



**RBC
Financial
Group**

Letter of Comment No: 108
File Reference: 1082-200
Date Received: 09/03/02

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August 29, 2002

Ms Suzanne Bielstein
Director of Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7,
P.O. Box 5116
Norwalk, Connecticut
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Dear Ms. Bielstein:

FILE REFERENCE 1082-200 - CONSOLIDATION OF CERTAIN SPECIAL-PURPOSE ENTITIES

RBC Financial Group would like to thank the Financial Accounting Standards Board ("FASB") for this opportunity to comment on the Exposure Draft on Consolidation of Certain Special Purpose Entities ("Exposure Draft"). Our comments are formulated from a financial reporting perspective and will focus on the reporting issues noted.

In response to the Exposure Draft on *Consolidation of Certain Special-Purpose Entities* issued June 28, 2002, we have some overall observations regarding the exposure draft. The balance of our comments will relate to the conceptual framework, some specifics issues related to interpretation and clarification. In addition, we will provide some suggested changes to address the aforementioned concerns.

Overall Comments

RBC Financial Group supports FASB's effort to improve financial reporting by issuing the Proposed Exposure Draft which clarify consolidation rules for Special Purpose Entities ("SPE") in order to improve comparability between enterprises and to provide meaningful and relevant information to financial statement users. We agree that financial statement users require more meaningful information about an enterprise's involvement with Special Purpose Entities ("SPE"). In particular, the risks and rewards and rights and obligations associated with the SPE should be presented in an enterprise's financial statements when the enterprise has a controlling financial interest in the SPE.

We believe that to achieve this goal of improving financial reporting, FASB should ensure that the standard allows for interpretations that achieve a balance between form and substance of a transaction. We believe that rules which attain this balance will consistently result in the recognition of assets and liabilities in which an enterprise has rights to the rewards or has exposure to risks. With a well crafted standard, professional judgement will prevail in finding a reasonable and fair representation of both the legal and economic nuances of an enterprise's involvement in an SPE.

Conceptual Framework

Key comments

1. Consolidation based on majority interest
2. Definition of SPE is too broad
3. Multi-seller conduits

Consolidation based on majority interest

We agree with FASB that any standard issued should be consistent with the conceptual framework as outlined in the Exposure Draft. Furthermore, we believe that the Proposed Exposure Draft should also be consistent with existing standards. We believe that in requiring an enterprise who provides either a majority of the variable interest or a variable interest that is a significant portion of the total variable interest and that is significantly more than the variable interests held by any other individual party as outlined in Paragraph 13 c, to consolidate the SPE would result in companies consolidating SPE activities where the entity owns less than a majority interest. This approach is inconsistent with existing consolidation rules where an enterprise is only required to consolidate a subsidiary if it holds a *controlling financial interest*, which is usually determined as 50% or more in voting control. Under ARB 51, controlling financial interest is “ownership of a majority voting interest” and over 50% of the outstanding interest is a condition pointing to consolidation. In addition, the need to consolidate if an enterprise that has “significantly more” of a *variable interest* will result in additional reporting and testing as entities will need to reevaluate whenever any entity with a *variable interest* alters its holdings or commitments to the SPE.

We request that the final Interpretation restrict the definition of primary beneficiary to one holding a majority of the variable interests.

Definition of SPE too broad

We believe that the current definition of SPE is broad and will result in inappropriate results. Since SPE’s are all enterprises that do not meet the definition of a *substantive operating enterprise* (paragraph 7a), many structures which currently are used as vehicles for assets being managed or administered on behalf of unrelated parties such as Mutual Funds, Separate Accounts, Investment Funds and Hedge Funds may meet the definition of SPE. If administrators of these business are viewed as the *primary beneficiary* the activities of these funds would be presented on the administrator’s balance sheet. We believe this would misrepresent the economic nature of these business operations to financial statement readers since administrators usually only earn a fee. Administrators of these funds do not receive any further benefits from the funds assets and are not responsible for providing any financial support to the fund unit holders.

An alternative would be to explicitly scope out of the final Interpretation these investment pools such as Mutual Fund trusts/corporations, Investment Funds and Hedge Funds and compensation related vehicles that are presently not excluded from the standard.

Venture capital and Private equity investments are typically carried out through limited partnerships (LPs). These LPs pool capital from various investors who take on limited partnership interests in the LPs. The general partner of the LP typically manages the investment pool for a fee and a residual share in profits, typically 20%. There could be situations where the LPs are wholly owned by a *substantive operating enterprise*, which also is the managing general partner as well as a limited partner investing no more than 25%. The interests as a general partner when combined with the interest as a limited partner could result in the *substantive operating*

enterprise being looked upon as the *primary beneficiary*. However, there are no guarantees or any downside protection provided to the partnership or any limited partner. The LP is a true pooling of risks of unassociated investors where one investor has a base and an incentive fee arrangement to encourage the maximization of results for all limited partners. Categorizing the *substantive operating enterprise* as the *primary beneficiary* would result in the creation of a large minority interest on the balance sheet of the *substantive operating enterprise*. This result would be contrary to the intended effect of the Exposure Draft, which is to make the provider of significant financial support to an SPE consolidate the SPE. In this situation, no financial support is being provided to the SPE by any party.

We request that the definition of *variable interest* be clarified to ensure that in situations where a *substantive operating enterprise* has no direct or contingent obligation to provide financial support to the SPE other than its commitment of capital on terms and conditions similar to all other limited partners, that it is not considered to be variable interests. This would ensure that we satisfy condition (e) in paragraph 9 of the ED and consequently, evaluate the LP for consolidation based upon voting interests.

An alternative would be to explicitly scope out of the final Interpretation these Venture Capital Limited Partnerships, that are presently not excluded from the standard.

Multi-seller conduits

Asset back commercial paper conduits are an example of SPE's which hold financial assets. The variable interest resides with sellers who bear the risk of first loss and earn the gains associated with the financial assets. While most administrators to these conduits do provide program credit support, which under the standard is a variable interest, program supports do not represent a material risk to the administrator as this is not a first loss guarantee, which resides with the seller. Therefore, it would be inappropriate for the conduit administrator to consolidate the SPE.

We request that para 23(b) be clarified such that a credit or asset support or facility be a first loss bearer. Suggested wording as follows: ...that is subordinate to all the interests of all other parties.

With respect to silos, the exposure draft states in para 17 that an enterprise with rights and obligations substantially restricted to specifically identified assets of an SPE, shall treat those assets and the portions of the SPE's liabilities attributable to those assets as a separate SPE. This leads to, what in our opinion is an erroneous and unintended application of the SPE consolidation criteria. For instance, where a participant has provided overall liquidity support to an SPE, but is protected by a more subordinate support albeit at a silo level, it would be misleading to conclude that the participant is the primary beneficiary of the overall SPE by virtue of providing liquidity support that is subordinate at the overall SPE level, assuming that one of the remaining two conditions in para 23 is also met. Instead such a participant should be allowed to evaluate his interest in each silo giving due consideration to the various levels of subordinate protection available to it within each silo.

We request that the treatment of a SPE's silos as separate SPEs should be consistently extended to all participants involved with the SPE whether on a silo-specific basis or on an overall basis.

Regulatory capital implications

Certainly in the case of financial institutions, the Exposure Draft could mean substantial increases in the total balance sheet resulting in increased capital charges. SPEs have always existed for their valid purposes and regulators have not required financial institutions to hold additional capital for the assets held by the off balance sheet SPEs except to the extent of risks directly undertaken by the financial institution. Consolidation of the SPE could mean additional capital requirements under the existing balance sheet based capital regime.

These additional capital charges would seem unwarranted and may also result in altering the business fundamentals of certain secondary capital market activities.

We request that the implementation of the standard be delayed until financial institution regulators have assessed the Exposure Draft and modified the current capital adequacy requirements to accommodate and offset the increased assets resulting from consolidation.

Specific Interpretation issues

For enterprises who are involved in multi-seller conduit, it is unclear as to whether the company should evaluate its variable interest at the silo level or at the level for the entire multi-seller conduit. (paragraph 17).

Clarification or guidance should be provided to aid in determining when market based fees are deemed to be a variable interest under paragraph 23 c.

The definition of *significant variable interest* should be clarified. How much is *significant*?

Additional guidance needs to be provided on what constitutes *persuasive evidence* as outlined in paragraph 12 for an enterprise to support a judgement about the sufficiency of its equity interest in an SPE. The standard requires that the equity investment should be equal to at least 10 percent of the total assets.

Implementation and measurement issues

We believe that the requirement to quantify variable interests and determine which entity has the majority of the variable interest presents significant modelling and measurement issues. Most SPE's are structured to diversify risk such as credit risk, foreign exchange risks, liquidity risks, operational risks and first loss risks. Therefore variable interests such as guarantees, management contracts, credit enhancements and derivative instruments represent these different risks. As a result it is not clear how these various different risks will be quantified or weighted when an enterprise determines whether or not it has a majority of the variable interest. For example, how do management fees rank in relation to transaction or program liquidity facilities in a multi seller conduit when quantifying variable interests.

We suggest that FASB provide additional guidance or clarification on how to calculate and weight different risks as represented by different variable interests in an SPE.

The standard emphasizes an analysis of risk based on loss as illustrated by the definition of *Variable interests* which are defined in the Exposure Draft as "the means through which **financial support is provided to an SPE...**". In addition, para 20 states that variable interests are quantified by "comparing expected future losses from the interests."

To ensure that users are provided with a proper reflection of an enterprise's economic involvement and an understanding of the rewards as well as the risks associated with an SPE, guidance should be provided to ensure quantification of both the rewards and the losses when determining the relative size of an enterprise's variable interest.

Additional reporting and information requirements

Extra resources would be required to monitor the SPEs on-going. Because of the definition of *primary beneficiary* includes a company that holds a significant variable interest that is significantly more than other

variable interest holders, the ongoing monitoring and requirement to calculate fair value of SPE's assets and liabilities and expected losses and their sharing could be quite onerous. The costs of reporting and monitoring on an ongoing basis the variable interests in an SPE will be significant.

If consolidation is not restricted to a majority variable interest holder as suggested earlier, then we suggest that FASB require an entity to re-evaluate its need to consolidate an SPE using an event based approach so that a material change in a party's variable interest would require all SPE constituents to view their involvement with the SPE.

Transition timeline

The requirements in the ED are onerous and we believe more time is required to assess the Interpretation and address implementation and additional reporting and monitoring issues after the Exposure Draft is finally issued.

Disclosure suggestions

We suggest that the following items should also be disclosed in the annual financial statements as a separate note for SPEs that are not consolidated.

- Nature of an enterprise's involvement in an SPE
- The assets and liabilities of an SPE and any recourse restrictions between them.
- The amount of the liquidity, credit enhancements and other guarantees.
- Nature, notional and fair value amounts of any derivatives associated with the SPE.
- Whether the company has transferred any of its own assets into the SPE.

Conclusion

In conclusion, we commend FASB for their expeditious approach to addressing current financial reporting and accounting needs. We agree that new guidance on the consolidation of SPE is required to ensure consistent and comparable financial reporting. We would like to ensure that new standards and interpretations meet the objectives FASB has stated and encourage FASB to consider our comments.

Should you have any questions or desire any clarification concerning the matters addressed in this letter, please do not hesitate to contact Sheena Kotecha, Senior Manager Accounting Advisory Services at 416-955-6273.

Yours sincerely,

Myra Boekhout for Stephen Bitove

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