

Stacey Sutay

From: Len Tatore
Sent: Thursday, October 31, 2002 7:12 AM
To: Stacey Sutay
Cc: Ron Lott
Subject: FW: SPE Consolidation

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FACB SPE



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consolidation Example... xt

Stacey, please log as an SPE comment letter. Thanks.

Len

-----Original Message-----

From: Monson, Dennis [mailto:DennisMonson@kpmg.com]
Sent: Wednesday, October 30, 2002 4:31 PM
To: 'ewtrott@fasb.org'; 'director@fasb.org'
Cc: 'john.e.stewart@us.andersen.com'; Bascom, Kimber K; Tracy, Shaileen M
Subject: SPE Consolidation
Importance: High

Sue and Ed:

Shaileen and Kimber provided me with some examples that I understand the staff put together to test the consequences on various leasing structures of including or not including paragraph 8c from the ED in a final Interpretation on SPE consolidation. If I understand it correctly, the Board and staff currently are trying to decide what to do with the so-called "virtual" SPE issue and are concerned that if paragraph 8c remains in a final Interpretation such virtual SPEs effectively will be scoped out of the document. Since I know that Andersen devoted a significant part of its comment letter to the subject of virtual SPEs and since you (Ed) shared my personal comment letter on the ED with John Stewart before, I have taken the liberty of copying John on this message in which I will share with you my thoughts, for what they are worth.

First of all, I agree that the exclusion of paragraph 8c from the final Interpretation would produce troublesome anomalies in the accounting and I think the examples illustrate that fact quite convincingly. On the other hand, while including paragraph 8c will eliminate such anomalies, I believe Andersen and others are quite correct when they describe the 8c scope exception as a major loophole in terms of permitting companies to avoid the effects of the Interpretation while continuing to engage in off-balance-sheet financing of PP&E. Indeed, my colleagues in Germany who work with the deal structurers have indicated to me that German companies are not concerned about the effect of the Interpretation on their customers who report under US GAAP because they believe that it will be possible to structure deals in SPEs that they would have to consolidate if they reported under US GAAP and, accordingly, that their transactions will be outside of the scope of the Interpretation from their customers' perspective. It appears that the Board will have to choose between the anomalies identified in the examples and the prospect of providing a major loophole that I have no doubt the transaction engineers immediately will move to exploit. There are pros and cons to each position and I haven't found a clear basis for choosing one over the other. I guess the Board will just have to decide

which it thinks is more important.

Second, regardless of whether or not you decide to leave paragraph 8c in your final Interpretation, I am not quite sure what to make of paragraph 17 of the ED which, to the extent I understand it, appears to address "virtual" SPEs created within a larger SPE by contract. I do not understand the language in paragraph 17 - in particular the reference to the interests of the creditors applying "equally to all of its assets" appears to me to be the opposite of the guidance on so-called silos contained in Question 1 of EITF 96-21 but I suspect some of the anomalies surfaced in your examples are likely to manifest themselves within these structures as well if transactions are refinanced or restructured after the initial closing.

Third, I found the examples not very representative of the transactions that actually occur in the marketplace. To the extent that you provide a limited number of examples to illustrate the intended operation of the Interpretation (and I hope you will do so) I would suggest that you make the assumptions track more closely with the way transactions actually are structured. I understand that the numbers used in the examples were intended to produce certain relationships that would allow you to observe the accounting results of various basic structures and the effects on everyone's accounting of modifying those structures at closing and at a later date. However, I think it is important for the credibility of the document that any examples provided to illustrate the operation of the final Interpretation reflect the real relative relationships among lessor, lessee and lenders that occur in actual transactions. To that end, I have included in the attached Word document certain comments concerning changes you should make to the assumptions if you decide to include any of these examples in an appendix to the final document.

Fourth, the examples and related accounting discussion raised in my mind a number of other peripheral issues concerning the intended operation of the proposed Interpretation. These are addressed as well in the attachment to this message. Of greatest concern to me is the operationality of using "expected losses" to measure the variable interests of those parties providing financial support to the SPE. While that concept might be made to work when all of the participants share in losses *pari passu*, I think it will be very difficult to obtain consistent application of the concept in practice and the concept will not represent faithfully the participation of variable interest holders whose exposure to loss is senior to or subordinate to other holders. I do not find the guidance on this subject very in paragraph 20 of the ED very helpful - I don't know how to translate the requirement to give the subordinate interest "more weight" into a conclusion about who is the primary beneficiary. If the intention is that the party holding exposure to first loss is presumed to be the primary beneficiary I think you should just say that and the expected loss calculation is unnecessary. If not, I don't know what to do given that the relationship between senior and subordinated expected losses that we will encounter in practice are likely to be all over the lot. I think the examples provide an excellent opportunity to stress test that approach and I have tried to share with you in the attached document the concerns I identified on this subject while reviewing your examples.

When you move into transactions involving financing leases I think you run head-on into inconsistencies between the FAS 140 concept of control and the underlying risks and rewards approach reflected in the ED. Under some of the scenarios addressed in your examples, it appears to me that you would have entities "consolidating" financial assets that are "controlled" by someone else.

Finally the examples served to remind me of a fact that I have shared with you before but I will repeat again - namely that virtually all leveraged leases I have ever seen were housed in trusts or other entities that would appear to meet the definition of an SPE and, by definition, all transactions

that qualify to be classified as leveraged leases include nonrecourse debt in an amount sufficient to produce substantial leverage. As you deal with the virtual SPE issue, I think you need to be very careful that you do not inadvertently incorporate language into the final Interpretation that will change the accounting for leveraged leases in ways you did not intend.

Having shared with you my comments and observations for whatever they are worth, there are a couple of issues that I would appreciate getting a better understanding of with respect to the Board's intended application of the language in the ED. I tried to send these questions to you (Ed) some time ago but I am not sure whether you ever received them as I have not heard back from you. I was hoping the examples would provide me with some insights that would help me find the answers, but unfortunately, they did not. However, I continue to get questions from others on these points and I do not know how to answer them. If you are unable or unwilling to answer them for me now, I hope you will make the answers clear in any final document you decide to issue. Specifically:

I am having a difficult time determining from the ED when or how the level of equity investment interacts with the notion that an entity that assumes first-loss exposure is potentially the primary beneficiary who should consolidate. Is that always true, regardless of the level of equity and regardless of the magnitude of the first-loss guarantee? Assume for discussion purposes that a partnership is formed for the sole purpose of owning property subject to an operating lease. The entity is an LLC and it is capitalized 100 percent with equity investments from unrelated third parties (e.g., individuals who invest their IRA funds in the LLC). I would be hard-pressed to conclude that this is not an SPE just because it has no debt so I assume it would be within the scope of the Interpretation even is paragraph 8c remains in the final version. Furthermore, it would appear that the entity is capitalized with enough equity to finance all of its operating needs without support from variable interest holders (i.e., it has sufficient cash to purchase the property to be leased without the need to obtain any debt financing). Under the model proposed in the ED, does the presence of a first-loss residual guarantee (i.e., a synthetic lease) create a Primary Beneficiary that must consolidate the LLC? If so, why? If not, why not and either way, how do you get there from the language in the ED?

Obviously, I have used the extreme case in framing the question. However, it is possible to vary both the amount of the equity investment and the magnitude of the first-loss guarantee. If the first-loss guarantee is capped at the first ten percent of the asset's fair value is the lessee still the Primary Beneficiary if the equity investors have a much greater investment at risk? If the SPE is capitalized with 50 percent equity and 50 percent debt is the lessee still the Primary Beneficiary? I do not know how to reconcile the discussion concerning sufficient equity with the discussion suggesting that a first-loss guarantee creates a primary beneficiary with a controlling financial interest in the SPE.

Just so you don't think the only SPEs I see or think about involve leases, what if the assets purchased by the SPE are loans backed by a letter of credit or credit guarantee. Might the issuer of such LOC or guarantee be the Primary Beneficiary because it holds the first-loss position in the entity's assets? What if the original transaction was with a real SOE, the guarantor agreed with that SOE to assume first loss exposure to the assets for a market fee and the originator of the assets subsequently transfers those assets to an SPE in a transaction in which it surrenders control under FAS 140 (possibly without the the guarantor's approval or, perhaps, even without his knowledge). Does the guarantor become a Primary Beneficiary who must consolidate the SPE? What guidance in the ED is intended to help us answer these questions?

I hope you find my comment and observations helpful and I would very much appreciate anything you might be able to share concerning the Board's or

staff's current thinking on the questions I have raised. If you would like to discuss any of my comments further, please do not hesitate to let me know.

Best regards,

Dennis

<<FASB SPE Consolidation Examples.doc>>
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Comments and Observations Re: the FASB's SPE Consolidation Examples

Note: My comments refer to the first example I encountered to which the comment applied. However, in general, I have not repeated the comments with respect to later examples although they may be equally applicable to those examples.

1. **Example 1a:** The amounts assumed for the present value of minimum lease payments is backwards. In virtually all cases the lessee's incremental borrowing rate will be higher than the lessor's implicit interest rate. Therefore, the lessor will compute a higher present value for the lease payments than the lessee.

Prior to the widespread use of so-called synthetic leases, this difference in discount rates was the principal means by which lessees and lessors achieved asymmetrical classification. Virtually all traditional leveraged leases have taken advantage of this difference in lease rates to enable the lessee to have an operating lease while the lessor has a financing type (i.e., leveraged) lease. (And virtually all leveraged leases are housed in trust structures that would appear to meet the definition of an SPE, and therefore, would need to be evaluated for consolidation under the Interpretation.) Perhaps the staff should explore the accounting using an example in which the lease is classified as operating by the lessee and financing by the lessor.

2. **Example 1b:** The changed assumptions concerning expected losses do not appear to be consistent with the other assumptions of the example. Specifically, because the lender incurs no loss until the equity has lost everything, it would be illogical for the lender to conclude that its expected loss is \$2,500 without also expecting that the equity investor would lose his entire \$5,000 investment. It is difficult to conceive of a realistic loss function/probability distribution that would produce the result indicated in the example, in any case. As the firm pointed out in its comment letter on the ED, the use of an expected value calculation based on a statistical probability distribution is not operational because it is prone to produce illogical results when exposures to loss are not *pari passu*. Furthermore, a requirement that each variable interest holder must estimate every other participant's expected loss in order to determine who has the majority of the expected loss or significantly more expected loss will only result in inconsistency in practice as different participants use different loss function/probability distributions for the same transaction.
3. **Example 1b:** The analysis includes the assertion that the structure gives rise to a virtual SPE because "there is only five percent equity in the transaction." However, it would appear that this virtual SPE would satisfy, in substance, all of the conditions in paragraph 9 to be evaluated based upon voting interests – in which case, I presume the lessor would consolidate and an analysis based on variable interests would be unnecessary. Specifically, the fact that an unrelated lender is willing to lend 95 percent of the cost to acquire the asset, secured only by an assignment of the lease payments and the equipment, suggests that five percent equity is all that the market needs to satisfy the requirements of paragraph 9b – unless one takes the view that all loans are a form of financial support provided by a variable interest holder, in which

case it seems that one could never satisfy the literal language in paragraph 9b with anything less than 100 percent equity.

4. **Example 1c, Equity participant, Scenario 2:** I agree that the results are anomalous and they also call into question the premise underlying the Interpretation- i.e., that the party with the greatest variable interest has “control” of the SPE in any meaningful sense.
5. **Example 1c, Equity participant, Scenario 3:** I agree that the results are anomalous. Equally anomalous would be results in which the lessor finances the lease acquisition initially with 100 percent equity or equity and a small amount of recourse debt and six months later (a) refinances with 95% nonrecourse debt or (b) sells the property and lease to a thinly capitalized SPE. Depending on the transaction, either of these scenarios could result in a requirement that the lessee consolidate a virtual or actual SPE that it had no involvement in establishing and of which it may not even have knowledge. In my view all of these anomalies further call into question the underlying premise that the party with the greatest variable interest has “control” of the SPE in any meaningful sense when that party is not the lessor and is not directly involved in the refinancing.
6. **Example 1c, Lender, Scenario 2:** I do not understand the proposed entry. I would have thought that when the lender consolidated the SPE it would eliminate the SPE’s debt against its loan receivable and show a \$5,000 minority interest for the equity investors’ investment. The rest of the effect on the lender’s balance sheet would depend on how it funded the loan - which could be with debt, equity or a combination of the two. However, that part of the lender’s accounting is independent of the consolidation of the SPE.
7. **Example 2b:** It is not clear to me why the expected future losses for the lessee should equal the original time value of the option. Given that it is not possible for the holder of a call option to lose more than the option premium, the use of that value as the expected loss implies that there is a 100 percent probability that the lessee will incur a loss and that it will equal 100 percent of the original time value of the option. In fact, any proper expected value calculation should consider not only the magnitude and probability of losses but also the magnitude and probability of gains from the option which would produce a much smaller expected loss or possibly even an expected gain depending on the type of property leased and, if real estate, its location. As you know, I find it conceptually difficult to justify an approach to consolidation based upon risks and rewards. However, even within such an approach a requirement to focus only on risks and ignore rewards in computing the probability-weighted expected value associated with a position smacks of trying to engineer the outcome rather than to produce a representationally faithful portrayal of the underlying economics of the transaction. Furthermore, as the staff notes in the Lessee Accounting section of this example, the lessee has no recognized assets or liabilities with respect to this lease. Under these circumstances, it is difficult to see how it can incur any accounting loss in this instance.

8. **Example 3a:** The amounts assumed in the changed assumptions do not reflect real conditions likely to occur in the marketplace. I noted in comment 1 that the lessee's calculation of the present value of minimum lease payments is not realistic because it assumes that lessee's the incremental borrowing rate is lower than the lessor's implicit rate. However, if the residual value guarantee is a "first-loss" guarantee, the rates will be the same because the lessee will be able to compute the lessor's implicit rate and must use it if it is lower. With synthetic leases where the lessee and lessor must use the same discount rate to classify the lease under paragraph 7d of SFAS 13, the lessor must purchase additional residual value insurance from a third party if it wants to classify the lease as a financing-type lease. In my experience, this third-party guarantee is always a last-loss guarantee (i.e., the guarantor agrees to make a payment only if the fair value of the leased asset cannot be sold for a price in excess of a stated amount) because such guarantees have virtually no risk and, therefore, the premium required to obtain the guarantee is nominal in relation to the guaranteed amount.
9. **Example 3b:** As noted in comment 8 above, the lessee's residual value guarantee could be a first-loss guarantee of a last-loss guarantee – the facts don't say. If it is a last loss guarantee, the lessee guarantees that the asset will be worth at least \$10,000. In order for the lessee to lose even \$1 on such a guarantee, the lessor and lenders would have to lose substantial amounts (i.e., \$16,000 and \$9,000, respectively) first. If the expected residual is \$35,000, the probability that the lessee would lose anything on its guarantee is very small and the expected loss would be very small. It certainly would be much smaller than the expected losses of either the lessor or the lenders. On the other hand, if the guarantee is a first-loss guarantee neither the lessor nor the lenders would lose anything until the lessee had lost the full \$10,000 amount of the guarantee. This only further illustrates the operationality problems of the expected loss concept as the means for identifying the primary beneficiary of an SPE when risks and benefits are not shared *pari passu* by all participants. This issue will become even more important when we get to the examples in which a third party provides a residual value guarantee to convert the lease from operating to financing from the lessor's perspective because, in my experience, such guarantees usually are last-loss guarantees.
10. **Example 3b, Lessor Accounting, View A:** The verbal description of the accounting indicates that the lessor would "deconsolidate" the virtual SPE and recognize a \$5,000 investment and the \$95,000 of nonrecourse debt. I recognize that the nonrecourse loan would not qualify to be treated as having been extinguished under paragraph 16 of SFAS 140. However, if the nonrecourse debt is what cause the transaction to become a virtual SPE, I do not understand why the lessor would not "deconsolidate" the entire virtual SPE, including its debt, and not just the assets. "Consolidating" only the assets of a virtual SPE seems to me to be a whole new approach to consolidation procedure which is difficult to justify, conceptually, and, in any case, hardly seems appropriate for what purports to be an Interpretation of ARB 51.

11. **Example 3b, Lessor Accounting, View B:** I do not understand the words describing this view and, accordingly, I guess I don't understand the view. If the transaction constitutes a virtual SPE, the conclusion that the lessor would "not consolidate the 'virtual' SPE" but nevertheless would record the assets and debt that constitute the virtual SPE sounds like sophistry at best and nonsense at worst. I am at a loss to understand what not consolidating the virtual SPE could mean if it does not mean excluding the virtual SPE's assets and liabilities from the lessor's consolidated financial statements.
12. **Example 3b, Lessor Accounting, View B, Lessee Accounting:** I do not understand the proposed accounting for the lessee. If the lessee is "consolidating" an SPE that has \$95,000 of debt and \$5,000 of equity, I would expect the lessee's consolidated balance sheet to reflect the asset, the debt and a \$5,000 minority interest. Assuming that the FASB goes forward with its intention to declare minority interests a part of equity, it would appear that "consolidation" of the virtual SPE in this example should result in an increase in the lessee's equity for the amount of the asset acquisition cost that was not paid for with the proceeds of the nonrecourse loan that caused the transaction to be transformed into a virtual SPE in the first place.
13. **Example 4b:** A couple of observations about the facts assumed for this example. First, in addition to the fact that the assumed present value of minimum rentals is backwards (i.e., the lessor's present value should be higher than the lessee's and, in reality the lease term would be 7.4 years and the lessee's present value of the minimum rental payments would be under 90 percent while the lessor's would be over 90 percent), in my experience the unamortized balance of the debt funding at the end of the lease term would be zero or very close to zero. This is because nonrecourse loans are secured by a pledge of the lease payments and such lenders generally require that most if not all of the collected lease payments go towards servicing the debt until it is fully amortized. Second, it is virtually certain that the lessor would classify and account for this lease as a leveraged lease unless the nonrecourse debt was put in place some time after the commencement of the lease – i.e., the transaction was converted into a virtual SPE well after the closing.
14. **Example 4c, Equity Participant Accounting, Scenario 2:** Here the proposed accounting would result in the lessor's derecognizing its investment in a finance lease, a financial asset within the scope of SFAS 140, without surrendering "control" of that asset in accordance with paragraph 9 of that Statement. Furthermore, the lender would record a financial asset that it does not "control" under the guidance in paragraph 9. It is difficult, if not impossible, to reconcile the control concepts of SFAS 140 with the notion that the party holding a financial instrument that exposes it to significantly more *expected loss* than any other party has a "controlling" financial interest in the entity issuing that interest when it does not control that entity's assets. Indeed, under SFAS 140, a transferor is required to derecognize a financial asset that it does not control - even if it retains all of the risks associated with the asset as a result, for example, of providing an unlimited recourse guarantee - yet this proposal

would have a lender recognizing, under a theory of consolidation, financial assets it does not control under SFAS 140. Note that this comment applies to stand-alone SPEs even if the Board decides to keep paragraph 8c and ignore virtual SPEs.

15. **Example 6b, Equity Participant Accounting, Scenario 2:** As noted previously, in practice virtually all leveraged lease transactions are housed in trusts with the equity participants contributing their equity contribution in exchange for a beneficial interest in the trust. If one views these trusts as separate accounting entities that must classify and account for their lease independent of their owner(s), virtually none of these leases would qualify as leveraged leases under paragraph 42 of SFAS 13 because the trusts do not pay income taxes directly and, accordingly, their after-tax cash flows would not evidence the decline-rise-decline pattern required under paragraph 42d to qualify as a leveraged lease. Under existing practice, the holder of the beneficial interest in the trust performs the paragraph 42d test by combining the cash flows of the trust with its own tax cash flows that result from including the taxable income or tax loss generated by the trust in the investor's consolidated tax return. If the combined after-tax cash flows satisfy the paragraph 42d test they account for their investment in the trust as an investment in a leveraged lease. Currently, when multiple equity participants hold interests in such a trust formed to invest in a leveraged lease, each participant combines its proportionate share of the cash flows from the trust with its own tax cash flows, resulting from the trust's pass-through of its tax attributes, and evaluated those net cash flows under the provisions of paragraph 42c. Assuming they satisfy those provisions, each investor accounts for its equity investment as an investment in a leveraged lease. While some have compared this to proportionate consolidation of the trust, I believe that it is more akin to accounting for undivided interests in an asset. In any case, the Board needs to be aware that by introducing the issue of consolidation into these transactions it may be altering long-standing practices with respect to accounting for leveraged leases.
16. **Example 8a:** The proposed accounting does not include any accounting for the premium paid to obtain the residual value guarantee. Interpretation 19 says that regardless of who pays the premium it should be treated as an executory cost which is not included in the minimum lease payments but, nevertheless has to be accounted for - by the lessee at a minimum and by whoever pays it as well if it is someone other than the lessee.
17. **Example 8b:** The assumed magnitude of the third-party guarantor's expected future loss is not consistent with the assumption that the guarantor in a substantive entity in business to make a profit. No such entity would charge \$1,000 for a guarantee if it estimated that its future losses determined using a probability-weighted expected value calculation would be \$3,000. Such a guarantor could get better odds than that in Las Vegas. Furthermore, as noted previously, many residual value insurance policies provide last-loss coverage which means that the guarantor would only incur an actual loss after the other participants have sustained significant losses. Finally, if the residual value insurer could cause the primary beneficiary to change as a result of its obtaining reinsurance, how would the other participants even know of that change

and, if such a change occurred without the “new” primary beneficiary’s knowledge or involvement, in what sense could the new primary beneficiary be said to “control” the SPE whether it is an actual or virtual SPE?