represents the only asset of the entity, that equity investment is not at risk.”

If “b” above was the intended principle, we recommend that the Proposed FSP provide a discussion and example as to when the economic analysis would differ from the accounting classification or legal form.

CONCLUSION

The Joint Working Group appreciates the opportunity to provide the foregoing comments. Should you have any questions or desire any clarification concerning the matters addressed in this letter please do not hesitate to contact any of the undersigned at the telephone numbers provided, or George Miller, Executive Director of the ASF at 646.637.9216; or Robert Pickel, Director and CEO of ISDA at 212.901.6020; or Jerry Quinn, Vice President and Associate General Counsel of SIA at 212.618.0507.

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Attachment I

The American Securitization Forum (the “ASF”), an adjunct forum of The Bond Market Association, is a broadly-based professional forum of participants in the U.S. securitization market. Among other roles, the ASF members act as issuers, underwriters, dealers, investors, servicers and professional advisors working on securitization transactions. More information about the ASF and their respective members and activities may be found at the ASF’s internet website, located at www.americansecuritization.com.

CMSA is an international trade organization dedicated to improving the liquidity of commercial mortgage backed securities (“CMBS”) through access to the capital markets. Headquartered in New York City, CMSA has chapters in Canada, Europe, and Japan, and has expanded to more than 300 member firms since it was founded in 1994. CMSA’s members include leading CMSA originators, issuers, investors and service providers, including the largest money-center banks, investment banks, insurance companies, money managers, specialty finance companies, loan servicers and rating agencies. Additional information on CMSA can be found at www.cmbs.org.

ISDA is the global trade association representing leading participants in the privately negotiated derivatives industry. ISDA was chartered in 1985, and today has more than 600 member institutions from 46 countries on six continents. These members include most of the world’s major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. Information about ISDA and its activities is available on the Association’s web site: www.isda.org.

The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker’s Association, brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs 790,600 individuals. Industry personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2003, the industry generated \$213 billion in domestic revenue and an estimated \$283 billion in global revenues. (More information about SIA is available on its home page: www.sia.com.)

The Bond Market Association (“the Association”) represents securities firms and banks that underwrite, distribute and trade debt securities domestically and internationally. The Association’s member firms account for in excess of 95 percent of all primary issuance and secondary market trading activity in the U.S. debt capital markets, including the issuance, underwriting and trading of securitized instruments. More information about the Association and its members and activities may be found at its internet website, located at www.bondmarkets.com.