
The Goldman Sachs Group, Inc. | 10 Hanover Square | New York, New York 10005
Tel: 212-357-8437 | Fax: 212- 346-2996 | email: matthew.schroeder@gs.com

Matthew L. Schroeder
Vice President
Director of Accounting Policy



August 30, 2002

Letter of Comment No: 79
File Reference: 1082-200
Date Received: 08/30/02

Ms. Suzanne Bielstein
Director of Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7, P.O. Box 5116
Norwalk, CT 06856-5116

Re: File Reference No. 1082-200; Proposed Interpretation, *Consolidation of Certain Special-Purpose Entities*

We appreciate the opportunity to comment on the above-referenced Proposed Interpretation (the Proposal). We have monitored the Board's deliberations on this project and agree the existing accounting literature is fragmented, incomplete and in need of a conceptual model founded on broad-based principles. We support the objective of the Proposal, which is to improve the transparency and comparability of financial statements by clarifying the consolidation rules applicable to special-purpose entities (SPEs). However, we believe the Proposal will not achieve its objective because it will require the inappropriate consolidation of certain legitimate risk-dispersing transactions involving the securitization of financial assets, contrary to the Board's stated intent.

The consolidation of SPEs that would result from implementation of the Proposal—including SPEs that are issuers of collateralized debt obligations, asset-backed and multi-seller commercial paper, risk-linked securities (e.g., catastrophe bonds), and credit-linked notes, among others—would not improve financial statement comparability or transparency. Such transactions allocate risks inherent in financial assets held by an SPE in a manner that makes it inappropriate for any single party to consolidate the assets and liabilities of the SPE. Moreover, such consolidation could have an adverse impact on

market liquidity, funding sources for a wide range of public and private companies, and the availability of high-quality investments. These outcomes would needlessly impair the efficiency of capital formation in a large and critically important sector of the U.S. financial markets.

Through our involvement with the American Securitization Forum (ASF), we participated in the development of its comment letter dated August 22, 2002 on the Proposal. The ASF's letter suggests many ways the Proposal could be changed to clarify the consolidation rules for SPEs. We broadly support the ASF's comment letter and urge the Board to give careful consideration to the complex issues and recommendations for enhancement contained in that letter. Accordingly, we have limited the scope of our letter to address only our principal concerns and issues either not addressed by the ASF letter or where we have a different view.

The use of a "significantly more" standard for consolidation

The Proposal generally requires an entity to consolidate an SPE if that entity holds a significant portion of the variable interests in the SPE and that portion is significantly more than the variable interests held by others. This means an entity could be the primary beneficiary of an SPE based on the actions of others. We believe requiring an entity to determine its accounting based on the actions of third parties is virtually without precedent, conceptually unsound, impracticable of implementation, and will not enhance the usefulness of financial reporting. An entity could therefore be required to consolidate the SPE in one period, deconsolidate it in another period, and reconsolidate it in yet another period. We also believe such a result would severely tax the credibility of financial statements and cause significant confusion for financial statement users.

We offer the following examples to highlight the fundamental problems with the model:

- Party A owns 34% of the variable interests of SPE1 and two other parties each own 33% of the variable interests of SPE1. Party A will not consolidate SPE1 because it does not own substantially more than any other owner of variable interests. Party B owns 34% of the variable interests of SPE2, which owns assets identical to SPE1; however, six other parties equally own the 66% interest in SPE2 not owned by Party B. Party B must consolidate SPE2 because it owns a significant portion of the variable interests that is significantly more than any other party. This example illustrates that two different entities—Parties A and B—with exactly the same risks, rewards, rights, and obligations in similar SPEs could account for their interests differently based on the holdings or actions of third parties.
- Party A owns 50% and Party B initially owns 50% of the variable interests of an SPE. Party A and Party B do not consolidate the SPE because neither owns the majority of variable interests and neither owns significantly more than the other. Subsequently, Party B sells one-half of its interest. Party A now will consolidate the SPE because it owns a significant portion of the variable interests that is significantly more than any other party. Party A's risks, rewards, rights, and obligations are the same under each

scenario, yet its accounting over time changes dramatically depending on the actions of Party B.

These examples demonstrate the Proposal will not improve comparability between enterprises engaged in similar activities. Nor will it necessarily result in consistent accounting by an entity over time. Thus, it will fail to achieve two of the key characteristics that make accounting information useful—comparability and consistency—and as a result, it will fail to improve the transparency and usefulness of financial statements.

The Proposal also states all evidence an “entity would be reasonably expected to possess” shall be reconsidered at each reporting date but “an entity is not required to conduct an exhaustive search for information about the actions of other unrelated parties that might cause the entity to become the primary beneficiary or to cease to be the primary beneficiary.” We believe determining what an entity would be reasonably expected to possess and what constitutes an exhaustive search are extremely subjective matters, exposing companies to the risk of being second-guessed with the benefit of hindsight. We observe the identity of variable interest holders and the size of their related holdings often is confidential information that generally is protected from disclosure by one or more of law, regulation, market practice and internal policy. As a practical matter, a company could end up devoting significant amounts of time conducting an exhaustive search, with little benefit as a result of its efforts.

Finally, we believe some investors will be less willing to buy the residual tranches of an SPE or will purchase smaller positions to avoid the risk of becoming the primary beneficiary. In order to attract additional buyers, yields on SPE securities will have to increase, raising the cost of capital and making SPEs less attractive economically. In our view, the net effect of the Proposal is to restrict the use of SPEs, contrary to the Board’s stated objective.

Consolidation based on a majority standard or a controlling financial interest

The Proposal identifies four SPE consolidation models, one for qualifying SPEs (QSPEs), one for SPEs that are evaluated for consolidation based on voting interests, one for SPEs that hold certain financial assets (FSPEs) and one for all other SPEs. The net effect of these four models is a rules-based versus principles-based approach to SPE consolidation.

We believe the Board should retain the consolidation model for QSPEs under Statement 140 and adopt a *single* consolidation model for non-qualifying SPEs that requires consolidation only when a controlling financial interest is present. In our view, a controlling financial interest is present when an entity holds a majority of the SPE’s variable interests or when it controls the SPE and has a significant variable interest in the SPE, which need not be a majority. In determining the amount of an entity’s variable interests in an SPE, we support the framework contained in the Proposal, subject to our comments below on derivatives.

We believe an entity controls an SPE when it has the unilateral ability over the life of the SPE to make key substantive, economic decisions that maximize the value of the SPE's net assets for the benefit of the residual interest holders. Whether an entity controls an SPE would be a matter of judgment based on an evaluation of all relevant factors, including the governing documents, substantive voting rights, substantive removal rights and related contractual relationships. We believe such an approach is consistent with the current consolidation model applied to substantive operating entities, which is control plus a significant financial interest, which need not be a majority.¹

With respect to a majority standard versus a significantly more standard, we believe the rationale in paragraph 7 of SOP 78-9, *Accounting for Investments in Real Estate Ventures*, is instructive:

The division believes a general partnership that is controlled, directly or indirectly, by an investor is, in substance, a subsidiary of the investor. APB Opinion 18 states that the usual condition for control of a corporation is ownership of a *majority* (over 50 percent) of the outstanding voting stock. However, if partnership voting interests are not clearly indicated, a condition that would usually indicate control is ownership of a *majority* (over 50 percent) of the financial interests in profits or losses. The power to control may also exist with a lesser percentage of ownership, for example, by contract, lease, and agreement with other partners, or by court decree [emphasis added].

Derivatives as variable interests

Dealers hold large, dynamic inventories of derivative contracts that are marked-to-market under Statement 133. Dealers make no practical distinction for risk management and reporting purposes between derivatives with SPEs and substantive operating entities. That is because the derivative contract typically has a senior or *pari passu* claim on the assets in the SPE, substantially mitigating the dealer's credit risk of the derivative contract.

Paragraph 18j of the Proposal states that a variable interest can arise from a derivative instrument. Prudent financial management will require derivatives dealers to assess whether the counterparty to each derivative in inventory is an SPE and, if so, to determine if the derivative is a significant variable interest in the SPE and whether it is significantly more than any other variable interest. Clearly, such a result is not practicable for a derivatives dealer with a large, dynamic inventory of derivatives.

We believe derivatives are appropriately accounted for under Statement 133 on a mark-to-market basis. In our view, requiring an enterprise to consolidate an SPE based on a derivative variable interest is tantamount to recognizing derivative notional amounts on

¹ We also observe the current consolidation model for a substantive operating entity does not contain a "significantly more" standard.

the balance sheet, an approach considered and rejected by the Board in the development of Statement 133.

For example, this could occur in the case of an SPE that holds Japanese Government Bonds (JGBs) and has entered into a credit default swap with a dealer linked to the credit risk of a BBB-rated Japanese company. An investor desires credit exposure to the company but not the yen currency risk associated with the JGBs. To accommodate the investor, the SPE issues five-year, credit-linked notes denominated in U.S. dollars. The SPE hedges the currency risk between the JGBs and the credit-linked notes by entering into a currency swap with the dealer. To mitigate its credit risk under the derivative contracts, the dealer's claim on the JGBs is senior to the investor's in all cases. Finally, the use of an SPE limits the investor's credit risk to the dealer to just the replacement cost of the derivative contracts and not the notional amount of its investment, as would be the case if the dealer had directly issued credit-linked notes to the investor.

From a risk perspective, the dealer bears the currency risk between the JGBs and the SPE notes, and the investor bears the default risk of the BBB-rated Japanese company. We believe a reasonable interpretation of paragraphs 20 and 21 of the Proposal could require the dealer to consolidate the SPE, depending on the current mark-to-market of the currency swap and the expected volatility of yen/dollar exchange rates relative to BBB-rated credit spreads over the five-year term of the notes.² If consolidation were required, the dealer would be effectively recognizing the notional amounts of the currency swap on its balance sheet because it would have yen assets funded by dollar liabilities. We observe that if the dealer had entered into a currency swap with a substantive operating entity, it would not recognize the notional amounts on its balance sheet, even though the dealer's credit risk could be higher because it would not have the immediate benefit of the up-front "collateral" associated with the JGBs in the SPE structure.

We suggest the Board exclude arm's-length derivative transactions from the definition of variable interest if:

- (a)** There are investors in the SPE that have cash at risk that is subordinated to the claims of the derivative counterparty, i.e., they have made a meaningful investment in the SPE that is at risk based on the performance of the SPE's assets and contracts entered into by the SPE; and
- (b)** The derivative does not concentrate substantially all of the risks and rewards of the assets in the derivative counterparty (e.g., as is the case with some total return swaps).

² The SPE would not be evaluated under paragraph 22 of the Proposal because it would fail paragraph 35(c)(2) of Statement 140, as interpreted by paragraph 40 of that Statement. For further discussion about this issue, see our comments below on SPEs that hold certain financial assets.

Consolidation based on voting interests³

Paragraph 9 of the Proposal states that an SPE should be evaluated for consolidation based on voting interests instead of the Proposal if one or more parties hold *equity* investments that meet certain conditions. In many structures without an equity class in legal form, first losses are allocated to subordinated debt. We suggest the Board clarify whether consolidation based on voting interests requires voting equity in legal form and whether other forms of residual interest can be viewed as voting equity investments subject to first dollar loss (e.g., participating subordinated debt or preferred stock).

Paragraph 9b, together with paragraphs 11 and 12, specifies an algorithm to determine if an equity investment is sufficient to allow an SPE to finance its activities without relying on financial support from variable interest holders. If an SPE's equity is less than 10% of its total assets, a potential primary beneficiary must compare the amount of the equity investment with the amount of equity invested in comparable substantive operating enterprises that engage in similar transactions with similar risks, provided that information is available. If that information is not available, a potential primary beneficiary must determine whether the equity invested in the SPE is greater than or equal to expected future losses at all times. To determine whether an SPE is capitalized appropriately for its intended purpose, we suggest the Board eschew the rules-based approach contained in these paragraphs in favor of a principles-based approach that establishes a rebuttable presumption that a completed arms-length transaction is *prima facie* evidence of the sufficiency and appropriateness of the capitalization of an SPE.

Footnote 3 to paragraph 9b states that expected future losses refers to a probability-weighted estimate of losses *without considering possible gains*. This calculation is of paramount importance to the consistent application of the Proposal. We believe this critical aspect of the Proposal and its practical application is not clearly articulated. We suggest the Board clarify how the concept of expected future losses *without considering possible gains* is to be applied in the context of determining the sufficiency of an equity investment in an SPE. Several examples based on complex, real-world transactions involving various types of variable interests (e.g., derivatives, management contracts, service contracts, referral agreements) would be helpful. If the Board does not accept our recommendation above to exclude arms-length derivative transactions from the definition of variable interest under certain conditions, we suggest the Board clarify the application of the concept of expected future losses to derivative transactions between an SPE and a counterparty when the derivative has an initial fair value of zero.

Paragraph 9e is intended to prevent disguising the identity of an enterprise that is providing the real financial support for an SPE. The Board acknowledges in paragraph B8 that this provision is not necessary if the Proposal is applied in good faith. While this provision likely will achieve its objective, it also will have the effect of prohibiting an equity investor in an SPE that is evaluated for consolidation based on voting interests from having *any* other variable interest in the SPE (e.g., owning a portion of the senior

³ Our comments in this section assume the Board decides to not adopt our earlier recommendation of a single SPE consolidation model for non-QSPEs.

debt)—a result we believe is not justifiable. We suggest the Board either remove this provision from the Proposal or clarify it such that it does not have significant unfavorable and unintended effects. Whether a transaction is intended to prevent disguising the identity of an enterprise providing the real financial support for an SPE should be a matter for company management to determine and the independent auditors to affirm.

SPEs that hold certain financial assets⁴

The Proposal sets forth special rules created for FSPEs. Although we understand these rules were intended to identify and accommodate risk-dispersing securitizations, they likely will result in *greater* instances of consolidation for FSPEs than for non-FSPEs. This is because paragraph 23 does not have any absolute or relative size requirements on the conditions it imposes. As a result, a party with a very small variable interest in the form of a subordinated interest would be required to consolidate an SPE if the party also either has the discretion described in paragraph 23a or receives a non-market based fee, regardless of size.

Paragraph 22b states that certain SPEs are not necessarily restricted to acquiring their assets by transfer from a transferor nor are they necessarily subject to the restrictions on sales of assets described in Statement 140. However, the Proposal is unclear about how much discretion the Board intends an FSPE (or its agents) to have in the purchase and sale of eligible financial assets. If an FSPE cannot have broad discretion over the purchase and sale of qualifying financial assets, paragraph 23a appears to be redundant. We suggest the Proposal clarify the extent to which FSPEs may purchase and sell assets and whether an FSPE also will be permitted to hold derivatives that involve decision-making within the parameters of the legal documentation, e.g., exercising an option.

Securitizations often have transaction-specific credit enhancements that cover a conservative multiple of expected losses before any amounts become due under third-party guarantees. In determining whether an entity provides financial support to an SPE such as a guarantee or other form of credit support, the Proposal should clarify whether the guarantee/credit support first be assessed as to the likelihood of its being drawn upon and if it is remote that the guarantee or other form of credit support will ever be called upon, whether an entity would fail paragraph 23b for determining the primary beneficiary of an FSPE. We believe financial statement users would be better served by the disclosures to be made pursuant to the Board's project on guarantees.

The pending amendment to Statement 133 will increase the number of derivatives deemed to be held by SPEs because of the requirement to bifurcate embedded derivatives in beneficial interests issued by SPEs. Statement 140 restricts QSPEs from holding certain derivatives. These restrictions presumably will extend to FSPEs under the Proposal. We do not see any relationship between the Statement 133 and Statement 140 restrictions on derivatives and the risk-dispersing function that is supposed to characterize FSPEs. In addition, the QSPE-style limitations significantly reduce the potential utility of

⁴ Our comments in this section assume the Board decides to not adopt our earlier recommendation of a single SPE consolidation model for non-QSPEs.

FSPEs. Specifically, they exclude any CDO or other SPE that holds, or has the power to acquire, synthetic assets as well as SPEs used to issue credit-linked notes (because credit-linked notes typically include credit default swaps that do not meet the Statement 133 and 140 limitations on QSPEs). Also, under the pending amendment to Statement 133, many SPEs will not qualify as FSPEs because embedded derivatives in beneficial interests issued by the SPE likely will be viewed as pertaining to other derivatives held by the SPE, including those derivatives that simply serve to redistribute or offset other risks.

We understand the Board originally limited the derivatives QSPEs could hold to ensure transferors could not use QSPEs to circumvent Statement 133 and because a QSPE cannot engage in transactions that give it discretion. In light of the pending amendment to Statement 133 and the other differences between QSPEs and FSPEs, these reasons are not relevant to FSPEs. We believe the pending amendment to Statement 133 addresses the concern about circumventing Statement 133; and the amount of discretion that can be exercised related to derivatives does not seem to be greater than the amount of discretion the Proposal permits an FSPE to have in other areas, particularly regarding the purchase and sale of assets. We believe the Board can ease the restrictions on derivatives without compromising its other objectives. This would significantly increase the utility of paragraphs 22 and 23 in providing appropriate consolidation guidance for FSPEs.

Impact of SPE Operating Losses on Consolidation Analysis

The Proposal requires an entity involved with an SPE to determine at each reporting date whether it is the primary beneficiary of the SPE. This requirement could result in a variable interest holder who was not the primary beneficiary of the SPE at its inception (because of low *expected* future losses, e.g., a BBB-rated note holder) having to consolidate the SPE at a later date if *actual* losses exceeded expected losses. We believe it is inappropriate for a passive investor to have to consolidate an SPE at a later date simply because actual losses exceeded expected losses. We observe that a similar passive investor in the securities of a substantive operating entity would not be subject to this requirement unless they acquired control of the entity through bankruptcy or other form of reorganization, as acknowledged by footnote 4. We do not believe the nature of the issuer's activities (substantive operating entity versus SPE) should determine consolidation policy in this instance.

We observe a similar issue with respect to paragraph 9b, which requires an equity investment to be greater than or equal to the expected future losses of the SPE *at all times* during the SPE's existence. If this condition and the other conditions of paragraph 9 were met, the SPE would be evaluated for consolidation based on voting interests instead of the provisions of the Proposal. However, if actual losses exceeded expected future losses at a later date, the SPE would no longer be evaluated for consolidation based on voting interests but rather variable interests. In the example above, this means the BBB-rated note holder could have to consolidate the SPE at a later date even though the investor did not have voting control at inception. We believe the Board should delete the phrase "at all times" from paragraph 9b, to avoid this potentially illogical result.

Related parties

Paragraph 15e of the Proposal requires a party that has a de facto agency relationship with an enterprise as a result of providing a significant amount of professional services or similar business arrangements to be considered a related party of that enterprise. As a large investment banking, securities, and investment management firm, we provide a wide range of professional services to our clients. And we occasionally invest alongside our clients in transactions because of marketplace expectations or for proprietary reasons. As such, under the broadly written standard of paragraph 15e, diversified financial institutions could be considered related parties of their clients as a result of an arm's length transaction. Given the "significantly more" standard in the Proposal, a variable interest of as little as 5% held by a financial institution could cause its client to consolidate the SPE. Any change in a financial institution's interest in such an SPE could expose the financial institution to potential liability if it failed to disclose such a change to its client because of the financial reporting implications it could have for the client. We believe this result is unworkable and irrational and suggest the Board remove this requirement from the Proposal.

Disclosure

Paragraph 25 of the Proposal requires an administrative services provider (such as a placement agent) that is not the primary beneficiary to disclose the assets and liabilities of the SPEs that it serves and the purpose of those SPEs. Financial institutions underwrite billions of dollars of various types of debt and equity securities. We believe this disclosure will place undue emphasis on the underwriting of SPE securities without any discernable benefits. Disclosure by placement agents of SPE securities underwritten is similar to disclosure of "league tables" of such activity, which information is widely reported in the financial media.

The financial statements of an SPE, and the required disclosures may be material to the financial statements of the primary beneficiary or the administrative service provider. Paragraph 7a implies, and our experience corroborates, that many SPEs do not issue financial statements. Some SPEs that do issue financial statements may not issue reviewed or audited financial statements with sufficient timeliness to permit their consolidation in the reviewed or audited financial statements of a primary beneficiary or the incorporation of the required disclosures in the reviewed or audited financial statements of the administrative service provider. This is more likely to be the case when the primary beneficiary or administrative service provider does not control the SPE. The accelerated filing requirements for companies with publicly-held securities recently enacted by the Securities and Exchange Commission will exacerbate the problem of obtaining reviewed or audited financial information from SPEs in a timely manner. Further, if the primary beneficiary of an SPE changes near a quarter or year end, the primary beneficiary's auditor may find it difficult to expand its audit scope to review the work of the SPE's auditors in sufficient time to "sign off" on the primary beneficiary's earnings. And when the auditors of the SPE differ from the auditors of the primary

beneficiary and the administrative services provider, those auditors both might require separate reviews of the SPE's auditor's work papers.

While these issues do not relate to the accounting principles of consolidation *per se*, we believe the Board should consider the logistical implications for preparers and auditors imposed by the variable interests model and the proposed disclosure requirements.

Effective date and transition

We believe the Proposal should be implemented as soon as is practicable and we support the staggered approach contained in the Proposal for newly created and existing SPEs. However, the proposed effective dates are not practicable for financial institutions associated with large numbers of customer-driven risk-dispersing SPEs. If the Board's redeliberation of the Proposal extends well into the fourth quarter of 2002 and a final Statement is issued late in the year, the proposed effective dates will be onerous to comply with, particularly if significant revisions to the Proposal are made. These compliance problems will be exacerbated by the many other exigencies of year-end closing procedures and the complex new critical accounting policy disclosures recently proposed by the Securities and Exchange Commission.

We suggest the final interpretation become effective for newly-created SPEs beginning in the first fiscal period beginning three months after the final Interpretation is released; and the transition period for pre-existing SPEs be extended so the provisions of the Interpretation must be applied as of the beginning of the first interim or fiscal period beginning after October 15, 2003.

* * * * *

Thank you for the opportunity to provide you with our feedback. If you have any questions regarding our comments, please do not hesitate to contact me at 212-357-8437.

Sincerely,

/s/ Matthew L. Schroeder
Matthew L. Schroeder