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October 10, 2003

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**Proposed FASB Staff Position 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* (FSP FIN 46-d)**

Dear Mr. Smith:

We applaud the FASB staff for seeking to issue implementation guidance on the treatment of fees paid to decision makers and guarantors in FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* (FIN 46). However, we have significant concerns about whether the guidance provides an approach that is operational in more complex structures and provides results that are consistent with the underlying concepts of FIN 46. Our primary concerns are:

1. It appears that cash flows relating to fees paid to decision makers and guarantors are treated inconsistently with other cash flows in order to increase the probability that the decision maker or guarantor will be the primary beneficiary. We do not agree with this approach and believe it may result in counterintuitive conclusions in certain cases that do not appear consistent with the underlying principle the Board was attempting to achieve.
2. The example in Exhibit A is a very simple situation. We are concerned that the analysis illustrated with the example in Exhibit A may not be operational in more complex structures. For example, the approach for allocating expected losses and expected residual returns illustrated in Exhibit A is not operational in structures

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with multiple risks that are shared disproportionately amongst various variable interest holders.

Each of these concerns is explained in more detail along with other suggested improvements to the proposed FSP in Appendix A.

Should you have any questions regarding our response, please contact Bob Uhl at (203) 761-3705.

Yours truly,

Deloitte & Touche LLP

**Appendix A**  
**Proposed FASB Staff Position No. FIN 46-d**

As indicated in our cover letter we have the following comments on the proposed FSP FIN 46-d.

*It appears that cash flows relating to fees paid to decision makers and guarantors are treated inconsistently with other cash flows in order to increase the probability that the decision maker or guarantor will be the primary beneficiary. We do not agree with this approach and believe it may result in counterintuitive conclusions in certain cases that do not appear consistent with the underlying principle the Board was attempting to achieve.*

In previous comment letters we have described our concern over the bias in FIN 46 towards consolidation by decision makers because of the way that cash flows relating to decision makers are included in the analysis of expected residual returns on a different basis than returns to other variable interest holders. We are unable to discern the conceptual basis for the different treatment of cash flows pertaining to fees paid to decision makers and guarantors from cash flows pertaining to other variable interests. We do not believe these fees should be included on a fair value basis (as opposed to the variability of those fees) in the computation of expected residual returns. We believe that these fees should be included in the same fashion as all other cash flows of the entity. That is, the expected variability in these fees is the appropriate amount to consider in the computations of expected losses and expected residual returns and in the allocation of those expected losses and expected residual returns.

Consider the following two examples. In the first example, the variable interest entity (VIE) holds assets that are relatively stable in return and fair value. The variable interests are widely dispersed and the fee to the “decision maker”<sup>1</sup> is a fixed percentage multiplied by the total assets. In the second example, the VIE holds assets that are very volatile in return and changes in fair value. As in the first example, the variable interests are widely dispersed and the fee to the decision maker is a fixed percentage of the assets. Assume that because the variable interests are widely dispersed that no holder would absorb a majority of the expected losses in either example. In comparing these two examples, the decision maker in the first example is more likely to receive a majority of the expected residual returns taking into consideration the gross fees than the decision maker in the second example. This is because the variability of the assets in the second example is greater, and thus the fee as a percentage of this variability is less than the expected relationship in the first example. However, it would appear that the decision maker would have more decisions to make, and thus more control over the activities of the VIE,

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<sup>1</sup> In a previous comment letter we recommended that the FASB staff provide a definition of a decision maker for purposes of determining whether a service provider or other enterprise is a decision maker.

in the second example than in the first example. This result appears counterintuitive to the underlying principle the Board was attempting to achieve.

*The example in Exhibit A is a very simple situation. We are concerned that the analysis illustrated with the example in Exhibit A may not be operational in more complex structures. For example, the approach for allocating expected losses and expected residual returns illustrated in Exhibit A is not operational in structures with multiple risks that are shared disproportionately amongst various variable interest holders.*

We commend the staff for including an example of how to apply the proposed guidance. We believe that simple examples are often very powerful ways of illustrating the appropriate application of guidance. In this case, however, the provisions of FIN 46 and many of the types of entities to which this guidance would need to be applied are very complex. We believe that more comprehensive examples with fewer simplifying assumptions are needed to demonstrate the application of FIN 46 to complex provisions within various structures. We believe some of the examples should include aspects such as: multiple risks and rewards that are interdependent, decision makers who receive fees for both decision making and other services provided to the VIE, decision maker fees that are based on more than one factor, etc. The current example does not sufficiently illustrate the concepts to be applied such that constituents would be able to apply a consistent model to more complex structures and transactions.

We also have concerns about the approach for allocating expected losses and expected residual returns to variable interest holders illustrated in Exhibit A. As we understand the proposed FSP, the allocation approach in the example assumes that the expected loss or expected residual return occurs. Using the cash flows of the entity incorporating the assumed loss (or assumed return), the cash flows are then allocated to the variable interest holders based on the entity's contractual provisions (the "waterfall approach"). The approach is operational in simple structures where one class of variable interests is subordinate to all others with respect to all risks that may cause variability or where there is a single risk causing variability. However, this approach is not operational where there are multiple risks that may affect the results of the activities of the entity and the returns to interest holders are divided based on different risks. For example, consider a VIE which holds a single prepayable receivable. The VIE issues two variable interests, a principal-only strip and an interest-only strip. The various scenarios used to build the calculation of the entity's expected losses will incorporate losses due to credit defaults and losses due to prepayments. In using the waterfall approach, which risk should be assumed to have caused the expected loss (i.e., credit losses on the principal payment, credit losses on the interest payments, or a prepayment)? Depending on which risk is assumed to have caused the loss will affect with the holder of the principal-only strip or the holder of the interest-only strip is the primary beneficiary. In this type of situation, we believe it is impossible to use the waterfall approach to allocate to the variable interest holders the expected loss of the entity assuming it occurs because it cannot be determined that a single scenario resulted in that loss.

In addition, the waterfall approach may provide counterintuitive results. Consider a VIE that holds a single asset and is financed 90 percent by senior debt and 10 percent by subordinated debt. There is a very high probability that the asset will perform in accordance with its contractual provisions. There is also a low probability the asset will default. However, if the asset defaults, in all possible scenarios the amount of loss will be more than 50 percent of the original value of the asset. Because of the low probability of default the expected loss of the entity may be less than double the amount of the subordinated debt (i.e., the subordinated debt is more than 50 percent of the expected loss) and the subordinated debt holder would be considered the primary beneficiary under the waterfall approach. However, in every scenario used in the calculation of expected losses either (1) the asset performed and both debt holders receive payment in full, or (2) there is a default on the asset and the amount of loss absorbed by the senior debt is much greater than the amount of loss sustained by the subordinated debt. There was no scenario considered in the calculation of expected losses in which the amount of loss absorbed by the subordinated debt was greater than the loss to the senior debt yet that is the scenario the waterfall approach uses to determine the primary beneficiary.

We have identified a number of other methods for allocating expected losses which would address the issues raised above about complex structures with multiple risks. We would be happy to discuss these various methods with the FASB staff at their convenience. However, the different methods may identify a different primary beneficiary even when the methods incorporate identical assumptions and estimates about the timing and amount of the expected cash flows. Having diversity in permitted allocation approaches used may result in VIEs having no primary beneficiary when there should be one, or more than one enterprise consolidating the same VIE as its primary beneficiary when clearly there should be only one. We think it is important for the staff to provide direct guidance (not just in illustrations) as to the allocation approach that should be applied for all structures for which all entities must follow. In addition, as the allocation approach is critical to the example provided in the proposed FSP, we believe the example should not be issued in final form until the FASB has issued guidance with respect to allocating expected losses and expected residual returns to variable interest holders.

*Other suggested improvements to the proposed FSP*

- We are confused by the following sentence included in the proposed FSP:

“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.”

It is unclear to us how a fixed fee that does not vary can be considered a variable interest. This fee does not change with changes in the entity’s net asset value.

This conclusion does not appear to be consistent with the definition of a variable interest in paragraph 2(c) of FIN 46 which states:

“Variable interests in a variable interest entity are contractual, ownership, or other pecuniary interests in an entity *that change with changes in the entity’s net asset value.*” (Emphasis added).

In a related issue, we believe the FASB staff should provide clear guidance, possibly in a separate FSP, as to which cash flows (or income and change in fair value) associated with interests to or from the entity should be included in the calculation of the entity’s expected losses and which cash flows associated with interests to or from the VIE should be part of the allocation of the VIE’s expected losses to variable interest holders.

- The fourth assumption in Exhibit A states: “The appropriate discount rate (*in this case, the interest rate on risk-free investments*) is 5 percent” (emphasis added). We believe the FASB staff should explain in which situations it would be appropriate or inappropriate to use a rate different than the risk-free rate.
- We believe that the reference to the entity’s expected losses in the last paragraph of the Allocation of Expected Losses section in Exhibit A (second paragraph after table 5) should be changed to \$26,667. The existing sentence reads:

“Since no party holds a majority of the variable interests, neither the decision maker nor any other variable interest holder will absorb a majority of the entity’s expected losses of **\$25,334**, if they occur.”
- We have previously interpreted FIN 46 to indicate that all fees paid to decision makers or guarantors should be considered paragraph 8 fees, even if those fees are specifically for other services provided by the decision maker or guarantor. We feel that the proposed FSP should explicitly indicate if this is the appropriate interpretation, and if not to provide guidance on how to determine which fees paid to decision makers and guarantor’s should be considered paragraph 8 fees.
- We believe that the proposed FSP should also provide guidance on whether being a decision maker or providing a guarantee will always result in a fee being attributed to the decision maker or guarantor. For example, if the fee is embedded in another variable interest, and no explicit fee is received, must a fee be inferred? Consider a VIE which leases substantially all of its assets to one lessee. The lease terms require the lessee to make periodic lease payments and provide a residual value guarantee on the leased assets at the end of the lease term. There is no separate fee paid to the lessee for providing the residual value guarantee (i.e., it is assumed to be embedded in the lease as a reduction of the lease payments). Must a fee for the guarantee be separated and included in the calculation of allocating expected residual returns?