



October 10, 2003

Mr. Lawrence Smith
Director of Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Dear Mr. Smith:

The New York Clearing House Association L.L.C. (“The Clearing House”)¹ appreciates the opportunity to comment on the proposed Financial Accounting Standards Board (“FASB”) Staff Position (FSP) No. FIN 46-d, Treatment of Fees Paid to Decision Makers and Guarantors as Described in Paragraph 8 in Determining Expected Losses and Expected Residual Returns of a Variable Interest Entity under FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* (FIN 46-d).

While we acknowledge the difficulty in implementing FIN 46 and appreciate the Board’s attempt to provide implementation guidance for this standard, we believe that the current approach of issuing multiple FSPs is not an effective approach for addressing FIN 46 issues. Contrary to previous public statements made by the Board that it wanted to avoid recreating a similar situation for FIN 46 that occurred with Statement 133 and the creation of the Derivatives Implementation Group (DIG), the Board appears to be heading in that same direction with multiple FSPs on FIN 46 being issued. However, unlike the DIG process, which allowed industry representatives to assist in reaching an agreed-upon resolution to specific issues and submitted these issues for a 35-day public comment period, the FSP process for FIN 46 does not adequately factor in industry’s input regarding the complexities of FIN 46.

¹ The members of The Clearing House are: Bank of America, National Association, The Bank of New York, Bank One, National Association, Citibank, N.A., Deutsche Bank Trust Company Americas, Fleet National Bank, HSBC Bank USA, JPMorgan Chase Bank, LaSalle Bank National Association, Wachovia Bank, National Association, and Wells Fargo Bank, National Association.

To highlight some of the FIN 46 issues facing The Clearing House members, specifically with regards to FIN 46-d, we have included the following detailed comments.

Our Key Comments on FIN 46-d Cover the Following Topics:

- I. Guidance Represents a Significant Change to FIN 46
- II. Rationale of Adding Fees Back to Net Income and Inconsistency with Other Variable Interests
- III. Inclusion of Fees in the FIN 46 Calculation of Expected Losses and Expected Residual Returns (the “FIN 46 calculation”)
- IV. Issues with Conceptual Framework Regarding Fees in FIN 46
- V. Recommendations

I. Guidance Represents a Significant Change to FIN 46

The Clearing House believes that an FSP is an inappropriate means of addressing the accounting guidance prescribed in FIN 46-d, because the guidance does not represent a clarification or limited revision to paragraph 8(a) of FIN 46, which states the following:

A variable interest entity's expected losses and expected residual returns shall include (a) the expected variability in the entity's net income or loss...

FIN 46-d significantly modifies this provision by redefining the cash flows of 8(a) from “the expected variability in the entity’s net income” to “the expected variability in the entity’s net income plus fees expensed to the Decision Maker and/or Guarantor.” This modification alters the cash flows in the FIN 46 calculation—prior to assessing the fees in 8(c) and 8(d)—and results in a new expected mean for those flows, thereby, altering the variability associated with the entity’s expected losses and residual returns. We do not believe that this was the original intent of 8(a) and that the change represents a modification to FIN 46 that should be addressed through the amendment process, so that the appropriate due process is afforded for this significant change to FIN 46.

If the Board does not decide to amend 8(a) and redefines “net income” in this FSP to include fees paid to a decision maker and/or guarantor as part of that definition, the impact of this accounting guidance could be much broader than intended, since financial statement preparers do not currently interpret “net income” in this manner.

II. Rationale of Adding Fees Back to Net Income and Inconsistency with Other Variable Interests

The Clearing House has difficulty understanding the principle behind modifying 8(a) with respect to the entity’s net income and having only certain types of variable interests (i.e., fees) added back to net income as opposed to any other variable interest associated with the entity. For example, a senior beneficial interest in a securitization vehicle (non-QSPE) represents a variable interest for the enterprise that owns that interest. This variable interest also impacts the entity’s net income as the return paid to the senior beneficial holder is an expense to the entity, but FIN 46-d does not prescribe that this variable interest also be added back to the entity’s net income for the FIN 46 calculation. This inconsistent treatment of variable interests appears to have no underlying principle behind it, and the modification appears to be more of a form-based rule designed to achieve a specific accounting result for a particular enterprise. Introducing these types of form-based rules warrants redeliberation on the issue.

III. Inclusion of Fees in the FIN 46 Calculation

Based on the guidance provided in FIN 46-d, fees to decision makers and guarantors are included in the FIN 46 calculation in the following manner:

- Part of the 8(a) cash flows impacting the overall variability of the entity
- The variability of the fees is assigned to a decision maker and/or guarantor
- On a gross basis, the present value of fees are assigned to the decision maker and/or guarantor

The Clearing House believes that analyzing the FIN 46 calculation in a manner that captures fees as described above results in double counting fees in that analysis, which is not currently required in FIN 46. Counting the same item twice is inconsistent with the conceptual framework of any accounting model and prior conclusions reached by the Board.

IV. Issues with Conceptual Framework Regarding Fees in FIN 46

In addition to the issues noted above that relate specifically to FIN 46-d, the Clearing House would also like to highlight its conceptual issues with the lack of conceptual support for the bias in the FIN 46 calculation towards a decision maker.

Fixed Fees

The Clearing House understands that a decision maker has the ability to make significant decisions for a variable interest entity, but it is not clear why fixed fees, whether fixed dollar or fixed percentage of assets managed, are considered a critical factor in determining the primary beneficiary of a variable interest entity—provided such fees are comparable with usual and customary pricing for the services provided. These types of fee structures are designed to produce superior results for the beneficial interest holders of the entity as opposed to providing the decision maker with a majority of the entity's expected losses and/or residual returns. The Clearing House believes that a view similar to those expressed in FIN 46-b is more appropriate for these fees structures.

Fees that are a fixed dollar amount or a fixed percentage of assets managed are both fixed depending on how they are viewed. One perspective would be that a fee fixed in amount has no variability in dollar terms. Alternatively, a fixed percentage fee based on assets managed provides no variability when measured against the assets managed and, thus, presents a fixed cost relative to the investor's position. This fee structure recognizes the additional costs and effort needed for larger portfolios of assets as compared to smaller portfolios. Further, the dollar amount of a fixed percentage fee can vary due to additional investments in or withdrawals from the asset portfolios and, thus, changes in the fee are not always due to the performance of the asset portfolios.

Requiring that there is absolutely no variability in these fixed fee structures is somewhat inconsistent with paragraph B8 of FIN 46 which states that "a fixed and unconditional liability owed to a variable interest entity is not a variable interest in that entity because it is not variable." This fixed and unconditional liability represents an asset to the entity and it does have some variability associated with the credit risk of the obligor. The Clearing House agrees with FASB in that these types of liabilities should not be considered variable interests and recommends that fixed fees, whether fixed dollar or fixed percentage of assets managed, be allotted a similar treatment.

Ensuring Decision Maker Consolidates

The FSP references paragraph C31 as its support for including fees paid to the decision makers as part of the expected residual returns in the FIN 46 calculation. Paragraph C31 states that "...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." The guidance provided in FIN 46-d has taken this qualitative guidance and has transformed the guidance into a mathematical certainty that the decision maker will consolidate when no single party holds a majority of the beneficial interest—as discussed herein.

This result seems to be in direct conflict with paragraph C42, which states that "some variable interest entities effectively disperse risks and benefits related to their assets or activities...in that case, each party involved should account for its rights and obligations related to the assets in the variable interest entity, but it is inappropriate for any party to consolidate the assets and liabilities of the variable interest entity."

Assume that the decision maker does not own 10% of the beneficial interest as described in Exhibit A of FIN 46-d. Based on the FSP's guidance, the decision maker consolidates the vehicle in the example even though the risks and rewards have been dispersed in the following manner:

- No single beneficial interest holder bears the risks of the assets in the vehicle.
- The residual rewards of the assets are distributed to the various beneficial interest holders after the decision maker receives a reasonable fixed fee.
- The fixed fee is designed as an incentive for the decision maker to produce superior results for the benefit of the beneficial interest holders as opposed to giving it a controlling financial interest in the assets (i.e., shares in some of the rewards of the vehicle as opposed to being the enterprise receiving a majority of the economics in the vehicle).

Again, having each variable interest holder account for its respective rights and obligations as prescribed by paragraph C42 appears more reasonable than requiring consolidation by the decision maker in FIN 46-d's example. The Clearing House recognizes that there is a bias towards decision makers included in FIN 46; however, the Clearing House believes it is important to highlight to the Board the inconsistencies within FIN 46 that result when applying the guidance included in FIN 46-d.

V. Recommendations

- Include fees to a decision maker in the FIN 46 model similar to all other variable interest holders (i.e., include only based on variability and not gross). This will result in identifying the decision maker as the primary beneficiary in situations where that enterprise truly has a controlling financial interest and not in situations where the decision maker is acting in a fiduciary manner with incentives (i.e., fee based on percentage of assets) designed to produce superior results for the beneficial interest holders.
- Consider providing an FSP with the FIN 46 calculation in a real life example with multi-year contracts as opposed to the current example in FIN 46-d.
- If the Board is intent on modifying 8(a) as prescribed by FIN 46-d, then this significant change should be exposed through an amendment as opposed to an FSP.

In summary, we are concerned with the Board's attempt to redefine "net income" in FIN 46-d, the lack of conceptual support for the Board's treatment of fees in the FIN 46 calculation, and the current approach of issuing multiple FSPs without adequate input from industry to help assist in addressing FIN 46 issues. The Clearing House would welcome the opportunity to assist the FASB in the resolution of the issues raised in this letter. If you have any questions, please contact Norman R. Nelson at (212) 612-9205.

Sincerely yours,

A handwritten signature in black ink, appearing to read "N. Nelson", with a horizontal line underneath.