

Stacey Sutay

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

From: J.Douglas.Van.Ness@morganstanley.com [<mailto:J.Douglas.Van.Ness@morganstanley.com>]

Sent: Tuesday, December 10, 2002 9:57 AM

To: rwlott@fasb.org

Cc: sqbielstein@fasb.org; valusniak@fasb.org; ewtrott@fasb.org; staci.lublin@morganstanley.com; karen.dealey@morganstanley.com

Subject: Proposed Consolidation Interpretation -- Credit Linked Notes

As you may recall, at the September 30 Roundtable, I raised a question related to the potential consolidation of SPEs that issue credit linked notes. I explained why I believe that these SPEs are the perfect example of a risk dispersion vehicle. With the elimination of the special rules for financial SPEs contained in paragraphs 22 and 23 of the Exposure Draft, the uncertainty of consolidation for these SPEs remains. I have attached a letter with my comments on this issue.

Please call either Staci Lublin at 212-357-2456, Karen Dealey at 212-357-2452 or me at 212-761-1779 with any questions or comments.

J. Douglas Van Ness

Executive Director

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December 10, 2002

Mr. Ronald W. Lott
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: File Reference No. 1082-200
Exposure Draft on Consolidation of Certain Special-Purpose Entities, an interpretation of ARB No. 51
(the "Exposure Draft")

Dear Mr. Lott:

As you may recall, at the September 30 Roundtable discussion, I raised a question related to the potential consolidation of SPEs that issue credit-linked notes ("CLNs"). This question was in the context of the inability of SPEs that entered into certain derivatives to qualify for the proposed special rules for financial SPEs contained in paragraphs 22 and 23 of the Exposure Draft. With the recent elimination of these special rules, this uncertainty of consolidation remains.

SPEs that issue CLNs are in reality the perfect example of a risk dispersion vehicle. One party (the "Sponsor") has credit risk that it wishes to hedge and can achieve the hedge either by entering into credit default swap(s) with one or more swap counterparties that are substantive entities or by entering into a credit default swap with an SPE that issues CLNs. See the attached examples outlining these scenarios. As I explained at the Roundtable, either alternative achieves the same economic result.

If a substantive swap counterparty is an acceptable credit, no collateralization of the swap is required; if a substantive swap counterparty is not an acceptable credit, the Sponsor may require that the swap be collateralized. In each of these instances, the Sponsor and each of the substantive swap counterparties is required under FAS 133 to mark to market its derivative position. In the case of a collateralized swap, the substantive swap counterparty continues to recognize the collateral as its asset unless it has defaulted under the derivative. Consistent with FAS 140, the Sponsor does not recognize the collateral on its balance sheet since it does not have the right to sell or repledge the collateral.

Alternatively, the Sponsor may enter into a credit default swap written by an SPE. The SPE issues CLNs to third-party beneficial interest holders (the "BIHs"). The net proceeds are invested in essentially risk-free assets to ensure the availability of cash to make any payments by the SPE required under the credit default swap.

The recent modifications to the variable interest model made during the Board's redeliberations make the consolidation analysis unclear. Clearly, there is no decision-maker. As a result, we would look to identify a primary beneficiary as the holder of a majority of the variable interests. In identifying a variable interest holder, the focus is on the "downside" but the "upside" is given some consideration. The sum of the payouts to the Sponsor and the BIHs is identical in all scenarios. If no default trigger occurs on the credit default swap, the Sponsor pays the stated premium on the credit default swap and the BIHs receive the stated coupon on the CLNs. If the default trigger on the credit default swap does occur, the Sponsor receives the risk-free assets or the liquidation proceeds therefrom and the BIHs lose their principal invested in the CLNs. What is the "upside" and "downside" in a zero sum game?

In effect, the Sponsor has entered into collateralized credit default swaps written by each of the BIHs. The SPE has served merely as a vehicle of convenience for the Sponsor and the BIHs to enter into these swaps. The accounting result should be identical to the transaction described above where the Sponsor has entered into separate credit default swaps with substantive counterparties.

A requirement that the SPE be consolidated with either the Sponsor or one of the BIHs produces accounting results that do not accurately reflect economic reality. In the FASB's April materials, the Sponsor was identified as the primary beneficiary and required to consolidate the SPE in large part because its financial reporting would change as a result of consolidation. Fortunately, this reasoning has been eliminated as the consolidation project has progressed.

Consolidation of the SPE by the Sponsor would require that the Sponsor eliminate the credit default swap. The Sponsor would recognize the risk-free assets owned by the SPE as its assets and recognize the CLNs as its liabilities. This accounting treatment produces misleading financial statements. For example, when the market value of the swap is close to zero, the requirement that the Sponsor consolidate the SPE would require that it effectively recognize the swap at its notional amount represented by the consolidation of the risk-free assets rather than the fair value of the derivative.

Some participants have noted that consolidation of the SPE by the Sponsor produces an accounting result as if the Sponsor issued CLNs. However, issuance of CLNs by the Sponsor is not the same economic transaction as the SPE transaction and should not produce this accounting result. CLNs issued by the Sponsor are obligations of the Sponsor, and the Sponsor receives the proceeds from the issuance of the CLNs. In the SPE transaction, the CLNs are not the obligations of the Sponsor.

Similarly, consolidation of the SPE by a majority BIH would require that such BIH recognize as its assets all of the risk-free assets held by the SPE and the entire market value of the credit default swap. It would recognize the interests of the other BIHs as minority interests in a consolidated subsidiary. I do not see how this results in meaningful financial statements.

I believe that the SPE that issues the CLNs should meet the requirements to be a qualifying SPE ("QSPE") under FAS 140. Except for the proposed requirement in the upcoming project to amend FAS 140 within the context of FAS 133 that the beneficial interests be bifurcated, thus creating an "accounting derivative" that will violate the requirement of paragraphs 35.c.(2) and 40 of FAS 140 that a derivative not pertain to another derivative, the SPE meets all of the other requirements to be a QSPE. I believe that the application of FAS 140 that would view these SPEs as QSPEs would reflect the true economic substance of these transactions.

We recommend that the Interpretation include an illustration of SPEs that issue CLNs with an analysis that concludes that no party is the primary beneficiary. Clearly, there is no decision-maker. As noted in the first example attached, if the transaction is priced at market, the expected value of the "upside" to the Sponsor and the "downside" to the BIHs (i.e., the payment upon the occurrence of a default trigger) is equal to the expected value of the "downside" to the Sponsor and the "upside" to the BIHs (i.e., the premiums paid if no default trigger occurs). As a result, no party has a majority of either the "upside" or the "downside" and therefore no party should be considered to be the primary beneficiary.

We would be pleased to discuss our comments with the Board or the Staff. Please contact Staci Lublin at (212) 537-2456, Karen Dealey at (212) 537-2452 or me at (212) 761-1779 with questions or comments.

Sincerely,

/s/ J. Douglas Van Ness
Executive Director,
Securitized Products Group

cc: Ms. Suzanne Q. Bielstein
Ms. Vickie Lusniak
Mr. Edward W. Trott

EXAMPLE OF CREDIT LINKED NOTE ISSUANCE BY AN SPE

Assumptions

An SPE (the "CLN Issuer") has written a \$100 million credit default swap on Company XYZ with the Sponsor. The CLN Issuer receives an annual premium of 100 bp.

The CLN Issuer issues beneficial interests of \$10 million to each of 10 different investors (the "BIHs").

The proceeds are invested in asset-backed commercial paper ("ABCP") yielding LIBOR - 10 bp. The ABCP cannot be liquidated except at the maturity of the credit default swap or upon an earlier credit event.

The beneficial interests have an annual coupon of LIBOR + 90 bp and receive principal at the end of one year. If the CLN Issuer makes a payment to the Sponsor under the credit default swap, the BIHs incur a loss.

For simplicity assume only two possible outcomes: total loss at maturity and no loss.

| Outcome | Probability | Sponsor | Each of the BIHs |
|------------|-------------|--|--|
| No Loss | 99% | Pays 100 bp premium Receives nothing at maturity | Receives LIBOR + 90 bp coupon on \$10 million Investment of \$10 mm repaid |
| Total Loss | 1% | Pays 100 bp premium Receives \$100 mm at maturity | Receives LIBOR + 90 bp coupon on \$10 million Relinquishes \$10 mm principal invested (total \$100mm) |

The probability weighted
payoff equals the premium.

Balance Sheet of the SPE

| Assets | Liabilities and Equity |
|--------------------|-----------------------------------|
| ABCP \$100 million | Credit Linked Notes \$100 million |

Credit Default Swap marked to market could be an asset or a liability.

EXAMPLE OF CREDIT DEFAULT SWAPS WITH SUBSTANTIVE COUNTERPARTIES

Assumptions

Each of ten swap counterparties (the "Swap Counterparties") has written a \$10 million credit default swap on Company XYZ with the Sponsor. Each Swap Counterparty receives an annual premium of 100 bp.

Each of the Swap Counterparties is required to post collateral. The collateral is invested in asset-backed commercial paper ("ABCP") yielding LIBOR - 10 bp. The ABCP cannot be liquidated except at the maturity of the credit default swap or upon an earlier credit event.

Each of the Swap Counterparties receives a total annual payment of LIBOR + 90 bp (the 100 bp swap premium and LIBOR - 10 bp return on the collateral) and receives the proceeds from the liquidation of the collateral at the end of one year. If a payment is made to the Sponsor under the credit default swap, the Swap Counterparty receives no liquidation proceeds.

For simplicity assume only two possible outcomes: total loss at maturity and no loss.

| Outcome | Probability | Sponsor | Each of the Swap Counterparties |
|------------|-------------|--|---|
| No Loss | 99% | Pays 100 bp premium Receives nothing at maturity | Receives 100 bp premium on \$10 million Receives LIBOR - 10 bp return on \$10mm of collateral Retains \$10 mm collateral posted |
| Total Loss | 1% | Pays 100 bp premium Receives \$100 mm at maturity | Receives 100 bp premium on \$10 million Receives LIBOR - 10 bp return on \$10mm of collateral Relinquishes \$10 mm collateral posted (total \$100 mm) |
| | | The probability weighted payoff equals the premium. | |