



Letter of Comment No: 21
File Reference: 1100-163
Date Received: 7/1/02

July 1, 2002

Via email

Ms. Suzanne Q. Bielstein
MP&T Director – File Reference 1100-163
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

RE: Exposure Draft – Amendment of Statement 133
on Derivative Instruments and Hedging Activities

Dear Ms. Bielstein:

Wells Fargo & Company (Wells Fargo) is a diversified financial services company with \$312 billion in assets, providing banking, insurance, investments, mortgage and consumer finance. As a financial services provider, Wells Fargo routinely enters into derivative transactions for hedging and customer accommodation purposes and routinely invests in instruments that meet the definition of a beneficial interest. Wells Fargo is very interested in the major themes discussed below. We appreciate the opportunity to comment on the above referenced Exposure Draft (hereafter referred to as the "ED").

Our comments are focused on the following four major themes:

1. Amendment to Accounting for Beneficial Interests
2. Amendment to Definition of a Derivative
3. Application of Derivatives Guidance
4. Transition and Effective Dates

1. Amendment to Accounting for Beneficial Interests

We do not agree with the ED's proposed approach that requires analyzing beneficial interests as 1.) freestanding derivatives, or 2.) for the presence of embedded derivatives subject to bifurcation. Our concern centers around establishing concepts and processes for beneficial interests that substantially differ from those for other interest-bearing assets.

We do not see the value to investors or the decision-usefulness of amounts that arise from delineating between possibly variable cash flows attributable to features that constitute an accounting derivative (e.g., an implied interest rate derivative) and those that do not (e.g., prepayment and default experience). Under present guidance, beneficial interests that can contractually be settled in such a way that the

holder would not recover substantially all of its recorded investment is carried at its fair value. A holder does not split the fair value between a hypothetical debt host and a hypothetical derivative. We believe it is meaningful only to describe the beneficial interest as a whole as it is more difficult to understand the risks and economic factors affecting the beneficial interest when it is broken into two accounting components. We expect holders will attempt to overcome that problem through footnote disclosure. That disclosure may only contribute to more confusion and lengthy discussion, as information about the one instrument will appear in two places in the basic financial statements.

Furthermore, the complexity of the proposed guidance and the operational burden of initially implementing and then ensuring ongoing compliance would, in our opinion, far outweigh any benefits of such a conceptual result. Exacerbating our concern, we expect the accounting for many beneficial interests will not change as a consequence of the proposed new guidance. However, the effort to support that conclusion will be immense.

Based on the evolution of the guidance on accounting for beneficial interests, we believe retention of paragraph 14 in FAS 140 without major change appears to obviate the need for paragraph 14 of FAS 133. We also believe it supports the notion that beneficial interests should be considered like other debt securities. See Appendix 1 for further discussion.

If the Board decides to proceed with the approach as proposed, we offer for your further consideration our additional concerns with the ED in Appendix 2.

2. Amendment to Definition of a Derivative

We view the ED's proposed change to FAS 133, paragraph 6.b. to be significant and far-reaching. Yet, the reasons for the change are not clear. Paragraph A10 of Appendix A, "Background Information, Basis for Conclusions, and Alternate View," cites difficulty in applying the existing guidance to structured terms and the possible inconsistent implementation in practice. However, the Alternative View in Appendix A indicates the reason as the conflict between FAS 133 and FAS 140. We agree with the observations in the Alternative View that amending the definition of a derivative "has far more consequences that just resolving the conflict between Statement 133 and Statement 140," and "in order to contain the collateral effects of the amended definition, other provisions of Statement 133 are also being amended."

We do not see how the proposed change to the definition of a derivative would result in improved accounting and reporting for derivatives. We believe it would produce results that are overly complex and difficult to explain. It would result in contracts that presently are accounted for as a single derivative being bifurcated into a debt host and a derivative, when in fact the substance of the contract is a single derivative. To assist financial statement readers understand the true risks, characteristics and nature of the affected contracts, preparers of financial statements would need to reassemble them in narrative disclosures. We believe this result runs counter to the Board's simplification efforts. In addition to the lack of benefit, we note that the proposed accounting would be burdensome and costly to apply on an ongoing basis, not only at inception of affected contracts. See Appendix 3 for further discussion.

3. Application of Derivatives Guidance

Paragraph 15 of FAS 133 describes situations when an embedded foreign currency derivative instrument should not be separated from the host contract and considered a derivative under FAS 133, paragraph 12. Unfortunately, the ED includes the following sentence, “The evaluation of whether a contract qualifies for the scope exception in this paragraph should be performed only at inception of the contract.” The concept of performing this evaluation only at inception of the contract is inconsistent with the guidance contained in paragraph 57.c.(3) and DIG Issue A18 related to defining a derivative. Paragraph 57.c. discusses the derivative characteristics of net settlement via an established market mechanism and “readily convertible to cash” and how those notions should be applied to a contract throughout its life, not only at its inception.

Additionally, DIG Issue A18 addressed the concepts of “market mechanism” and “readily convertible to cash” and whether those criteria should be applied only at inception or acquisition of a contract or whether they should be applied and reevaluated during the entire term of the contract. The conclusion reached in DIG Issue A18 was that the “market mechanism” and “readily convertible to cash” evaluations must be performed at inception and on an ongoing basis throughout a contract’s life. We question the inconsistency in the evaluation of whether an embedded foreign currency derivative qualifies as a scope exception performed only at inception versus the requirement to apply the “market mechanism” and “readily convertible to cash” derivative characteristics on an ongoing basis throughout the contract’s life. We recommend the approach taken for evaluating embedded foreign currency derivatives be adopted consistently for all tests required to determine the existence of both freestanding and embedded derivatives subject to bifurcation.

4. Transition and Effective Dates

Paragraph 42 of the ED states that holders of beneficial interests issued by QSPEs meeting certain criteria should not apply several of the proposed amendments. Paragraph 43 of the ED states that holders of beneficial interests issued by QSPEs not meeting the criteria should apply those proposed amendments upon their issuance as final rules. That transition guidance could be interpreted to mean that holders of beneficial interests issued by QSPEs meeting the criteria are permanently exempt from the specified amendments. However, we doubt that is the case, because it would be inconsistent with accounting for beneficial interests issued by a SPE that was a QSPE prior to the proposed amendment and continues to be a QSPE after the amendment and with beneficial interests issued by a non-QSPE.

Also, we disagree with any effective date that is effective upon issuance of a final standard. It is unrealistic. It does not allow preparers any time to read, understand and appropriately implement the complicated transition provisions of the new rules. This is particularly egregious if the preparer is a holder of beneficial interests.

Again, we appreciate the opportunity to comment on the ED. If you have any questions regarding our comments, please contact Dan Christopherson at (612) 667-4531.

Sincerely,

Les Quock
Senior Vice President and Controller

Appendix 1

Amendment to Accounting for Beneficial Interests - Specific Proposed Changes to the ED

We believe the following three changes should be made to the ED.

A. Delete Paragraphs 14 and 58.d. and Revise Paragraph 59.f.

We question why the process by which a beneficial interest is issued should so heavily affect its accounting. The ED seems to place disproportionate significance on the sources and characteristics of cash flows in a securitization. A holder of any asset should understand how the nature of and rights to any collateral and guarantees and changes in interest rate indices affect the collectibility of the asset. However, we believe the proposed guidance about beneficial interests is overly detailed and therefore implies the holder should perform extensive additional analyses. For example, we are uncertain of the value of guidance in DIG Issue D2, which pertains only to beneficial interests, requiring a holder to “consider whether the nature and extent of cash flows generated by the securitized financial instruments are or are not consistent with the stated terms of the interest” and “the relative concentration of risks across various tranches of securities issued by the securitization vehicle.”

We note that it may be easier to identify the sources and characteristics of cash flows that relate to beneficial interests compared with those of interest-bearing assets not arising from a securitization. However, that should not trigger more burdensome accounting for beneficial interests. Corporate debt often is issued with a priority relative to other types of debt issued. Loans are commonly extended collateralized by specific property and without recourse to other assets of the borrower. The proposed guidance does not require holders of those assets to assess the cash flow sources and to identify embedded derivatives because of their relative priority or source of repayment. It only requires the holders to understand the contractual rights and terms of their assets.

B. Delete Paragraph 61.m. and DIG Issue B12

We do not believe whether an SPE is a QSPE should affect the analysis of the resulting beneficial interest. We understand the link between the passive nature of a QSPE and the absence of equity whose holders experience the risks and rewards typical of owners. However, we note that many non-QSPEs, like QSPE's, issue beneficial interests where none of the holders experience the risks and rewards typical of owners.

From a practical standpoint, we question the ability of a holder of a beneficial interest to determine whether the issuing SPE is a QSPE at the time the holder acquires the security. A SPE can fail to meet the criteria of a QSPE after its inception, further complicating a potential investor's ability to determine the status of a SPE upon its purchase of beneficial interests in the secondary market. Again, we expect many beneficial interests will not contain embedded derivatives subject to bifurcation under the ED. However, the holder still would need to document compliance with the final rules. The burden of the accounting compliance will become so great that we wonder whether holders of a beneficial interest other than the transferor would find it economical to hold it.

C. Revise Paragraph 13.a.

We recommend paragraph 13.a. be revised so the conclusion regarding the ability to recover substantially all of the recorded investment considers expected cash flows. Under the ED, the accounting determinant for splitting a single instrument would rest on events that have a remote chance of occurring. Using expected cash flows would be consistent with Concepts Statement 7, which is being introduced into accounting standards. It would produce more meaningful results and would relieve an extensive amount of the implementation burden.

Appendix 2

Amendment to Accounting for Beneficial Interests – Additional Concerns if ED Retained

If the Board decides to retain the approach as proposed, we present the following additional five concerns with the ED.

A. Amendment to Paragraph 58.d.

The proposed addition of paragraph 58.d. states, “Beneficial interests arising from securitization transactions that distribute noncontractual cash flows to beneficial interest holders do not satisfy the criterion in paragraph 14(a).” We question the likelihood of the distribution of noncontractual cash flows. We recommend deletion of the sentence.

B. Paragraph A20

Paragraph A20 states, “Similarly, the Board believes that paragraph 6(b) will not be satisfied for many beneficial interests held by transferors (for example, a retained interest) because the initial net investment in a beneficial interest held by a transferor is the fair value at the date of transfer of the interest retained.” We understand FAS 140 to require a transferor to initially record a retained interest at allocated cost, not fair value. However, allocated cost, like fair value, probably would preclude the beneficial interest from meeting the definition of a derivative, so we agree with the expected result as expressed in the quote.

C. DIG Issue C17

DIG Issue C17 states, “Similarly, the criterion in paragraph 14(a) would not be satisfied for a securitization involving the distribution of liquidation proceeds upon termination of an SPE prior to the maturity of the securitized assets. Such a termination is based on the legal documents establishing the SPE, and the distribution of liquidation proceeds is not considered a contractual cash flow as described in paragraph 14(a).”

We note that many securitizations include a clean-up call. Also, others often contain early termination provisions, for example, in the event of changes in laws that may make a feature illegal or result in adverse tax consequences to the parties involved. As such, we expect the above guidance will result in very few beneficial interests qualifying for the paragraph 14 scope exception.

Furthermore, C17 requires the holder to determine whether the collateral contains embedded derivatives subject to bifurcation. To literally apply the guidance, holders should read loan documents and other documentation setting forth detailed provisions affecting the collateral. We recognize that FAS 133 presently contains that language. However, because of the clearance of DIG Issue D1, holders did not have to apply it. In our opinion, requiring holders to make that assessment of the collateral is not reasonable.

Given the near impossibility of implementing the guidance plus the expectation that almost no beneficial interests would qualify under paragraph 14 of FAS 133, we question the usefulness of DIG Issue C17.

D. Issue B12

Please see our comments above.

E. Issue D2

Because of the complexity of the proposed guidance on accounting for beneficial interests, we expect the examples will be a critical resource in properly implementing the final rules. Regarding Example 1, we have the following comments:

- The example describes the A-class as follows, “The interest rate is effectively capped [at a rate that is significantly greater than the current market] because the A-class can never receive more than 100 percent of the cash flows of the loans” [brackets added]. We find the sentence structure confusing, because the words in the brackets, while accurate, are not qualifiers necessary to make the phrase that follows true. Or, perhaps the sentence should read: “The A-class can receive up to but no more than 100 percent of the cash flows of the loans. Consequently, the interest rate is effectively capped but at a rate that is significantly greater than the current market rate.”
- The Paragraph 14 Analysis states, “The B-class absorbs the prepayment risk of the particular securitized loans. While that, in and of itself, does not disqualify the B-class from the paragraph 14 scope exception” We recommend deletion of the comment about prepayment risk. It detracts from the usefulness of the sentence.
- The Paragraph 12 Analysis states, “The A-class does not contain an embedded derivative that must be reported separately. The interest rate cap is considered clearly and closely related to the debt instrument and therefore should not be reported separately from the debt in accordance with the guidance in paragraph 61(f) of Statement 133.” It is not clearly evident why that is the case. Presumably, the A-class investor would recover substantially all of its initial recorded investment through the contractual settlement. For that to be the case, any shortfall between LIBOR and the fixed rate on the loans in excess of \$20,000,000 would not cause sale of loans to fund the interest payment. If that is the reason, it should be added to the explanation.
- The Paragraph 12 Analysis also states, “Applying paragraph 13(a) of Statement 133, the B-class would be required to bifurcate a derivative instrument because it is possible that the investor in the B-class would not recover substantially all of its initially recorded investment.” To avoid the possibility of misunderstanding, the FASB should add the reason—that is, the residual had an initial net investment of greater than zero and its contractual rights to “principal” cash flows could be reduced to zero depending on changes in LIBOR. Further, we assumed loans up to \$20,000,000 would be sold to fund the A-class LIBOR payments in excess of the fixed rate up to \$20,000,000. The example should state that as a term of the beneficial interests.

A subordinate class paying LIBOR should be added to the example. Many securitizations involve the issuance of several classes of securities. An example illustrating the mechanics of a collar on cash flows would be very useful.

Appendix 3

Amendment to Definition of a Derivative

Following are additional four additional thoughts regarding our concerns related to the lack of benefit and burden caused by the proposed change to paragraph 6.b.

A. Existing Guidance Responsive to Substance

In our opinion, the approach taken in DIG Issue A9 in analyzing the upfront exchange of cash in the context of the definition of a derivative is superior to the ED because it produces results that reflect the substance of the example contracts. We believe the substance of each of the prepaid interest rate swap and structured note is that of a derivative. We support the DIG Issue A9 approach when a contract involves leverage—that the notional amount for the purpose of a derivatives accounting analysis is the stated notional amount multiplied by the factor that provides the leverage.

DIG Issue A9 observes that a contract with a much lower leverage factor than that of 8.142 used in the structured note example would meet the criterion in paragraph 6.b. That observation could have given rise to the concern over possible inconsistent application. However, we do not believe that point indicates a weakness in the clarity of the existing guidance. We do not find the guidance “little or no initial net investment” particularly vague. In our opinion, the approach to analyzing the effect of leverage on a contract meeting the definition of a derivative expressed in DIG Issue A9 is a workable concept. We acknowledge that it requires application of judgment, which we believe is vital and integral to accounting for transactions. However, to alleviate the inconsistency concern, paragraph 8 could be amended to indicate its guidance pertains to contracts that do not involve leverage.

Further, DIG Issue A9 includes the comment that its guidance is considered to be consistent with DIG Issue A1. We agree. DIG Issue A1 discusses a prepaid forward contract where the amount of cash exchanged at inception of the contract equaled the current fair value of a cash security. That situation does not involve any leverage, and the amount of the upfront cash settlement of the forward contract indeed equates to the measurement of a cash transaction involving the same asset. Therefore, it represents a true debt host.

B. Proposed Guidance Overly Complex

The prepaid swap and structured note in DIG Issue A9 both meet the existing definition of a derivative, so they are required to be carried at fair value. That result is consistent with the Board’s stated goal of measuring all financial instruments at fair value. We believe the proposed change will cause overly complicated accounting, as exemplified in DIG Issue A20, because it would cause one agreement to be broken apart into smaller pieces, which would obfuscate the economic consequences of the contract. We doubt that the proposed change would improve accounting or transparency.

Using the prepaid swap example, according to DIG Issue A20, the upfront payment of the fixed-rate cash flows would be accounted for as a loan. However, because it is not a loan, one would need to assign loan terms to it. For example, one would need to determine whether the loan should bear a fixed or floating interest rate. DIG Issue B19 states that, in the absence stated or implied substantive terms of the hybrid instrument, an entity may make its own determination as to the characteristics of a debt host. We believe that guidance would apply to the prepaid swap example, because there are no stated or

implied terms to the “loan.” We expect that situation will create inconsistency in practice. We believe this inconsistency should dissuade the Board from adopting the proposed change.

Since the Company has commercial banking and consumer finance subsidiaries, we are particularly troubled that the proposed change would generate items labeled as loans that are not in the legal form of loans. We are subject to a variety of laws and regulations that relate to specific loan information (e.g., amounts, volumes, types). To measure and monitor compliance, we often use loan data captured in the general ledger and loan application systems. To the extent the general and subsidiary ledgers contain transactions that do not meet the legal definition of a loan, it would be necessary to manually adjust data retrieved from those sources.

Also, as lending is a core activity of our commercial banking and consumer finance operations, we have an extensive monitoring, reporting and control structure supporting our deliberate extension of credit. It does not make sense in our operating environment to force through that infrastructure by-products of derivatives accounting. The effort to ensure certain debt hosts bypass the loan infrastructure would be extensive.

Finally, we enter into derivatives as an accommodation to customers. A popular structure is an interest rate swap with an embedded cap somewhat similar to Example 3 in DIG Issue A20. Because the proposed accounting does not reflect the legal form, we would need to maintain two sets of records in our systems—one for GAAP purposes and the other for customer statement/settlement purposes. (If the Board clears DIG Issue A20 without change, we recommend it revise Example 3. A cap rate above the fixed rate of 6.65% would be more realistic, and the difference between the contractual fixed rate and the current market fixed rate should be consistent with the cap “premium.”)

To estimate the effort to apply the proposed new definition of a derivative, we prepared the equivalent of term sheets that would support data entry into our loan and derivatives systems for the prepaid swap in Example 1 of DIG Issue A20. We spent about six hours just preparing input documents for this one relatively simple example. Factors that caused this to be such a time-consuming process include the need to arbitrarily create loan terms and to design a check of the estimated cash flows from the two accounting parts (i.e., the loan and the swap) to ensure they agreed to the estimated cash flows according to the contractual terms. We expect those procedures would be more time-consuming for an actual transaction, which generally would be longer dated and would have more complex terms. Also, we note the time spent related to initial set-up only. It excludes incremental time for data entry, for performing ongoing reconciliations of cash flows and for removing non-legal loans from standing loan reports.

C. Proposed Amendment to Paragraph 12.

The proposed new addition to the end of paragraph 12 would give holders a choice of accounting for a forward contract that meets the definition of a derivative as either a derivative or a hybrid instrument. Paragraph A15 indicates the reason for providing that choice is “to provide flexibility in order to alleviate the requirement that entities bifurcate off-market swap or forward contracts that are just slightly more or less favorable than similar instruments in the market.” It seems the flexibility would permit more contracts to be bifurcated. But, it would not reduce those that the ED requires to be bifurcated.

D. Effect of Change to Paragraph 13.a.

As discussed above, we recommend the guidance in paragraph 13.a. focus only on expected outcomes and exclude remote outcomes. That change also would eliminate many of our concerns expressed above. It should result in the bifurcation of embedded derivatives that is deserved and is meaningful.