



LETTER OF COMMENT NO.

23



Shannon Warren
Managing Director

September 14, 2007

Mr. Russell G. Golden
Director of Technical Application & Implementation Activities-FSP
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: Comments on Proposed FSP FAS 140-d
Accounting for Transfers of Financial Assets and Repurchase Financing Transactions

Dear Mr. Golden:

JPMorgan Chase & Co. (the "Firm") is pleased to submit its comments on the Proposed FASB Staff Position No. FAS 140-d, *Accounting for Transfers of Financial Assets and Repurchase Financing Transactions* (the "proposed FSP"). Although the Firm appreciates the Financial Accounting Standards Board's ("FASB" or the "Board") efforts to clarify paragraphs 9 and 15 of Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* ("SFAS 140") in response to issues related to the accounting for repurchase financings in the mortgage real estate investment trust (REIT) industry, we, however, do not believe additional broad-based guidance is warranted and are concerned about the wide implications that the proposed FSP will have for financial reporting.

In addition to our comments and concerns expressed in this letter, we have also participated in the preparation of the joint industry comment letter submitted together by the American Securitization Forum ("ASF") and the Securities Industry and Financial Markets Association ("SIFMA") and endorse the views and positions expressed in their letter.

We believe that SFAS 140 currently provides sufficient guidance on whether sale and subsequent repurchase transactions satisfy the accounting sales criteria. Paragraph 9 of SFAS 140 states that a transfer of financial assets in which the transferor surrenders control over those assets shall be accounted for as a sale to the extent that consideration *other than beneficial interests in the transferred assets* is received in exchange. The response to Question #60 of the Financial Accounting Standards Board Special Report—*A Guide to Implementation of Statement 140 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*—

J.P. Morgan Chase & Co. 245 Park Avenue, Floor 10, New York, NY 10167-1299

Telephone: 212 648 0906 Facsimile: 646 534 6153 warren_shannon@jpmorgan.com

Questions and Answers ("SFAS 140 Q&A") states, "Any beneficial interest whose cash flows are derived from assets transferred by the transferor should be treated as retained interests" and that "A Transferor should treat the beneficial interests as new assets to the extent that the sources of the cash flows to be received by the transferor are assets transferred by another entity." Additionally, paragraph 272 of SFAS 140 states that a "careful examination of cash flows, risks, and other provisions should provide a basis" to distinguish between a retained interest in the asset transferred and a newly created asset.

In applying this existing guidance, if the initial transferor has access to assets of the transferee that were not transferred by the initial transferor (i.e., access to the general credit of the transferee), the initial transferor has received consideration other than beneficial interest in the transferred assets and should analyze the transaction under SFAS 140 independently from the repurchase agreement; thus the transactions should not be linked. If however, the asset received from the transfer (i.e., repurchase agreement) only limits the initial transferor to the cash flows of the underlying asset, then the transferor did not receive consideration other than a beneficial interest in the transferred assets and thus, would not qualify as a sale under paragraph 9 of SFAS 140.

As many repurchase transactions are generally of a much shorter-time frame than the maturity of the asset that is used for collateral, there is no obligation that requires the initial transferor to continue to finance the asset. Thus, we believe that effective control has transferred to the initial transferee as part of the initial transfer. As long as control has transferred (to the initial transferee) and the repurchase agreement does not cause the risks and rewards of the transferred assets to be transferred back to the initial transferor, the initial transferor has sold the transferred assets and received a new asset in return and therefore, the two transactions should be accounted for separately.

If the Board does not agree with the application of SFAS 140 noted above, then the Board should consider other linkage models that already exist in GAAP as noted in the joint industry comment letter submitted by the ASF and SIFMA. We do not support another linkage model being introduced, that would only serve to increase the complexity in accounting standards.

If the Board believes that further clarification is necessary and proceeds with the issuance of the proposed FSP, then we urge the Board to consider the following issues:

- The statement in the proposed FSP that the lapse of time is not relevant in determining whether two transactions are linked is inappropriate and will be a challenge to implement. Additionally, the definition of a repurchase agreement in the proposal is ambiguous.
- The items listed in paragraph 7 of the proposed FSP (taking into consideration our comments herein) should be constructed as indicators rather than as *criteria* that must be met since the facts and circumstances of the transactions should be considered.
- The criteria of paragraph 7a and 7c are impractical and unduly restrict sale accounting for transactions with a valid business and economic purpose.
- The proposal may decrease transparency in the financial statements for transactions that are linked.
- The proposed effective date would not provide sufficient time to implement the proposed FSP and is unrealistically aggressive due to the number of critical operational constraints

that would have to be overcome to identify and monitor all transactions within the scope of the proposed FSP.

The remainder of this letter provides more detail on the above concerns with the proposed guidance.

Scope

The proposed FSP as currently written states the lapse of time between the initial transfer and the subsequent repurchase financing is not relevant in determining if the transaction is a repurchase financing. However, as noted below under Operational Feasibility, if the two transactions are more than a few months apart, it becomes extremely difficult to track the exact financial asset being transferred. First, the financial assets transacted in repurchase financings are usually liquid and trade frequently and with various counterparties, this includes Level 2 securities. This makes recording and maintaining information each time a trade occurs an enormous effort. Second, many of these securities are fungible which would imply that tracking the exact security being sold is extremely difficult and essentially a futile exercise. Third, the Firm currently does not maintain trade information on sales of securities. As such, it is not only impossible to obtain past sales data but would require an overhaul of our entire systems to begin to record and maintain such information going forward. Lastly, the cost involved with storing such massive amounts of information would be very expensive and does not add much incremental value.

In addition to the operational constraints mentioned above, the Firm believes that it is unreasonable to assume without clear indication of such contemplation that transactions done months apart could be in contemplation of each other. Continuously changing market conditions and price movements make it unlikely that two counterparties would contemplate transactions to occur at a future date with the sole purpose of avoiding a particular accounting treatment. Therefore, we expressly ask the Board to limit the scope of the proposed FSP to transactions occurring contemporaneously (i.e., on or near the same date).

We acknowledge that paragraph 55 of SFAS 140 states that a change in circumstances may result in the transferor regaining control of assets previously accounted for appropriately as having been sold, because one or more of the conditions in paragraph 9 are no longer met. Therefore we understand that the Board was reluctant to narrow the scope to transactions that occur on or near the same date. However, as we indicated above, the initial transfer has met the conditions of paragraph 9 of SFAS 140 and the asset the initial transferor is receiving in consideration is a new asset, not a beneficial interest in the transferred asset. Thus, paragraph 55 of SFAS 140 would not apply. We do not believe it is appropriate to force linkage of the two transactions under paragraph 55 in order to comply with paragraph 9 of SFAS 140.

In addition to the issue regarding the lapse of time, the proposed FSP's definition of a repurchase financing also seems unclear. We believe a more specific definition of repurchase agreements will be useful to ensure consistent application of the proposed FSP and will reduce the need for future clarifying guidance on what transactions are within its scope. We ask that the Board clarify the proposed FSP's scope to comprise of repurchase agreements as defined in FASB Interpretation No. 41, *Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements* ("FIN 41"), which states that "for purposes of this Interpretation, a repurchase agreement (repo)

refers to a transaction that is accounted for as a collateralized borrowing in which a seller-borrower of securities sells those securities to a buyer-lender with an agreement to repurchase them at a stated price plus interest at a specified date or in specified circumstances.”

Paragraph 7 - Proposed FSP Criteria

We urge the Board to amend the proposed FSP to construct the items listed in paragraph 7 of the proposed FSP (taking into consideration our comments herein) as *indicators* rather than as *criteria* that must be met. The use of indicators rather than criteria is consistent with the principles of existing guidance on linkage (specifically FASB Staff Implementation Guidance, “Guide to Implementation of Statement 133 on Accounting for Derivatives and Hedging Instruments”, Issue K1, *Determining Whether Separate Transactions Should be Viewed as a Unit*), which recognizes that the facts and circumstances of the transactions should be considered when determining whether two transactions should be linked. To presume linkage of two transactions based on a set or rules without considering the facts and circumstances of the two transactions would be inappropriate.

In addition, we believe that the criteria proposed would suggest linkage of most (if not all) sale and subsequent repurchase agreements. In particular, we are concerned with criteria 7a, 7c, and 7d as currently written for the following reasons:

- Paragraph 7a states that the initial transfer and the subsequent repurchase financing should not be contractually contingent on one another and that there are no implied commitments. We are concerned with the difficulty of demonstrating whether or not one contract is contingent upon another contract because the proposed FSP assumes an implicit commitment to exist when the transactions are entered into at or near the same time. We believe that this criterion would automatically fail when the transactions are done at the same time, resulting in many transactions inappropriately considered to be linked for accounting purposes. Furthermore, the task of disproving implied commitments to our external auditors would be challenging as implied commitments are near impossible to document and have an insufficient audit trail.

Paragraph 7a also states that “if the pricing or performance of either the initial transfer or the repurchase financing depends on the terms and execution of the other agreement, an implied commitment likely exists”. Paragraph A8 in the basis of conclusions goes on to say that “if the transferor requires specific knowledge of the asset to provide a “better” rate on the repurchase financing, the initial transferee is economically compelled to execute the repurchase financing with the initial transferor”...thus, “the initial transferor effectively maintains control over the transferred financial asset because the initial transferee is unlikely to execute the repurchase financing with anyone other than the initial transferor.” We disagree with the Board that the initial transferor retains control. In cases where the transferred financial asset is an illiquid asset (generally, a Level 3 asset) we believe that parties that are interested in buying the asset mainly do so because they desire the risks and the related rewards of such asset and that they would transact with any counterparty that is able to finance their purchase of that asset. In such cases, however, it is generally only the initial transferor who knows the asset well enough to be able to finance these positions as there is no ready market. As such, we believe that neither counterparty receives any preferential pricing and that the transferor does not retain any control over the asset.

Furthermore, in almost all cases the term of the repurchase agreement is significantly less than the maturity of the underlying collateral, thus the initial transferee can choose not to finance the asset after the term of the repurchase agreement and in effect they have control over the asset. We agree with the position taken in the ASF/SIFMA comment letter that such transactions do in fact have the specific valid and distinct business purpose to minimize credit risk. By requiring such transactions to be linked, the proposed FSP could cause market inefficiencies where although the best economic rationale would be to transact with the original transferor, such transactions might not occur due to the punitive impact of the proposed FSP.

- Paragraph 7c requires that the asset subject to the transfer and repurchase agreement have a quoted price in an active market (Level 1 inputs as defined in Statement of Financial Standards No. 157, *Fair Value Measurements* ("SFAS 157")). We disagree with the proposed FSP's implication that only financings of transfers of Level 1 assets have a valid and distinct business or economic purpose. We urge the Board to avoid any implication that certain transfers or arrangements do not have a valid and distinct business or economic purpose based on whether such asset has a quoted price in an active market. The transfer of risk between the initial transferor and the initial transferee provides for a valid reason for the transactions. The financing of the sale of such asset does not mitigate the intent of the original sale. We do not understand why actively traded assets should be accounted for differently from assets that do not have an active market nor do we understand why the accounting should be different if an actively traded asset becomes a non-actively traded asset (whether due to market disruptions or not).

This criterion is not necessary as long as the initial transferee has the risks and rewards of the asset and maintains control over the asset. At minimum, we urge the FASB to include Level 2 assets as there are many securities, such as corporate bonds and private-label asset-backed securities for which JPMC utilizes matrix pricing, where input prices are based on characteristics of Level 1 market traded financial instruments and are liquid. Additionally, the exclusion of Level 2 assets significantly limits the amount of trades that would be considered de-linked and makes it operationally difficult to implement and maintain, particularly when an asset moves from level 1 to level 2.

- Paragraph 7d requires that the initial transferee maintain the right to the collateral by having the ability to take control of the transferred asset and substitute it with a different financial asset. While the Firm appreciates the FASB's effort to prove that control remains with the initial transferee if the initial transferee has the right to substitute the transferred financial asset with a different asset, the issue is that Master Repurchase Agreements generally do not afford the initial transferee the unilateral right to substitute as the pricing and terms of the repurchase agreement are determined by the nature of the underlying collateral. It is only reasonable that the initial transferor be given the ability to protect its position and approve the asset being substituted so as to ensure that the financing terms given is still appropriate or that such substitution would not be detrimental to the initial transferor. In our experience, if the borrower in a repurchase agreement requests a reasonable substitution, it will generally be granted. Thus, we ask the Board to clarify that the initial transferee does

not need the unilateral right to substitute the transferred financial asset, but instead have the right to substitute when the terms are considered reasonable to both parties to the repurchase agreements.

Linked Transaction Presentation

Under the proposed guidance, if the two transactions are deemed to be linked, the asset will remain on the books of the initial transferor and the repurchase agreement is considered to be a forward agreement. This will result in the initial transferee not recording a liability under the repurchase agreement in its financial statements. In addition, the forward agreement needs to be assessed to determine whether it meets the definition of a derivative as defined in Paragraph 6 of SFAS 133, *Accounting for Derivative Instruments and Hedging Activities* (SFAS 133). As the forward agreement will require physical settlement, the forward will need to be assessed under paragraph 9(c) of SFAS 133 in determining whether the underlying security is readily convertible to cash. For level 3 securities, the forward will not meet the definition of a derivative. As a result, the initial transferee retains the risk but does not record the asset or a derivative in its financial statements. Whereas, the initial transferor who does not retain the risk of the asset, will continue to record the asset on its balance sheet.

As a result, we believe that the proposed FSP would not provide more useful information and could prove to be confusing to the users of the financial statements, which may hinder users' strategic and investing decision making. The Board should re-evaluate the consequences of this proposed guidance as we do not believe it is the Board's intent to decrease transparency in the financial statements.

Operational Feasibility

In order to determine the operational feasibility of the proposed guidance, we held detailed conversations with each of our lines of businesses that may be impacted by the proposed FSP. From our conversations, we have determined that there are a number of critical technology and resource constraints to overcome before we can track repurchase financing trades and securities sold to the same counterparty.

As a global financial institution, the Firm has a multitude of trading and financing desks located all over the world that operate independently of each other. They are not only housed in different lines of businesses, but also use different technology platforms. Repurchase financing arrangements, specifically, are transacted throughout the Firm in separate legal entities. Further complicating a potential implementation of the proposed FSP is the substantial volume of repurchase and reverse repurchase transactions at the Firm. For example, in North America alone, on average there are 1,900 daily transactions with a total notional of \$170 billion. To maintain the appropriate trade data to comply with the proposed guidance, the Firm will need to create a centralized system to capture and store all trades where securities have been sold, in order to subsequently link repurchase financing transactions with securities previously sold. The magnitude and global scale of operations greatly complicates the task of both changing the Firm's existing systems and setting up new control systems.

For sales of securities, the Firm currently does not retain any trade specific information in the risk management systems after the trade date or in the sub-ledgers after the settlement date. Therefore,

it is not currently feasible for the Firm to retrieve information on securities that have already been sold. At minimum, the Firm requests the Board to consider prospective application so that the Firm may put in place the systems required to track new security sales and repurchase financings. Moreover, in the initial months post implementation, we believe that the new process will introduce significant operational risk with complete reliance on off-line manual processes.

Transition and Effective Date

The proposed effective date of fiscal years beginning November 15, 2007 is not practical for the proposed FSP in its current form. In light of the concerns expressed above - particularly with the scope and lapse of time, paragraph 7 criteria, and operational feasibility - the timeline for implementation is not workable. As such, the effective date should be no earlier than fiscal years beginning on or after November 15, 2008.

Furthermore, if the Board decides to issue a form of this guidance, we believe the proposed FSP should be applicable to prospective deals only. Since most repurchase agreements are short term in nature (usually about three months), prospective application would not greatly alter the financial statements of the parties to the repurchase transaction.

* * *

In summary, we strongly recommend that the Board not issue a final FSP on this topic until it holds additional discussions with both the preparer community (including both financial and corporate institutions) and financial statement users to fully assess the financial reporting implications and the operational burdens of implementing the guidance of the proposed FSP.

We appreciate the opportunity to submit our views and would be pleased to discuss our comments with you at your convenience. If you have any questions, please contact me at 212-648-0906 or *Giovanna Acquilano* at 212-648-0908.

Very truly yours,

Shannon S. Warren