

**RBC FINANCIAL GROUP**

October 10, 2003

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

**RE: PROPOSED FASB STAFF POSITION 46-D**

RBC Financial Group would like to thank the Financial Accounting Standards Board (“FASB”) for this opportunity to comment on the FSP 46-d. As described in the notes to our third quarter interim financial statements (appended), FIN 46 has several unexpected consequences. In particular, these are mutual funds sponsored by us and trust arrangements where we act as trustee of assets settled by our personal clients, in addition to the impact on the multi-seller asset-backed commercial paper conduits (“multisellers”) administered by us. We appreciate this opportunity to voice our concerns with these unexpected consequences and provide our suggestions to address them.

Our comments are divided into the following:

- Decision-maker fees – double counting
- Decision-maker fees – fair value
- Decision-maker fees – fixed or variable
- Controlling financial interest
- Allocation of expected losses and expected residual returns

**Decision-maker fees – double counting**

The proposed methodology in FSP 46-d to allocate expected residual returns to the various variable interest holders results in double counting of fees. The FSP requires that variability in net income be determined from the perspective of the variable interest holders. Thus, decision-maker fees would be added back to net income and such grossed-up net income would then be subject to a calculation of variability. Variability in decision-maker fees would be allocated to the decision-maker. FIN 46 also requires the fair value of decision-

maker fees to be included in expected residual returns. This results in double-counting in expected residual returns to the extent of the amount of variability in such fees.

We consider such double counting to be an artificial element in the determination of primary beneficiary and therefore ask that fees be considered only once in the determination of expected residual returns. If they are paid to a decision-maker or substantial guarantor, then the fair value of such fees only should be included in expected residual returns but not their variability. The variability in these fees should be included in expected losses, and in expected residual returns only if the recipient is not a decision-maker or substantial guarantor.

#### **Decision-maker fees – fair value**

FSP 46-d requires the inclusion of paragraph 8 fees in expected residual returns at their fair value. Fair value has been defined as a probability-weighted mean based on the same cash flows and assumptions used to calculate the expected losses of the entity. This definition ignores the obligations that the recipient of the fee is required to perform. All service contracts entail obligations on the part of the fee recipient. The proposed definition of fair value in FSP 46-d ignores the cost of fulfilling these obligations. Concept statement 7 requires that such costs be considered in determining the fair value of liabilities (reference paragraphs 117 and 118 of Concept statement 7). FSP 46-d ignores this component which is an integral part of the service contract. It focuses only on the revenue stream. We believe that the entire service contract should be fair valued in accordance with Concept statement 7, not just the revenue stream.

#### **Decision-maker fees – fixed or variable**

FSP 46-d states that “Even if a paragraph 8 fee is a fixed amount and will absorb no losses in any of the estimated outcomes used to determine expected losses of the entity, the fee is a variable interest because it will receive a portion of the expected residual returns of the entity if they occur.” This proposal further exacerbates our concern with respect to the unexpected consequences for mutual funds and personal trusts.

FSP 46-c states that the existence of “kick-out” rights does not affect the status of a decision-maker. Combined together, these two proposals result in conclusions which we believe will result in misleading financial statements. We have described these conclusions in the appendix. In summary, we would be considered a decision-maker in our capacity as an investment manager or trustee regardless of others’ ability to remove us from these positions. We would be the primary beneficiary where the fair value of our fees exceeds the variability that the investors or beneficiaries are exposed to. This conclusion is an extreme outcome of applying the various FSP proposals in combination. To reiterate, these proposals would require us to:

- (i) consider ourselves a decision-maker even when others can remove us,

- (ii) include the probability-weighted mean value of our fees in expected residual returns, ignoring the cost of the obligations that are required to be fulfilled to satisfy the service contract,
- (iii) ignore the fact that our decision-making is circumscribed by the contractual arrangements agreed upon by the investors at the time of their initial investment,
- (iv) ignore the fact that there are other expedient ways in which investors can control their interests, for example by “voting with their feet”,
- (v) ignore the fact that our decision-making ability is to be exercised on behalf of our clients. These clients have legal recourse if we fail to protect their interests or put our personal interests above theirs,
- (vi) in spite of all of the above, skew the calculations such that average fees we earn are compared to variability faced by the other investors.

We do not believe this results in better financial reporting, when we have to consolidate such mutual funds or trusts with low volatility assets but not consolidate the same structures that have more volatile assets.

The premise of FIN 46 is a determination of primary beneficiary based on expected variability. In suggesting that fixed fees can be a variable interest if paid to a decision-maker, FSP 46-d has ignored this premise. Suggesting that a decision-making role takes precedence over variability in applying FIN 46, is a significant departure from the rationale in paragraph C31 of FIN 46 which states that “The ability to make decisions is not a variable interest, but if the decisions significantly affect the value of the variable interests, decision making will almost certainly be directly or indirectly associated with the holder of a significant variable interest. For that reason, decision-making is an indicator of the primary beneficiary of a variable interest entity. A majority of either the exposure to expected losses or the right to receive expected residual returns (or both) identifies the primary beneficiary. The Board considered the exposure to losses to be the more important of the two conditions and established it as the more important factor if one enterprise has a majority of the exposure to expected losses and another has a right to a majority of the residual returns.”

We realize that FSP 46-d purports to create an exemption for certain types of fees. This sentence states “Fees described in paragraph 8 will always be variable interests in the entity, unless the fees are excluded from paragraph 8(c) by other guidance.” We believe this other guidance should cover fees that are either fixed dollars or a fixed percentage of net asset value. We appreciate the concern that you may have with scoping out fees that are a fixed percentage of assets in situations where such fees are subordinate or have performance incentives. Both these objectives can be achieved by crafting an exception for fees that are fixed, whether in dollar amounts or as a percentage of assets, except where they are otherwise subject to expected losses or expected residual returns. This will maintain variability as the primary consideration while at the same time ensuring that a simple variability based on net asset value does not lead to consolidation of an entity with low volatility assets by such an entity’s manager.

## **Controlling financial interest**

A central theme and a source of concern in the above is the definition of a decision-maker of a variable interest entity (“VIE”). We do not understand the rationale behind a difference in the definition of a decision-maker for a VIE versus a non-VIE. FSP 46-c disregards “kick-out” provisions. Yet EITF 97-2 continues to require “exclusive” authority over all decision making in order to prove control.

FSP 46-d focuses exclusively on fees as the financial interest of a decision-maker. Yet EITF 97-2, in addition to fees, requires other criteria to be met. It requires that the financial interest of the manager be unilaterally salable and requires a facts and circumstances based determination, which includes fees and proceeds from the sale of the interest, of whether it is significant. A comparison of paragraph 8 fees to variability faced by other variable interests results in an inequitable determination of the entity with a controlling financial interest that is inconsistent with other GAAP and compromises a substance-based application.

We ask that “kick-out” rights be reinstated as a legitimate means of proving that an entity is not a decision-maker if it can be “kicked out” of that position by the investors or other parties.

## **Allocation of expected losses and expected residual returns**

FSP 46-d provides an example of allocating expected losses and expected residual returns to the various variable interest holders. The proposed approach requires us to consider a scenario that is equal to the expected outcome less the expected loss amount or plus the expected residual returns amount. The share of each variable interest holder is then determined in this scenario and in the expected scenario. The difference between the two is the expected loss or expected residual return.

This allocation method has limited applicability. Consider an entity that is exposed to more than one source of variability, and each source of variability is shared differently by the various variable interest holders. When estimating the entity’s cash flows, there could be several combinations of the various variables leading to the same cash flow estimate. As such, there could be various ways in which the variable interest holders can share such a cash flow estimate depending on the source of variability.

We fail to see how the proposed methodology can be objectively applied where there are several factors that can individually cause losses to equal the expected loss amount. The various variable interest holders may share each such loss differently depending on the factor contributing to such losses. As such we disagree with the proposed methodology.

In conclusion, we commend you for the expeditious approach to addressing a current financial reporting and accounting need. We agree that more interpretative guidance is required to apply this complex accounting standard in a consistent manner across

jurisdictions and hope that our comments and suggestions will enable such a consistent interpretation framework.

Should you have any questions or desire any clarification concerning the matters addressed in this letter, please do not hesitate to contact myself at 416-955-7876.

Yours sincerely,

Linda Mezon  
Vice President, Accounting Policy  
RBC Financial Group

## Appendix

Extract from the Notes to our third quarter financial statements:

### *Mutual Funds*

We sponsor several open-end mutual funds which at July 31, 2003 had assets totalling \$56 billion. We are involved with their ongoing management and administration for which we earn a fee based on asset value. We do not guarantee either principal or returns to the investors in these funds. Most of our mutual funds in the U.S., with assets totalling \$16 billion, are organized as corporations with sufficient voting rights to the investors such that these funds are not considered VIEs. However, our mutual funds in Canada are organized as trusts and the investors in them do not have voting rights comparable to those of a common shareholder of a corporation. As a result, these mutual fund trusts are considered VIEs. We may be the Primary Beneficiary of the VIE mutual funds that experience low volatility of returns, such as money market funds, due to our role as trustee and fund manager which entails decision-making and results in our fees being included in expected residual returns. Consolidating these funds would increase the Consolidated balance sheet by approximately \$14 billion as estimated at July 31, 2003. Our maximum exposure to loss from our involvement with the VIE funds is \$53 million as at July 31, 2003, primarily as a result of our investments in seed capital. Our rights to the assets of these mutual funds are restricted to this seed capital. The other investors in these funds do not have recourse to us.

### *Assets administered in trust*

We act as trustee administering assets settled by clients, on behalf of designated beneficiaries. Clients use these arrangements primarily for asset protection, inter-generational wealth transfer and estate and financial planning. These arrangements are presently being evaluated and some of them could be VIEs. Where we have lending relationships with the trust, they are fully collateralized with secure assets, thereby our exposure to loss is nil. There may be instances where there are multiple unrelated beneficiaries and the assets experience low volatility and, we may be deemed to be the Primary Beneficiary if we have the ability to make decisions regarding the management of these assets, and earn a fee that varies with the value of the assets. We are evaluating trust arrangements with assets totalling \$36 billion against these criteria. We have no rights to these assets except for our fees and recovery of expenses. The beneficiaries do not have recourse to us.