

Letter of Comment No: 48
File Reference: 1082-200
Date Received: 08/29/02

August 29, 2002

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

Re: File Reference No. 1082-200

Dear Director:

American Express Company is pleased to submit its comments on the FASB's proposed interpretation "Consolidation of Certain Special-Purpose Entities" (the ED). The company is keenly interested in the outcome of this project because it: (1) originates securitizations, primarily of revolving credit card receivables, that currently receive derecognition treatment under SFAS 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," (2) invests in, and in some cases manages, collateralized debt obligation structures (CDOs), and (3) sponsors and manages mutual funds and hedge funds. The company's American Express Financial Advisors operating segment had \$238 billion in owned, managed and administered assets at June 30, 2002.

American Express endorses the FASB's goal of clarifying the rules for determining when an enterprise should consolidate a special purpose entity (SPE). The ED represents a remarkable effort to quickly address recently publicized shortcomings of current practice. Based on our experiences with the activities mentioned above, we present below several observations and recommended modifications designed to prevent unintended and counterintuitive consequences from applying the ED, as well as to correct otherwise fatal weaknesses in concept and application. Our observations and recommendations are presented in the order discussed within the ED. However, we have particular concerns regarding issues surrounding paragraph 23 of the ED as discussed in "SPEs That Hold Certain Financial Assets."

Scope

We agree with the scope exclusions contained in paragraph 8, which exclude qualifying SPEs as defined by SFAS 140, such as asset securitizations and retirement plans. We recommend that scope exclusion also be provided for mutual funds and hedge funds not only from the mutual fund or hedge fund reporting perspective, but also from the perspective of an investor in or sponsor of a mutual fund or hedge fund. Mutual funds and, by analogy, hedge funds are precluded by the SEC's Regulation S-X, Article 6 and by the AICPA's Audit and Accounting Guide, Audits of Investment Companies, from consolidating other investment companies. Thus, without the scope exception, the ED can create a direct conflict with these rules if the fund invested in an SPE. In addition,

we are not aware of any particular abuses by sponsors of or investors in these investment vehicles and these vehicles are not traditionally viewed as being SPEs. In any event, we believe that mutual funds and hedge funds would not meet at least two of the three conditions set forth in paragraph 23 and, therefore, consolidation would not be required. Thus, it is appropriate to specifically exclude them from the scope of the Interpretation.

Consolidation Based on Voting Interests

We wish to communicate two observations with respect to paragraphs 9-12, which set forth the conditions under which consolidation is determined based on the more traditional voting interests approach rather than a variable interests approach.

First, a fatal weakness of the ED (briefly introduced in paragraph 6) is in paragraph 9(b). That paragraph establishes a test based on whether: "The amount of the equity investment is sufficient to allow the SPE to finance its activities without relying on financial support from variable interest holders." To ensure transparent and representationally faithful financial statements, the ED must make a distinction between an ongoing commitment and a one-time, non-recourse investment in a closed-end investment vehicle. In the quoted sentence, the word "additional" must be inserted before "financial support" for this test to be economically valid. We explore this weakness to a greater extent in our comments on "SPEs That Hold Certain Financial Assets."

Further, paragraph 9(b) states: "Generally, that ["that" refers to the equity investment being large enough to enable the SPE to conduct its activities without direct or indirect support from variable interests] means that the equity investment should be greater than or equal to the expected future losses of the SPE at all times during the SPE's existence." The ED must comprehend the economic reality of many SPEs, i.e., that losses can exceed the equity interests. Our experience with CDOs suggests that the SPE continues to function despite the first loss positions having little or no economic value and no longer providing support. The simple fact is that the next higher subordinated positions assume the new first loss support roles with no intervention, direct or indirect, occurring. Again, see "SPEs That Hold Certain Financial Assets."

Our second observation is that, while the presumption that equity interests must be 10% of assets to allow the SPE to function independently (paragraph 12) is arbitrarily determined, we can propose no better solution and believe the 10% presumption should survive in the final rule. However, the 10% presumption is irrelevant for certain SPEs that hold financial assets, as discussed in "SPEs That Hold Certain Financial Assets."

Consolidation Based on Variable Interests

In paragraph 14, the ED introduces the requirement that "initial measurement of assets, liabilities and noncontrolling interests of an SPE shall be fair value at the time the enterprise becomes the primary beneficiary." Later in the effective date and transition section (paragraph 26), the same requirement is repeated for the initial consolidation of a preexisting SPE. The fair value measurement requirement for preexisting SPEs is a serious flaw in the ED because it represents a piecemeal approach to fair value accounting, i.e., a change in generally accepted accounting principles that is beyond the

scope of an FASB Interpretation. If the Board believes this is the appropriate answer, it must reexpose the ED as a change in accounting principle. Such a development would be a setback for the objective to quickly clarify practice.

In any event, we disagree with the requirement. While we do not know explicitly the Board's rationale for the fair value approach since the Basis for Conclusions is silent on the matter, the Board may believe that the initial consolidation of a preexisting SPE under the ED represents a change in control, and, therefore, requires a new basis of accounting. The fact is that no change in control or any other economic event has occurred. The mere reinterpretation of preexisting conditions should not give rise to a new basis of measurement. Instead, the assets, liabilities and noncontrolling interests of a preexisting SPE should be initially consolidated at measurements that would have resulted from the application of GAAP from the inception of the SPE.

In addition to our concerns surrounding the fair value approach as the initial measurement basis, the ED does not address the subsequent measurement and accounting for consolidated SPEs and the underlying assets and liabilities. In the case of CDOs, the underlying assets may be required to be marked to market in accordance with SFAS 115, "Accounting for Certain Investments in Debt and Equity Securities," whereas the liabilities would generally not be adjusted under existing GAAP. This situation would misrepresent the financial obligations of the consolidating entity.

Having argued against the ED's fair value approach, we ironically note that for financial SPEs, GAAP does support the fair value approach, both for initial consolidation and subsequent remeasurement of the consolidated accounts. SFAS 60, "Accounting and Reporting by Insurance Enterprises," sets forth the accounting by insurance enterprises for separate accounts. These accounts usually represent assets and liabilities that are maintained by an insurance enterprise for purposes of funding annuity contracts, pension plans, and similar activities. A financial SPE that requires no additional economic support from the primary beneficiary, but which is consolidated under the ED, most likely meets the definition of separate accounts. We recommend the FASB discuss with the American Institute of Certified Public Accountants (in connection with its reexamination of certain aspects of insurance industry accounting, including the accounting for separate accounts) the principles the ED should set forth with regard to the fair value accounting under a separate accounts basis for a consolidated financial SPE.

Another matter in this section of the ED is the determination of related parties that may also have an interest in a SPE. We agree that the interests of related parties should be aggregated with the enterprise's interest for purposes of determining whether it is the primary beneficiary. However, we do not agree with all of the ED's criteria for identifying a related party. Paragraph 15(d) includes a party that received its interest as a contribution from the enterprise. This condition should be modified to exclude qualified charitable trusts organized under Section 501(c)(3) of the Internal Revenue Code that, once they receive a contribution from the sponsor, their only task is to contribute the investment, or the cash if liquidated, to individual charitable organizations.

Paragraph 15(e) identifies a related party as one that “has a de facto agency relationship with the enterprise as a result of providing significant amounts of professional services or similar business arrangements.” This paragraph is over reaching because it identifies as related parties investment bankers that are counter parties in ongoing hedging and other activities. It is quite probable that one or more bankers will have an interest in an SPE in which the enterprise has also invested. We recommend clarifying this paragraph by excluding substantive operating enterprises from the condition.

Identifying and Comparing Variable Interests

A basic premise of the ED is that the primary beneficiary of an SPE is the enterprise with the most significant variable interest. Paragraph 20 states that the relative size of variable interests shall be determined by comparing expected future losses from the interests. The paragraph then suggests that expected future losses should be calculated based on the guidance in Concepts Statement 7, “Using Cash Flow Information and Present Value in Accounting Measurements.” That guidance uses a probability-weighted estimate of losses without considering possible gains. We submit to the Board that such guidance is not applicable to many SPEs, and clearly not to most financial SPEs in which gains are integral to the SPE’s activities. We recommend the Board focus on basic characteristics of size (e.g., 60 units vs. 40 units) rather than to require a measure of potential future losses that will invariably result in inconsistent determination due to the inherent subjectivity in this approach.

SPEs That Hold Certain Financial Assets

We fully endorse the Board’s acknowledgement that certain financial SPEs (so called FSPEs) are designed to diversify an investor’s risks and rewards related to the FSPE’s assets and should not be consolidated by any of the investors. One of our greatest concerns with the ED is ensuring that the qualifications of FSPEs are well defined and understood such that application of the ED will not cloud the transparency of or actually misrepresent the balance sheet of an investor. American Express could suffer that outcome under the ED as written with respect to CDOs that it both manages and in which it has a variable interest. CDOs are typically originated by an investment banker who obtains the collateral from various bond or loan issuers, and deposits the collateral with a trustee who manages the cash flows. As a matter of market practice, a CDO manager must take a first loss position in the CDO as a condition of managing the underlying portfolio. The motivation for managing the portfolio is that the market-based fees earned enhance the overall return from investment in the CDO. The economics of our CDO investments is a return on investment represented by a series of net future cash flows that, other than our initial investment, require no further economic support whatsoever. The investment yield is appropriately accounted for under existing literature, i.e., EITF 99-20, “Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets,” and the fees are recorded as earned in accordance with EITF D-76, “Accounting for Management Fees Based on a Formula.”

Our focus is on paragraph 23, which sets forth three criteria; the meeting of any two criteria by the investor means it is considered to provide significant financial support through a variable interest, and therefore must determine if, relative to any other variable

interests, it is the primary beneficiary, and must consolidate the FSPE. Referring to the investor, the paragraph sets forth the criteria as follows:

Paragraph 23(a):

“It has authority to purchase and sell assets for the SPE and has sufficient discretion in exercising that authority to significantly affect the revenue, expenses, gains and losses of the SPE.”

In the case of a CDO, this criterion would appear to be met by the asset manager. The asset manager is responsible for making sell and reinvestment decisions to maintain the quality of the collateral portfolio on behalf of the senior investors. This activity does significantly affect the performance of the CDO. However, while the tactics are at the manager’s discretion, the manager’s fiduciary requirements are set forth in the CDO’s governing documentation. Failure to adhere to those requirements can result in the manager being voted out by the other investors. The manager has no vote in this decision. The important point for the Board to understand is that the manager’s sell and reinvest decisions are designed to protect the senior investors. Thus, while these decisions significantly affect the CDO’s performance, they are not made solely on behalf of the manager’s own account. To make this point clear, a CDO manager may have a view that certain credit-distressed collateral should be retained as its ultimate recovery is, in the manager’s judgment, probable. However, to ensure the full realization of future cash flows attributable to senior investors, the manager must trade out of the credit risk into a higher quality instrument. The result is that the CDO realizes a substantial loss that automatically accrues to the manager’s residual interest. We recommend that paragraph 23(a) be modified to read:

“It has authority to purchase and sell assets for the SPE and has sufficient discretion in exercising that authority to significantly affect the revenue, expenses, gains and losses of the SPE *such that the discretion benefits it to a greater degree than others.*”

Paragraph 23(b):

“It provides a guarantee, a back-up lending arrangement, or other form of liquidity, credit, or asset support that is subordinate to the interest of other parties.”

As observed earlier with regard to paragraph 9(b), the ED must embrace the notion of an entity’s continued risk of providing additional economic support to an FSPE as being a key to consolidation. We fully agree with the criterion above in so far as an investor’s guarantee, back-up lending arrangement, or other form of liquidity, credit, or asset support to the extent such support embodies the risk of providing funds to the FSPE beyond the investor’s initial investment. However, it appears that this criterion goes too far by scoping in an initial investment in a residual or other subordinated interest that would experience losses before other investors in the FSPE. The fact that an investor takes a subordinate interest that is riskier than the more senior interests in a FSPE simply represents an investment decision or a requirement imposed by the marketplace as it relates to CDO managers, not an indication that the subordinate position should be more responsible for the operations of the structure as in a parent company-subsidary

relationship. The key consideration must be whether further economic support is potentially required. If such a requirement exists, we agree that an indicator of consolidation is present. Otherwise, the present accounting for investments appropriately presents the economic effects of the FSPE on the subordinated investor's balance sheet and results of operations. Thus, we urge the Board to modify paragraph 23(b) as follows:

"It provides a guarantee, a back-up lending arrangement, or other form of liquidity, credit, or asset support that is subordinate to the interest of other parties and is in addition to its initial investment."

Notwithstanding the need to modify paragraph 23(b), the Board must consider how the ED should cope with the realities of CDOs. As a result of the unprecedented high yield default rates experienced over the recent past, certain of American Express' residual interests in CDOs have little or no economic value such that there are no future risks or benefits associated with owning the legal form equity of the CDO. As a result, other investors now are in first loss positions. As noted earlier, the ED must recognize that a FSPE's losses can exceed its subordinated interests and still continue to function. Therefore, we believe that in evaluating consolidation issues the focus should be on remaining economic interest rather than "legal form equity." We assume that application of the ED as currently written would not require the initial consolidation of these CDOs by the CDO manager owning a subordinate interest with no economic value. However, more explicit language related to the distinction between economic interests and legal form equity would provide clarity. We further assume that had the ED been in place when these CDOs were created, and the CDOs had been consolidated, that they would have been deconsolidated once the economic interest became worthless, i.e., when there was no longer the subordinated support as represented by the initial investment. This fact pattern reinforces the fallacy of paragraph 23(b)'s representation that an initial subordinated interest represents support for future operations of the FSPE.

Paragraph 23(c):

"It receives a fee that is not market based. (Refer to paragraph 19)."

We agree that a fee arrangement that is not market based represents an indicator of a non-arms length relationship that can be akin to a parent company/subsidiary relationship. However, we are concerned that the reference to paragraph 19 may be misunderstood. Our belief is that the intent is to refer to the last sentence of paragraph 19, which states that a fee from an SPE is presumed to not be market based unless it can be demonstrated to be comparable to fees in similar observable arm's length transactions. We recommend the Board clarify the reference accordingly. On the other hand, if the reference is intended to assert that a fee from an SPE can never be arm's length if the manager also has an investment at risk in the SPE, we would strongly disagree with such an assertion as not being representative of economic reality.

Disclosure

In our view, paragraph 24 highlights the fallacy of consolidating an FSPE that truly diversifies the risks and rewards of investors. The disclosure requires that the FSPE's

assets and liabilities, now appearing in the appropriate lines of the consolidated balance sheet, be separately detailed in the notes or on the face of the balance sheet as being those of the FSPE. Further, the fact that the FSPE's creditors have no recourse to the general credit of the consolidating enterprise must be disclosed. This requirement bears out our concern that, under the conditions described above, consolidating a FSPE misrepresents the liabilities of the consolidating entity by overstating them to the extent of the FSPE's liabilities. The corollary is that the assets of the consolidating entity are also overstated, misrepresenting the resources available to the consolidating entity's creditors. Disclosing that fact is far more critical to the entity's stakeholders than the required liability disclosure, and further demonstrates the fallacy of consolidating the FSPE in the first place and is in conflict with FASB Concepts Statement No. 6, Elements of Financial Statements.

Effective Date and Transition

For calendar year companies, the ED's proposed effective date for preexisting SPEs is April 1, 2003. Substantial effort and systems investment must be undertaken to consolidate the assets of an FSPE. As the Board may be aware, a trustee administers the underlying collateral of an FSPE. While the asset manager has extensive knowledge of the characteristics of the collateral, it does not have the collateral integrated within its records and systems in such a way as to account for them under GAAP. To accomplish that integration is not unlike integrating the investment portfolio of a money manager acquired in a business combination, with the exception that the cooperative effort may not be as evident.

Additionally, we believe that many structures that are in substance FSPEs, but may meet the consolidation criteria of the final rule, can be modified such that the economic characteristics of an investment rather than those of a consolidated SPE are substantiated. Such modifications require more time than will be available between the date the rule is finalized and April 1, 2003.

Furthermore, the effect of consolidating SPEs will likely create the need to review and perhaps renegotiate debt covenants and other financial contracts, such as swap agreements and forwards. Rating agencies will require detailed explanations of the operations, risks and rewards of an SPE. These requirements and those mentioned above will severely impinge on the heavy year-end reporting schedule, making the transition requirements extraordinarily punitive.

For these reasons, we strongly urge that the FASB adopt a bifurcated requirement with respect to preexisting SPEs, i.e., require disclosure of the effects of the ED for all periods subsequent to the issuance of the rule to the extent practicable, and require the initial consolidation of preexisting SPEs in fiscal years beginning after September 15, 2003.

* * * * *

We would be pleased to answer any questions the Board or Staff may have with respect to these matters. Please call me at 201-209-5216, or Jay Perrell at 203-658-1166.

Alternatively, please email me at Tom.A.Iseghohi@AEXP.com, or Jay Perrell at Jay.Perrell@AEXP.com.

Yours truly,

Tom A. Iseghohi
Senior Vice President and Comptroller