

November 30, 2005

Mr. Lawrence W. Smith
Director, TA&I - FSP
Financial Accounting Standards Board
401 Merritt 7
P. O. Box 5116
Norwalk, CT 06856-5116

Re: Proposed FASB Staff Position No. FIN 46(R)-c, "Determining the Variability to Be Considered in Applying FASB Interpretation No. 46(R)"

Dear Mr. Smith:

Deloitte & Touche LLP is pleased to comment on the proposed FASB Staff Position No. FIN 46(R)-c, "Determining the Variability to Be Considered in Applying FASB Interpretation No. 46(R)" (the "proposed FSP"). Clarifications that we believe would make application of the proposed FSP simpler and more operational are detailed below.

Definition of Variable Interest and Swaps

In the interest rate and foreign currency swap examples of the proposed FSP, the principle behind the conclusions that swaps (i.e., instruments that both create and absorb offsetting variability related to the same risk) are typically not designed to absorb variability of the entity and therefore should not be considered variable interests is not readily apparent. We believe this principle should be clearly articulated in the final FSP. If such a principle cannot be clearly articulated, perhaps a practical scope exception would be the best and clearest solution for certain interest rate and foreign currency swaps that both create and absorb offsetting variability related to the same risk. Such a limited scope exception could simplify the application of the proposed FSP and FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities*, and would not appear to undermine the objective of the standards (i.e., "plain-vanilla" interest rate and foreign currency swap instruments by themselves do not provide the counterparty with control or a majority of the risks and rewards of an entity). If the Board finds that a limited scope exception is appropriate, we believe it should include the following criteria: (1) the swap should not be unusually leveraged; (2) the swap should eliminate or significantly reduce an interest rate or foreign currency mismatch between (a) assets and (b) variable interests; and (3) the swap should not be subordinated to other senior interests. If all three of these criteria are met, the swap would be considered a creator of variability; otherwise it would be an absorber of variability.

Combining Interests

The last paragraph of Example 2 states, "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." It is unclear from the proposed FSP (1) when a

preparer would combine a swap with other interests and (2) what impact the combining of interests would have on the determination of whether an interest is a variable interest.

We believe the FSP should explicitly state when multiple interests held by the same enterprise or its related parties should be combined prior to making any determination of whether an interest creates or absorbs variability and how the combined interest should be considered in determining whether it is a creator or absorber of variability. It appears that such clarification could be a further elaboration of the principle started in paragraph B7 of Interpretation 46(R) that multiple interests held and/or issued by a single counterparty are combined when those interests share a common risk.

Paragraph 10 — Consideration of Risks

There appears to be some uncertainty in how to apply the proposed FSP to a structure in which investors are to receive fixed periodic interest payments but are also subject to prepayment risk. The apparent uncertainty involves (1) whether the prepayment risk associated with the investors receiving the periodic interest payments over a shorter period of time (as opposed to through maturity) should be variability to consider, and if so, (2) how that risk should be incorporated into the expected loss calculation. We believe variability associated with prepayment risk should be considered, and that this risk should be captured in the discounted cash flows to be received under each scenario used in the expected loss calculation. We do not believe that prepayment risk should be incorporated into the expected loss calculation by fluctuating the discount rate. If the Board believes prepayment risk should be considered, we suggest that paragraph 10 of the proposed FSP include prepayment risk as a risk that should be considered in determining the nature of the risks that an entity was designed to create and pass along to interest holders in the entity.

Additionally, we believe that in applying the proposed FSP, clarification is needed as to when variability associated with variable periodic interest payments should be considered. For example, an entity is created and financed with variable-rate debt and uses the proceeds to purchase variable rate (same index as the debt) assets. Although there is no interest rate mismatch, the debt holders are subject to interest rate risk associated with the variable periodic cash flows. It is unclear under the by-design approach whether interest rate risk associated with the variable periodic interest payments should be considered or ignored.

Examples

The examples in Appendix A of the proposed FSP are helpful in illustrating the application of the by-design approach. However, we believe additional examples should be included in Appendix A to demonstrate the application of the proposed FSP to non-financial instruments. In particular, we believe more examples are needed demonstrating the analyses used to determine whether forward contracts to sell products to or purchase products from an entity are variable interests. Such examples should consider forward contracts involving fixed prices as well as forward contracts involving variable prices (e.g., market or cost-plus type contracts). These situations are very common, but the principles to be applied to these instruments are unclear (see further discussion within *Example 6* below).

In addition, we believe certain of the examples need further clarification as described below.

Counterparty Credit Risk in Examples 1c, 4, 5, 6

The evaluation of counterparty credit risk in several of the examples is not consistent. In Examples 4 and 5, the conclusion reached was that counterparty credit risk **only** impacts what portion of the underlying variability gets allocated to the guarantors versus the VIE investors. Yet in Examples 1c and 6, credit risk to the cross-currency swap provider or the forward counterparties is specifically a risk of the entity born by the investors. It is not clear why similar circumstances would have differing conclusions.

Example 6

It is unclear in the proposed FSP how an enterprise determines whether a forward contract for a product is a variable interest. In Example 6 of the proposed FSP, the VIE entered into a fixed-price forward purchase and sale agreement for a specified product. The proposed FSP states that the VIE was designed to be in a neutral position with respect to product price risk, through a forward purchase contract and a forward sales contract with terms that are the same (except for price). Therefore, the forward contracts are creators of variability. This concept lacks clarity, because all entities are designed such that all risks are ultimately neutralized. That is, all variability that is created in an entity must be absorbed.

Perhaps, in this example, it is important to the conclusion that the counterparty to the forward sales contract is not entering into that contract with the intent to absorb variability created by the forward purchase contract (e.g., was not involved in forming the entity), but rather is a passive interest holder. However, would the forward sales contract in this example be considered an absorber of variability if the transaction was marketed to the counterparty as a contract that is intended to absorb the price risk that is created by the forward purchase contract (e.g., the counterparty was part of the team solicited to help the electricity producer monetize its positions)? If this is a key consideration in the analysis, the proposed FSP should explicitly state so, and if not, the proposed FSP should clearly state the key considerations in performing the analysis. If intent and perceptions of involvement in the design are important to the analysis, additional guidance developing these concepts are needed as they are currently abstract and will not be consistently interpreted by preparers and auditors.

Additionally, it is unclear how to apply the guidance in the proposed FSP to forward contracts that include a variable price component. For example, the price in both forwards (from Example 6) may include a component that is based on changes in the cost of producing the electricity. In this situation, electricity price risk would still appear to be neutralized from the entity's perspective. If, however, the entity held and operated a plant that produced electricity and the price in the forward contract was based on the costs of the plant, would the forward contract to purchase electricity from the entity still be considered to be in a neutral position with respect to price risk and thus not a variable interest? In the latter case, the contract appears to be protecting the debt and equity holders from variability in costs of operating the plant.

As noted above, the application of the by-design approach can sometimes be based on various perspectives and the determination of which variability to consider could be viewed as being dependent on which perspective one takes. However, there appears to be a theme running through several of the examples — in structured transactions, discerning an entity's design seems to start with the perspective of the cash investors as opposed to the counterparty in executory transactions. If this observation captures an accurate perspective, it would be helpful if the final FSP would add guidance along these lines.

Editorial Comments

- Paragraph 2 should say, "(d) the determination of which party, if any, is the primary beneficiary of the VIE" (addition underlined).
- The reference to a "guarantee of value" in paragraph 6 appears out of place. We do not believe there is diversity in practice in determining whether a guarantee of value is a variable interest. Furthermore, we do not believe a purchased guarantee could ever be in a liability position from the perspective of the entity nor could a written guarantee ever be in an asset position from the perspective of the entity.
- Footnote 7 should state that the determination of whether subordination is substantive should be based on the significance of the subordination rather than whether the subordinated interest will absorb expected losses prior to the senior interest. By definition, an interest that is subordinated to another will absorb specified losses prior to the senior interest. However, if specified losses are nominal or if the subordinated interest is de minimus in comparison to expected specified losses, the subordination may not be substantive.
- Paragraph A21 of the proposed FSP states that the entity was formed so that the lessee will "retain all of the risks and rewards from appreciation or depreciation in value of the leased property." Since the lease is classified as an operating lease, we suggest the wording be changed to from "all" to "a substantial portion."

We appreciate the opportunity to comment on the proposed FSP. If you have any questions concerning our comments, please contact Bob Uhl (203) 761-3705 or Randall Sogoloff (203) 761-3777.

Yours truly,

Deloitte & Touche LLP

cc: Jim Johnson