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Letter of Comment No: 15  
File Reference: 1200-001  
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Re: File Reference No. 1200-001  
Exposure Draft on Qualifying Special-Purpose Entities and Isolation of Transferred Assets—an amendment of FASB Statement No. 140

Dear Ms. Bielstein:

J.P. Morgan Chase & Co. appreciates the opportunity to comment on the Financial Accounting Standards Board's ("FASB") June 10, 2003 Exposure Draft of the Proposed Statement of Financial Accounting Standards, Qualifying Special-Purpose Entities and Isolation of Transferred Assets—an amendment of FASB Statement No. 140 (the "Exposure Draft" or the "ED").

We have actively participated in the preparation of the comment letters submitted by The Bond Market Association and the American Securitization Forum, and the New York Clearing House Association. As such, a number of our concerns are reflected in those comment letters and we urge the FASB to consider the views and adopt the recommendations (as they relate to changes to the Exposure Draft) set forth in those letters. Since we have significant concerns regarding this proposed guidance, we felt the need to provide our overall views separately, both in this letter and by requesting to participate in the Roundtable on August 28, 2003.

The FASB introduced the financial-components approach in Statement 125 and further clarified that approach in Statement 140. We believe that the financial-components approach, which requires that each party to the transfer recognize the assets and liabilities that it controls after the transfer and no longer recognize the assets and liabilities that were surrendered or extinguished in the transfer, best achieves the consistent accounting application for transfers of financial assets in the marketplace.

We would support the FASB's effort to provide any clarification to the financial-components approach; however, we do not believe that the proposed amendments in the Exposure Draft provide clarification to this approach, but rather introduce risk and reward concepts that undermine the broad control-based principles of Statement 140. These risk and reward concepts are in the form of specific rules designed to achieve a particular accounting result for certain structures. Similar to what has occurred with FIN 46, we believe that introducing form-based rules that are not in line with the underlying principles of a standard will have very wide-spread and unintended consequences.

The Exposure Draft would change the QSPE status for many legitimate structures that comply with the financial-components approach. Previously, the FASB spent a significant amount of time developing the QSPE model to ensure sale accounting for the transfer of financial assets where effective control had been surrendered. It was the FASB's view at that time that QSPEs improved financial accounting and reporting standards. The Exposure Draft appears to be reversing that view, a view that the marketplace has now adopted and had expected to be consistent going forward.

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In addition, the ED increases the complexity of an already complicated standard, increasing the likelihood of inconsistencies in application and resulting in a lack of comparability in financial statements. Introducing very detailed form-based rules that conflict with the underlying principles of Statement 140 will make the new guidance difficult to implement because it will cause uncertainty as to whether the financial-components approach is the preferred methodology for transfers of a financial asset or whether the risk and reward model is the preferred methodology. As was the case with FIN 46, it will require a significant amount of time from management, the businesses impacted, and internal and external accountants to interpret and eventually implement such conflicting guidance. Time spent to decipher the appropriate accounting for many legitimate structures can be quite costly to an enterprise. These costs are in addition to the cost associated with potential restructuring.

We believe that the financial accounting and reporting community would be better served if the FASB redeliberated and issued new guidance consistent with the basic financial-components approach of Statement 140 as opposed to reversing previous decisions made by the FASB. We have included detailed comments in this letter that illustrate these points.

**Our Key Comments Cover the Following Topics, in order of significance:**

- I. Commitments to Deliver Additional Cash or Other Assets to the QSPE or its *Beneficial Interest Holders (BIHs)*
- II. Additional Restrictions for Structures that Reissue Beneficial Interests
- III. Derivatives Between the Transferor and QSPE
- IV. Proposed Changes to Paragraphs 80-84
- V. Application of the Isolation Requirements to Transferor and Consolidated Affiliates
- VI. Restriction on Holding Equity Instruments
- VII. Transition Provisions

***I. Commitments to Deliver Additional Cash or Other Assets to the QSPE or its Beneficial Interest Holders (“BIHs”).***

We disagree with the FASBs’s position that a QSPE should not enter into an agreement (other than a forward contract in a revolving period) with the transferor, its affiliates, and agents that commits any of those parties to deliver additional cash or other assets to the SPE or its BIHs. It appears that the FASB is inappropriately mixing in the concepts of risk disbursement with the basic financial-components approach of Statement 140.

Additionally, the all-inclusive restriction prohibiting the transferor and its affiliates from entering into commitments with a QSPE to deliver additional cash or other assets as proposed would cover much too broad of a spectrum and would introduce significant issues by encompassing not only any minor liquidity or limited recourse arrangements with the transferor, but would presumably scope into the ED the following arrangements that can be best characterized as industry practices which facilitate the efficient functioning of the securitization marketplace:

Indemnities for breach of eligibility standards, representations, covenants and other customary commercial provisions – When an entity transfers assets, it customarily makes representations and warranties concerning those assets (whether or not a QSPE is involved). These representations and warranties give certain rights to other parties and impose obligations upon the seller or servicer of the assets, which may require the transferor to repurchase or replace the defective assets. Entities typically make a number of these factual warranties unrelated to the ongoing performance or the credit quality of the assets. Examples of such warranties include: warranties that assets have been underwritten or collateral appraised in conformity with identified standards, are free from environmental hazards, and warranties that provide for the return of assets in instances of incomplete documentation, fraud or misrepresentation. Other customary commercial terms include

indemnifications for impairments to the value of assets that result from specified events outside the control of the transferor and unrelated to the credit quality of the asset. Such provisions are very common in credit card master trusts in which transferors are obligated to make cash payments to QSPEs for noncash/noncredit adjustments to the receivables, such as, for rebates and returns.

Pre-funding structures – These structures involve a QSPE issuing beneficial interests with net proceeds in excess of the purchase price for the financial assets acquired at inception. The excess proceeds are placed in a pre-funding account and applied in the near future to pay for additional pre-specified financial assets transferred to the QSPE by the transferor.

Minimum Transferor Interest Requirements – Nationally recognized statistical rating organizations require that the total amount of receivables in the master trust meet certain minimum requirements. If the amount of the receivables in the trust falls below these limits, then the transferor is obligated to add additional receivables to the trust. However, these additional receivables are not used directly to make payments to investors. Collections of interest and principal continue to be allocated between the transferor interest and the investor interest.

Interchange – In most credit card securitizations, the transferor is required to pass through to the QSPE all interchange fees collected on the accounts within the master trust. Although intrinsically linked to the receivables, interchange is a distinct revenue stream and is not viewed as interfering with the legal isolation criteria of related receivables.

Compensating Interest Payments from the Servicer – In most mortgage-backed security transactions, a servicer, who may be the transferor, agrees to remit a full month's interest on loans that have been prepaid regardless of when prepayment occurred during the month. This is a long-standing practice and is accounted for when valuing any servicing asset or liability.

Reinvestment Proceeds of Trust Accounts – A QSPE is permitted to invest the collections from its assets pending distribution in relatively risk-free investments, which may include obligations of the transferor (e.g., commercial paper), if the transferor has the required high credit rating.

Servicing Advances on Government Agency (e.g., Fannie Mae) Mortgage-Backed Security ("MBS") Transactions – The servicer, which may be the transferor, is required to advance principal and interest on Fannie Mae MBS transactions regardless of recoverability. Furthermore, the servicer also is required to advance tax and insurance payments on behalf of the QSPE regardless of their recoverability in order to protect the security interest in the underlying collateral. The servicer may reimburse itself for these advances to the extent permitted by the guaranty agreement and/or the servicing contract arising from late mortgagor payments, liquidation proceeds or insurance/guarantee payments.

In its deliberations of Statements 125 and 140, the FASB has always permitted the transferor to provide some forms of recourse and still allow the transfers to qualify for sales treatment. Paragraph 11 (b) of Statement 140 clearly states that the transferor should recognize all assets obtained and liabilities incurred in consideration as proceeds of the sale, including guarantees or recourse obligations. This guidance should be consistent whether the transferee involves a QSPE or not. If the FASB believes that additional restrictions are needed for commitments made by the transferor to a QSPE to improve the financial-components approach, then we recommend that the transferor only be prohibited from providing commitments to deliver cash or other assets to a QSPE if such commitments interfere with the legal isolation criteria of Statement 140 or cause the transferor to maintain effective control.

However, if the FASB decides against our preceding recommendation and instead decides to continue to not allow transferors to enter into any commitments to deliver additional cash or other assets to the SPE or its BIHs, then the FASB should at least limit this restriction to only those commitments that add assets which function as substantive credit enhancements or which guaranty the performance or credit quality of

the transferred assets. An exception for servicing advances related to guaranteed mortgage securitizations should be created. Consistent with Statement 140, these recommendations are also in line with current industry practice and are predicated on regulatory guidelines. The Federal Reserve System, Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision (collectively, the “Banking Agencies”) use similar types of restrictions for their regulatory capital standards relating to asset sales with recourse<sup>1</sup>. This would address our concerns regarding the transferor’s arrangements noted above that are not meant to serve as substantive credit enhancements nor guaranty the performance or credit quality of the transferred assets but are rather practices which facilitate the efficient functioning of the securitization markets.

## ***II. Additional Restrictions for Structures that Reissue Beneficial Interests***

The Exposure Draft imposes significant additional limitations on an entity that reissues beneficial interests to qualify as a QSPE. We have significant concerns regarding those provisions.

### **A. Definition of Reissuance**

First, the Exposure Draft does not define “reissuance,” which creates ambiguity in whether a reissuance structure includes conventional master trusts where each series is paid from the aggregate collections of the assets and new issuances are made as a reduction of the retained Seller’s Interest. We believe that the conventional master trusts, as explained above, should not be considered a reissuance entity.

The Background Information and Basis for Conclusions section of the Exposure Draft focuses on asset-backed commercial paper conduits and other structures that finance long-term assets with short-term beneficial interests. The beneficial interests in these structures are paid from the proceeds of issuing new beneficial interests as opposed to the conventional master trust scenario, where each series of beneficial interests are paid from the cash inflows of the pool of assets and new issuances are made as a reduction of the retained Seller’s Interest.

FASB has long accepted conventional master trust structures, which are specifically described in Statement 125 and Statement 140. Paragraph 79 of Statement 140 (which is not being amended by this Exposure Draft) specifically states, in part, “To achieve another securitization using an existing master trust, a transferor first transfers additional receivables to the trust and then sells additional ownership interests in the trust to investors.” The sale of additional ownership interests should not be viewed as a reissuance of beneficial interests.

However, the Exposure Draft creates uncertainty as to whether such structures are reissuance structures subject to the additional proposed restrictions due to the vague wording in paragraph 5(f) of the ED. To resolve this uncertainty, the FASB should define a “reissuance” structure as a structure that applies the proceeds of new issuances of beneficial interests to retire maturing beneficial interests held by parties other than the transferor, its affiliates, and agents.

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<sup>1</sup> Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance Capital Treatment of Recourse, Direct Credit Substitutes and Residual Interests in Asset Securitizations (66 Federal Register 230, November 29, 2001).

## **B. Loss of QPSE Status Outside of Transferer's Knowledge/Control**

Second, the additional proposed restrictions for reissuance structures may result in the transferor consolidating a formally qualifying SPE based on the inconsequential actions of third parties that either: 1) the transferor does not control or 2) has no relevance on the transferor's economic position. The issue is that these additional proposed restrictions do not consider the amount of actual control held by entities that may be able to disqualify the qualifying status of an SPE. For example, an unrelated third-party interest rate swap provider or another party that has a commitment to deliver additional cash to a master trust may be in a position to disqualify the master trust from its qualifying status by inadvertently purchasing a subordinated security issued by the master trust, resulting in the consolidation of the master trust into the transferor's financial statements. To have a standard that determines what is consolidated on-balance sheet or remains off-balance sheet that is based on the actions of third parties that are beyond the transferor's control, is not appropriate and would make the consistent application of this provision difficult, creating misleading financial statements.

## **C. Additional Cost with No Benefit**

Third, the restriction to require at least 2 entities to provide commitments to deliver additional cash is unnecessary and would unjustifiably add to the cost of the structure. Although we understand from paragraph A12 that the FASB was concerned that the concentration caused by liquidity facilities by a single party may give that party the incentive and ability to direct a QSPE's activities, there are many other commitments to provide additional assets that do not have that result, such as basic plain-vanilla interest rate or foreign currency swaps. To require the syndication of these types of commitments is unwarranted.

## ***III. Derivatives between the Transferor and QSPE***

### **A. Risk and Reward Concepts with Derivative Instruments**

We disagree with the FASB's position that a QSPE may only enter into derivative financial instruments with counterparties other than the transferor, its affiliates, and agents for the same reasons why we object to the prohibition of a QSPE entering into commitments to deliver additional cash or other assets with the transferor as discussed above. The focus on derivatives for a QSPE has always been on whether the derivative instrument is passive in nature and pertains to beneficial interests issued or sold to entities other than the transferor, its affiliates, or its agents. This is clearly illustrated in Question 26 in FASB's Guide to Implementation of Statement 140, which states the following:

“To illustrate, a qualifying SPE is precluded from entering into written options that provide the holder with an opportunity to trigger a condition that enables the SPE to sell transferred assets under circumstances inconsistent with the requirements of paragraph 35(d)(2) of Statement 140.

If an SPE enters into certain derivatives instruments, sale accounting is precluded, not because the SPE is not qualifying, but because other provisions of paragraph 9 have not been met. Examples of those instruments include:

- Derivative instruments that preclude the transferor from achieving legal isolation under paragraph 9(a)
- Derivative instruments through which the transferor retains effective control over the transferred assets under paragraph 9(c).”

As clarified in Question 26, Statement 140, in its current form, prohibits sales accounting for derivatives that violate effective control or isolation requirements for the transferor, but these derivatives do not impact the “qualifying” status of the SPE. If the FASB wants to deviate from this Statement 140 concept and place an additional restriction on the permitted derivatives that a QSPE can hold, then we recommend that this additional restriction pertain only to derivative instruments that cause the transferor to maintain effective control over the transferred assets and/or jeopardize the transferred assets from being isolated from the transferor and its affiliates.

We do not understand what benefit is achieved by requiring the derivative to be with a party unrelated to the transferor nor do we know of any valid reason why the transferor should be prohibited from entering into certain basic derivatives such as “plain vanilla” interest rate or foreign currency swaps with a QSPE. Again, the FASB is inappropriately mixing risk disbursement concepts with the financial-component approach of Statement 140. The FASB has not provided any valid arguments in the Background Information and Basis of Conclusion section of the Exposure Draft that warrant an all-inclusive prohibition of derivatives between the QSPE and the transferor and its affiliates and to do so is unjust and needlessly adds to the cost of the transaction.

## **B. Restructuring Issues**

If the FASB adopts any additional restrictions on derivatives between a QSPE and the transferor, then situations may arise in master trust type structures in which a master trust may have a derivative or other commitment with the transferor that relate to pre-existing beneficial interests outstanding that is not able to be amended to comply with the new restrictions. Even if the derivative contract could be amended, Paragraph 40.a. of Statement 140 currently permits a QSPE to enter into a derivative financial instrument only: 1) when new beneficial interests are issued or sold to third parties other than the transferor, its affiliates, or its agents; or 2) when a derivative needs to be replaced upon occurrence of an event or circumstance (specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds) outside the control of the transferor, its affiliates, or its agents. QSPEs, such as master trusts, that have existing derivatives with the transferor would not be able to maintain their QSPE status if the final standard is issued as proposed, since it would violate the provisions of a transferor having a derivative with a QSPE and since the QSPE would not be able to replace the derivative with counterparties other than the transferor because the event (change in accounting) was not specified in the legal documents that established the SPE. As such, the FASB should include in its transitional guidance the following provision:

- The entity shall continue to be considered a QSPE even if, after the effective date, it issues new beneficial interests or receives assets other than those it was committed to receive, so long as any such new beneficial interests are not entitled to the benefits of the noncomplying derivative or commitment.

## ***IV. Proposed Changes to Paragraphs 80-84***

We do not understand FASB’s objective in creating a requirement that the second entity in any two-step transaction issuing beneficial interests must be a QSPE. Revising the language in paragraphs 80-84 of Statement 140 would create numerous uncertainties and unintended consequences. For example, some have interpreted the proposed rules to apply to the government agency MBS transactions (e.g., Ginnie Mae or Freddie Mac), since these markets generally do not use QSPEs and the interests issued may be viewed as undivided interests. If the FASB adopts the Exposure Draft in its current form and if agencies were deemed to be the transferors, then the agencies may be prevented from transferring loans into a QSPE given that paragraph 35 (e) of the proposed provisions prohibits a transferor from entering into any commitments to deliver cash or other assets to the SPE or its beneficial interest holders.

Furthermore, we do not understand why transactions that involve non-QSPEs in a two-step transfer, such as certain commercial mortgage-backed securities, would not be able to obtain sales treatment if the second entity had sufficient ability to pledge or exchange its assets. This would create inconsistent standards based on whether a transfer had one or two steps. Thus, we strongly urge that the FASB avoid these issues by leaving paragraphs 80-84 as they are and instead rely on the application of FIN 46 to transactions that do not involve a QSPE. However, if the FASB chooses not to accept our recommendation, then, to avoid issues with respect to agency mortgage-backed securities, the FASB should clarify that the new text in paragraph 83 does not apply to single-step transfers and add text to Statement 140, which states that grantor trusts are entities, similar to the language that is in paragraph 3 of FIN 46. Further, Statement 140 should define a “grantor trust” as a tax classification that does not necessarily require a separate legal entity. Some agency MBS pools are not separate distinct legal entities but qualify as grantor trusts for tax purposes.

#### ***V. Application of the Isolation Requirements to Transferor and Consolidated Affiliates***

We do not object to the principle of applying the isolation requirement of paragraph 9(a) of Statement 140 to the transferor and its consolidated affiliates. However, the FASB should clarify the wording in paragraph A16 of the Exposure Draft that the transferred assets must be isolated from all entities, which are consolidated into the transferor, but not from all sister-related entities located above the transferor in the consolidation chain. Paragraph A16, as proposed, is inconsistent with the wording of paragraph 3 of the Exposure Draft since paragraph 3 applies the isolation requirement to the transferor and its consolidated affiliates, but paragraph A16 applies the isolation requirement to the consolidated group that includes the transferor. A consolidated group includes affiliates under the ultimate parent that are not consolidated with the transferor (e.g., sister companies). The isolation requirement applied to the consolidated group that includes the transferor would make it impossible for transfers of financial assets to sister companies to meet the sales criteria in the transferor’s separate stand-alone financial statements since both parties are in the same consolidated group. We believe that sales accounting should be permitted for purposes of the transferor’s separate stand-alone financial statements even though the transaction would be eliminated in consolidation in the ultimate parent’s consolidated financial statements. Accounting for transfers between sister companies as sales is important since banking entities may utilize these transfers between sister banks in order to manage the regulatory capital and reporting requirements for each separate entity that file regulatory reports based on generally accepted accounting principles.

#### ***VI. Restriction on Holding Equity Instruments***

Certain provisions of permitted financial assets held by a QSPE may require the delivery of equity securities as a result of foreclosing on a collateralized loan or under a work-out/bankruptcy agreement. Just as current QSPEs are temporarily permitted to hold nonfinancial assets obtained in connection with the collection of financial assets that it holds, the FASB should add a similar provision that a QSPE would be temporarily permitted to hold equity securities obtained in connection with the collection of financial assets that it holds.

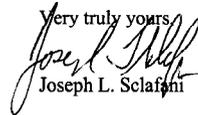
#### ***VII. Transition Provisions***

In addition to the requested transition period specifically for derivative contracts noted above, we also request additional time before the final standard becomes effective due to the significant amount of work involved in reviewing current QSPE documentation and making the necessary amendments to the documentation. In many instances, required changes may require investor consent. In instances that do not require investor consent, adequate time (at least six months from the issuance of the final standard) will be needed to review current documentation and make any necessary amendments before the final

standard can be implemented. In instances where investor consent is required to make any necessary amendments, the granting of additional transition time would be consistent with what FASB provided in FASB Technical Bulletin 01-1 (no later than 5 years from the date of issuance).

Furthermore, the financial accounting and reporting community is still in the process of implementing FIN 46. The process to analyze and implement FIN 46, an extremely complex accounting standard, within a short period of time, has placed tremendous burdens on financial reporters. Commensurate with FIN 46, preparers of financial statements are required to implement new guidance for derivatives and liability and equity instruments. To introduce additional SPE guidance while enterprises are still addressing the previously issued SPE guidance in FIN 46 and of the other standards, introduces additional operational and reporting risk.

Due to the significance of the issues addressed in this letter, J.P. Morgan Chase & Co. looks forward to participating in the Roundtable discussion on the ED on August 28, 2003. If you have any questions or would like to discuss our comments, then please do not hesitate to contact David M. Morris at (212) 648-0377 or me at (212) 270-7559.

Very truly yours,  
  
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