## PIMCO

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MP&T Director – File Reference 1082-200 Financial Accounting Standards Board 401 Merritt 7 Post Office Box 5116 Norwalk, Connecticut 06856-5116

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## Dear Sirs:

Pacific Investment Management Company LLC (PIMCO) is an institutional money manager with approximately \$275 billion in fixed income assets under management, of which \$6.5 billion is collateral for Collateralized Debt Obligations (CDOs). The CDO collateral PIMCO manages includes asset-backed securities, investment grade corporate bonds, high yield bonds and loans, emerging markets bonds and credit default swaps. With 20 CDOs under management, PIMCO is one of the largest and most diverse CDO collateral managers.

In 2001 the CDO market was estimated to be \$422.5 billion, with approximately half of these structures actively managed by an asset manager trading the underlying securities. <sup>1</sup> PIMCO feels that the Exposure Draft for Consolidation of Certain Special-Purpose Entities, an Interpretation of ARB 51 fails to properly address two items of importance to the actively managed CDO investment management community:

- Financial SPEs are based upon the definition of Qualifying SPEs which inappropriately restricts the use of speculative or risk additive derivatives within these bond portfolios; and
- 2) The definition of "market based fees" is vague and needs clarification.

The concept of a Financial SPE was introduced to allow for certain types of SPE, such as CDOs (a pure investment vehicle) that serve to distribute risk, to exist without the need for consolidation. Unfortunately, as presently written, the definition of a Financial SPE is an extension of the definition of a Qualifying SPE. FAS 140 prohibits the use of derivatives for risk additive purposes and the holding of nonpassive assets in Qualifying SPEs. These restrictions would apply to CDOs and is a critical flaw in the definition of Financial SPE. PIMCO views the use of Credit Default Swaps, Credit Linked Notes, Structured Notes, Synthetic Securities and other risk additive derivatives and nonpassive assets as critical to the effective management of any bond portfolio regardless of whether it is within a CDO or not.

<sup>&</sup>lt;sup>1</sup> Sam DeRosa-Farag, 2002 Overview of CBOs/CLOs, Credit Suisse First Boston, 2002

MP&T Director – File Reference 1082-200 August 23, 2002 Page 2

The credit derivatives market has grown tremendously in the last few years and is estimated to have \$1.6 trillion in notional outstanding.<sup>2</sup> These derivatives have become critical risk transfer instruments for the commercial banking industry and important diversification tools for the investment management industry. PIMCO uses Credit Default Swaps and Credit Linked Notes as an efficient way to gain exposure to corporate and sovereign credits. Credit Default Swaps are also used to take advantage of relative value opportunities. When the yield on a cash bond is less than the yield on a credit default swap, PIMCO will look to purchase the credit default swap. There are also companies and countries that have little or no public debt available, so the only way to gain exposure and diversify risks is through the use of Credit Default Swaps.

Structured Notes, such as commercial airline Enhanced Equipment Trust Certificates, are used to gain exposure to senior secured aircraft financing. In the event of a default by the underlying airline, the senior note holders control the liquidation of aircraft. This could therefore be construed as a nonpassive asset. This method of financing is critical to the U.S. airline industry.

It is also important to note that PIMCO treats CDO collateral portfolios the same as they treat any other institutional bond portfolio. These portfolios are managed to maximize value within the constraints of their guidelines or indenture. Therefore, utilization of derivatives and nonpassive assets is critical to the maximization of value within a bond portfolio. The current definition of Financial SPE would seriously handicap the investment management industry by excluding the use of Credit Default Swaps, Credit Linked Notes Structured Notes and Synthetic Securities. By extension, it would also damage an important subsector of the CDO market, synthetic CDOs collateralized primarily by Credit Default Swaps.

The second concern that PIMCO has is the definition of "market based fees." The meaning of this phrase is too vague. If not properly clarified, it could erroneously result in consolidation of an entity that owns no variable interest in and provides no financial support to the Financial SPE. For example, PIMCO as the asset manger of a CDO clearly has the authority to purchase and sell assets and therefore meets condition 23a. If PIMCO's fees were determined to be "not market based" it would meet condition 23c. PIMCO never buys or holds equity (variable interest) in its CDOs and so would never meet condition 23b. However, under most circumstances, the CDO investors will only meet condition 23b. Even an investor who holds 100% of the equity will meet only one

<sup>&</sup>lt;sup>2</sup> BBA Credit Derivatives Report 1999/2000, British Bankers Association This report is only published every two years.

MP&T Director – File Reference 1082-200 August 23, 2002 Page 3

condition: Since PIMCO, as asset manager only, could meet two conditions and an equity investor sponsoring the transaction will meet only one condition, PIMCO might be required to erroneously consolidate the Financial SPE without having any variable interest! This also has the unwanted effect of creating conflicts of interest between the asset manager and investors, which would result in perverse market dislocations.

It is PIMCO's belief that all CDO collateral management fees are market based since the fees are the result of a negotiated, or in some cases competitive, bid process between the collateral manager and the CDO investors. CDO asset managers do not unilaterally determine fees; they are competitively determined. The fact that a CDO is purchased by independent third parties means that all parties involved have reached an agreement on the fees. The particular size and structure of these fees relative to other market participants should be irrelevant for the purpose of consolidation determination. For example, PIMCO as a premier CDO manager commands higher than average fees, but investors feel this is justified based upon the firm's track record and expertise.

We hope you take our comments into consideration when promulgating the final rules. Do not hesitate to the call the undersigned at (949) 219-2297 or Powell Thurston at (949) 720-6426 with any questions or comments.

Sincerely,

John Maney

Chief Financial Officer

Pacific Investment Management Company