Letter of Comment No: 20 File Reference: 1100-163 Date Received: 7// /02

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July 1, 2002

Ms. Suzanne Bielstein
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Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: File Reference No. 1100-163: Proposed Statement of Financial Accounting Standards, Amendment of Statement 133 on Derivative Instruments and Hedging Activities

Dear Ms. Bielstein:

We are pleased to provide the following comments in response to the Financial Accounting Standards Board's above-referenced Exposure Draft (the "Exposure Draft") and the related tentative Statement 133 Implementation Issues No. A20, B12, B36, C17, and D2 (the "Proposed D2 Model").

Proposed D2 Model

Conceptually, we support the FASB's objective of requiring bifurcation of embedded derivatives in beneficial interests issued by special-purpose entities (SPEs) because it advances the Board's goal of fair value accounting for all financial instruments. However, we believe several changes need to be made to the Proposed D2 Model to make the related accounting more consistent with

economic substance rather than form, as well as to address certain implementation issues. We are aware of the comment letter from the Joint Industry Working Group of The Bond Market Association, the International Swaps and Derivatives Association, and the Securities Industry Association, and their concerns about applying the Proposed D-2 Model. We share those concerns and are supportive of the recommendations contained in their letter.

Interaction with Pending SPE Consolidation Guidance

The Proposed D2 and SPE consolidation models should be considered jointly and rationalized to a much greater degree than is presently the case. The Board has not addressed the critical issue of subsequent accounting for SPEs by the consolidator under either model. Due to the mixed attribute accounting model, subsequent accounting for the SPE's assets, derivatives, and liabilities could result in income statement distortion that would be misleading and confusing to users of the reporting entity's consolidated financial statements. An SPE's liabilities (i.e., beneficial interests) are typically non-recourse to the parent's operations, can only be satisfied by the SPE's assets, and are not payable or pre-payable from the parent's assets.

For example, assume a non-qualifying SPE has \$100 of credit-sensitive assets, including a de minimis amount of credit-linked notes issued by other unrelated SPEs. The SPE's assets are financed by \$70 of senior notes, \$20 of junior notes and \$10 of subordinated notes. Broker-dealer X does not manage the SPE but owns 40% of the subordinated notes. The remaining subordinated notes are held by three parties that each own 20%. Broker-dealer X's total investment in the SPE is \$4 (40% of \$10). Broker-dealer X owns none of the senior and junior notes. Broker-dealer X concludes that the SPE is not a QSPE because of the active management of its assets. In addition, broker-dealer X concludes that the SPE is not a "financial" SPE defined under the proposed SPE consolidation rules because of the credit linked notes that must be bifurcated under the Proposed D2 Model. Broker-dealer X concludes it is required to consolidate the SPE because it has a significant portion of the total variable interests that also is significantly more than the amount of interests held by any other individual party.

In its consolidated financial statements, broker-dealer X is required to account for the entire \$100 of SPE assets at fair value, with changes in fair value (realized and unrealized) recorded in earnings. In order to avoid income statement distortion that would be misleading and confusing to users of its consolidated financial statements, we believe broker-dealer X should be permitted to mark-to-market through earnings changes in the fair values of the SPE's outstanding

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liabilities of \$96. Otherwise, broker-dealer X would likely record gains or losses in its consolidated financial statements that it is not entitled to or will never bear. In short, consolidation should impact only the balance sheet of broker-dealer X, not its income statement. This makes intuitive sense in our view.

The accounting issue is how to fit the intuitive answer into the mixed attribute accounting model. In our view, because this is an SPE and not an operating subsidiary, one approach would be to view the \$96 of outstanding SPE debt as debt issued by a consolidated subsidiary that is not clearly and closely related to the credit standing of broker-dealer X's debt. We believe this approach is analogous to the parent company concept in consolidated financial statements. The embedded derivatives that would be bifurcated under this approach are a series of out-of-the money default options, i.e., default protection, linked to the credit sensitive assets held by the SPE. All embedded derivatives would be marked-to-market, effectively offsetting the changes in the fair values of the SPE's assets.

We recognize this approach would be in conflict with how an investor would apply the Proposed D2 Model because, in our example, an investor would likely conclude no bifurcation would be required because of the de minimis amount of credit linked notes. We believe the asymmetry can be justified as a practical solution to a real problem and is analogous to the different treatment afforded lenders and borrowers under DIG Issue C13.

A simpler approach would be to permit entities to mark to market the SPE's liabilities. This approach acknowledges the SPE's liabilities (i.e., beneficial interests) are typically non-recourse to the parent's operations, can only be satisfied by the SPE's assets, and are not payable or pre-payable from the parent's assets. Whether or not the Board adopts one of these suggested approaches, the issue needs to be addressed. We believe the Board should not finalize the Exposure Draft as it pertains to derivatives embedded in beneficial interests issued by an SPE without a complete analysis of the implications on SPE consolidation. These proposed standards are significantly interrelated and additional issues may become apparent as the SPE guidance becomes fully developed and constituents provide comments.

Loan Commitments

Proposed new paragraph 10(i) excludes loan commitments from the scope of the Exposure Draft due to practical and not conceptual considerations related to implementation of the characteristic-based definition of a derivative. We have

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previously expressed our disagreement with the proposed amendment and continue to adhere to the views we have previously expressed.

Revised Definition Of Initial Net Investment and Related Bifurcation Issues

Assuming all other criteria are met, we understand the Exposure Draft to require bifurcation of any option-based contract requiring an initial net investment of other than its fair value and any non-option based contract requiring an initial net investment of at least 5% of the fully prepaid amount. This would require financial institutions to evaluate almost every contract to determine whether bifurcation is required. Given the size and breadth of many financial institutions' derivatives portfolios, this would be a huge undertaking. Currently, bifurcation is required only when the initial net investment is not "small." We have found the current framework allows for the use of judgment across a broad spectrum of instruments and market conditions that can exist.

Our preference is to retain the current framework, which is consistent with the Board's desire to adopt a "principles" based approach to rule making, but to change the guidance in DIG Issue A9 on the grounds that the initial net investments in the examples are not small. If the Board does not share our preference, and to address our practical concerns, the Board should permit companies to account for all hybrids at fair value, with changes in fair value reported in earnings as they occur, regardless of whether the hybrid is an asset or liability. As the Board is aware, the current mixed attribute accounting model does not allow hybrid instruments that result in liabilities to be accounted for at fair value. By making this change, the Board would advance its goal of fair value accounting for all financial instruments. In addition, companies that account for hybrids at fair value could make full use of paragraph 12(b) and thus avoid the onerous bifurcation requirements, which, as noted above, could be substantial for dealers, like Goldman Sachs. Finally, we note this approach would also be consistent with the recent IASB decision to allow entities the option to mark hybrid instruments to market under IAS 39.

Statement 133 Implementation Issue A20 Example 3 Is Not Internally Consistent

The response to Example 3 in Issue No. A20, Application of Paragraph 6(b) regarding Initial Net Investment, states that the contract should be bifurcated into a debt host that is the option premium receivable with a value equal to \$18,838

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and a compound derivative comprised of an at-the-money swap component and a written cap component. This implies the following journal entry:

DR: Premium Receivable \$18,838 CR: Compound Derivative Liability \$18,838

However, as noted in the Background section of Example 3, the fixed rate on the swap has been adjusted from 6.65 percent to 6.64 percent so the fair value of the compound derivative at inception is zero. Therefore, if the above journal entry were recorded, the carrying value of the compound derivative liability would not equal its fair value. In our view, neither a derivative liability nor a premium receivable should be recognized. To do otherwise would result in a derivative liability being recorded at other than its fair value. It also would require the bifurcation of a compound derivative into its components. Both results are contrary to the core principles of FAS 133.

Moreover, as discussed above, the practical issues associated with an accounting rule that could require dealers to analyze their entire derivatives portfolios in a search for swaps with embedded options are significant. Nor do we understand the perceived improvements in financial reporting that would be expected from such a rule when no cash is exchanged. Finally, we would argue that even if a balance sheet gross-up were required (which we do not support), the grossed-up amounts are nettable because they are embodied within a single contract that will be net settled. In our view, they are analogous to the receive and pay legs of a swap contract.

We appreciate the opportunity to provide you with our comments. If you have any questions, please do not hesitate to contact me.

Sincerely,

/s/ Matt Schroeder