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November 30, 2000

Mr. Halsey Bullen  
Senior Project Manager  
Financial Accounting Standards Board  
401 Merritt 7  
PO Box 5116  
Norwalk, CT 006856-5116

**Re: FASB Statement No. 140**

Dear Mr. Bullen:

As you are aware, The Bond Market Association (the "Association")<sup>1</sup> has worked extensively as both respondent and field test participant to assist the FASB in enhancing the reporting under Statement 125. We note that Statement 140 has addressed many of our concerns, and we appreciate the cooperation we have received from you and other staff members during the course of this project.

However, we are extremely concerned with the guidance in paragraph 94 of Statement 140. Many readers are interpreting this guidance to require on-balance sheet treatment by a firm that has received securities from a counterparty to secure the firm's loan of securities to that counterparty (commonly referred to in the industry as a "borrow versus pledge" transaction). This represents a significant change from existing GAAP that would have a balance sheet impact in the billions of dollars for many financial institutions.

Our concerns are summarized as follows:

- The guidance in paragraph 94 is premised on a characterization of the transaction that is contrary to legal and business realities. Although Statement 140 concludes in paragraphs 94 and 257 that the securities received in exchange for the securities lent are "proceeds" rather than "collateral," our members do not agree with that conclusion nor is it consistent with the legal or business characterization of the transaction.
- The guidance in paragraph 94 is inconsistent with both the control requirements of paragraph 9 and the collateral requirements of paragraph 15.
- Our members have consistently objected to the recognition of collateral for the reasons we have given in the past.
- Had the new guidance in paragraph 94 been exposed for comment or had the Association been aware that the FASB intended to reach this conclusion, we would have had an opportunity to express our concerns and our views before Statement 140 was finalized.

The Association recommends that the securities received by the securities lender be treated as collateral and governed by paragraph 15(d) of Statement 140.

### **Transaction Analysis**

**Legal Form:** In contrast to the Board's unusual characterization, "borrow versus pledge" transactions are consistently documented as securities lending arrangements involving the loan of certain securities by one party, as lender, to another party, as borrower, against the borrower's pledge of other securities as collateral. The lender does not have ownership of the collateral pledged to it, but takes a security interest in such collateral in order to secure the borrower's obligations under the securities lending arrangement. Dealers confirm these transactions in a manner consistent with the legal documentation.

**Business purposes:** The primary motivation for borrowing against securities rather than cash is efficient inventory and collateral usage. Typically, it is the borrower who drives the transaction, looking to borrow a particular security<sup>2</sup>. In some cases, a borrower may want to borrow a specific security or securities; in other cases, the borrower may want to exchange illiquid securities for liquid securities that can be redeployed elsewhere. An example of the latter is where a borrower has low-grade corporate debt that cannot be used in a cash financing transaction and wishes to exchange it for high-grade government debt, to be used in a separate cash financing transaction (e.g., a repurchase transaction). To accomplish this, the borrower will borrow the high-grade government debt and pledge the low-grade corporate debt as collateral.

**Mechanics:** The mechanics of a typical transaction are as follows: Typically, a borrower provides a security (or pool of securities) as collateral for borrowing a specific security or securities. The collateral may come from either the borrower's excess inventory, (which is recorded on-balance sheet), or it may come from secured borrowing transactions, reverse repo transactions, or from client collateral provided by margin lending (which is not recorded on the balance sheet). The transaction is margined daily, and depending on the market, either the borrower or the lender is typically made whole by providing additional securities.

### **Accounting Concerns**

As noted above, we believe the guidance in paragraph 94 is inconsistent with both the control requirements of paragraph 9 and the collateral requirements of paragraph 15. We summarize our concerns with this accounting treatment as follows:

- We disagree with the assertion in paragraph 94 that the collateral received in "borrow versus pledge" transactions is "proceeds" of the transaction rather than collateral received to secure the transaction. The securities received by the lender as collateral are fundamentally different from purchased assets. Unlike the holder of purchased assets, the holder of the collateral is not entitled to the economic benefits of the security (e.g., interest, dividends, and appreciation) and is encumbered by its promise to return the security.

- In substance, paragraph 94 replaces the gross-up requirement in Statement 125 with a separate gross-up for collateral received from non-cash transactions. We believe that this gross-up is inappropriate for all of the same reasons that led to the elimination of the gross-up brought about by Statement 125.
- The paragraph 94 approach results in two entities recording the same asset, since the transferee is required to recognize an asset that it has not acquired in a purchase and the transferor does not derecognize the asset it has given up. This creates further conflict with paragraph 9 of Statement 140, as follows:

Recording both securities (the security loaned as well as the collateral received) on balance sheet as an asset would lead to distortive and misleading results, due to the fact that only one of the securities is realizable in bankruptcy. This would be inconsistent with the approach in paragraph 9, which looks to the events in bankruptcy in determining whether or not an asset belongs on the balance sheet.

The requirement for the transferee to recognize an asset that the transferor has not derecognized is inconsistent with the sale criteria of paragraph 9 as well as the derecognition criteria of paragraph 11; that is, one party is effectively recording a purchase but the other party is not recording a sale.

- The conclusion that the collateral received should not be treated as such for accounting purposes is inconsistent with the definition of "collateral" in the glossary in Statement 140 itself ("property in which a security interest has been given").
- Under the Bond Market Association's widely used Master Securities Loan Agreement, the securities pledged as collateral secure not only the particular securities loan, but all obligations of the borrower to the lender under other loans made under the same master agreement. This reinforces the point that the securities received are not only characterized as collateral by the legal agreements, but clearly fulfill this purpose.
- In addition, the recently updated AICPA Broker/Dealer Audit and Accounting Guide, in its discussion of securities lending arrangements, clearly states that both cash and securities received are considered collateral: "Collateral, **generally cash**, is received for the securities loaned." (par 4.32) The Guide also includes a footnote on Securities Lending Activities in the example financial statements (exhibit 4.8) that states the following:

"Securities borrowed and securities loaned transactions are generally reported as collateralized financings except where letters of credit **or other securities** are used as collateral. Securities-borrowed transactions require the Company to deposit cash, letters of credit, or other collateral with the lender. With respect to securities loaned, the Company receives collateral in the form of cash or other collateral in an amount generally in excess of the market value of securities loaned. The Company monitors the market value of securities borrowed and loaned on a daily basis, with additional collateral obtained or refunded as necessary."

In summary, we disagree with the concept that the securities received in "borrow versus pledge" transactions should be viewed as proceeds. We are disappointed by the fact that this significant change from existing GAAP was not included in the pre-ballot draft and, therefore, never formally or informally exposed for comment. Accordingly, we believe that this matter merits redeliberation by the Board. We believe appropriate forums for this discussion could include a Staff Announcement, or Q&A language clarifying that securities received by the lender in these transactions is indeed collateral and should be accounted for by applying the guidance in paragraph 15(d) of Statement 140.

Given the pending effective dates for adoption of Statement 140 and the need of many firms to comply with SEC disclosure requirements with respect to impending standards, we ask that the Board treat this as a matter of urgency.

We appreciate your time and attention in this matter. If you have any questions regarding this letter, please do not hesitate to call either myself at (212) 236-6361 or Wendy Fried, Vice President and Associate General Counsel of the Association and Staff Advisor to the Accounting Policy Committee, at (212) 440-9431.

Sincerely,

/s/ Esther Mills

Esther Mills, *Merrill Lynch*  
Chair, Accounting Policy Committee of  
*The Bond Market Association*

cc: Timothy Lucas, Director of Research & Technical Activities, *FASB*  
Wendy Fried, *The Bond Market Association*  
James Johnson, *Deloitte & Touche*, *Special Accounting Advisors to The Bond Market Association*

## FOOTNOTES

1. The Bond Market Association represents securities firms and banks that underwrite, distribute and trade debt securities, both domestically and internationally. This letter was prepared with the participation of the Association's Accounting Policy Committee, which is comprised of in-house accounting and financial management professionals at the Association's member firms, and the Executive Committee of the Association's Funding Division. More information about the Association and its members may be found at its internet website, located at <http://www.bondmarkets.com>.
2. For this reason, although paragraph 94 discusses the lender's accounting for collateral, we have described the transaction from the perspective of the borrower.