

Letter of Comment No: 103
File Reference: 1082-300
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December 1, 2003

Mr. Lawrence Smith
Director of Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: File Reference No. 1082-300
Exposure Draft on Consolidation of Variable Interest Entities, a modification of FASB Interpretation No. 46 (the "Exposure Draft")

Dear Mr. Smith:

Morgan Stanley appreciates the opportunity to provide comments on the Exposure Draft. Morgan Stanley is a member of The Bond Market Association (the "Association"), the American Securitization Forum (the "ASF") and the Securities Industry Association (the "SIA") and has participated in the comment letters submitted to the Financial Accounting Standards Board (the "Board") by those organizations. We support the positions and recommendations reached therein.

Executive Summary

We agree with the Board that FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* ("FIN 46"), requires modification to address various implementation issues that have arisen since its issuance. Overall, we continue to believe that in lieu of an all or nothing consolidation approach the Board should utilize a components approach¹, such that all parties to a variable interest entity record their involvement with respect to that entity. However, even if the Board continues to pursue only an all or nothing consolidation approach, we believe FIN 46 needs revision. This Exposure Draft attempts to provide clarifying guidance for certain of the identified implementation issues and we support many of the proposed modifications under this guise. However, we believe that the Exposure Draft does not address some of the broader critical issues confronting constituents faced with implementing, applying and understanding the financial impact of FIN 46. Three of seven members of the Board recognize these problems in their dissent. Those members note in paragraphs A43 and A44 of the Exposure Draft that,

"...the Interpretation (a) does not address all the issues that they view as most critical to achieve more consistent application of consolidation policies to variable interest entities and (b) does not provide a deferral of the effective date of Interpretation 46 for all entities to allow for efficient adoption.

Those Board members believe, for example, that there is currently a lack of clarity surrounding the application of the expected losses and the expected residual returns test,

¹ Further delineation of the components approach is contained within the Association's and ASF's comment letter dated October 31, 2003 submitted to the Board. The Board has also previously articulated a conceptual basis for the components approach as it pertains to financial assets in Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, a replacement of FASB Statement No. 125*.

which is the gateway for determining whether an entity is a variable interest entity and the key test for identifying who should consolidate an entity.”

In contrast to the Board’s view that FIN 46 (including its related guidance) and expected modification thereof may increase the costs of initial implementation, we believe the ongoing costs of applying this guidance will outweigh any perceived benefits users of financial statements will obtain given the lack of clarity in interpreting the provisions and the ongoing complex assessments that are required. While costs are always incurred in implementing a new accounting standard, we believe that a full cost/benefit analysis should not only contemplate those initial implementation costs but the ongoing costs of compliance, including an assessment of the operationality of the proposal. We are concerned that the ongoing operational costs surfacing among constituents necessitate further evaluation of the underlying premises of FIN 46.

In general, we find the proposed changes in the Exposure Draft to be largely technical in nature. That is, a number of the changes are minor corrections (e.g., certain reconsideration events that were originally omitted in paragraph 15 of FIN 46). As a result, we have only a few specific comments regarding such changes that are provided in Appendix A of this letter. However, the sheer magnitude of the number of changes included in the Exposure Draft (more than half of the paragraphs in FIN 46, excluding the Appendices, are being modified) supports our concern that a more comprehensive review of FIN 46 may be warranted. We believe that the Exposure Draft represents only the first step in an attempt to address such underlying issues.

Thus, we believe that the Board should immediately defer the effective date of FIN 46, including for involvement with variable interest entities post-January 31, 2003, until many more of the major implementation issues have been addressed. Such a deferral should provide sufficient time to vet the current guidance. Additionally, we believe that the much needed deferral would allow the Board an opportunity to amass the multitude of interpretive guidance surrounding FIN 46 into either one Interpretation or into this modification. We have provided further comments below on what we perceive to be significant implementation issues that warrant attention at this time in order to ensure a standard that will achieve the Board’s goal of improved financial reporting.

Clarity as to the Concepts of “Expected Losses” and “Expected Residual Returns” is Critical

We agree with the assessment by the minority Board members. The calculation of “expected losses” and “expected residual returns” represents the single most important factor in the application of FIN 46. Although, as noted in the summary of the Exposure Draft, the Board seeks “more consistent application of consolidation policies to variable interest entities,” the Exposure Draft is silent on the single most important issue in achieving this desired consistency. We do not believe that the FASB Staff Position (“FSP”) process represents a better forum for resolving this critical issue instead of clarifying this issue in the Exposure Draft.

While we praise the Board for deciding not to prescribe a one size fits all calculation of expected losses and expected residual returns, we believe too much divergence may result under the numerous interpretative calculations that currently exist. The Board apparently has also struggled with acceptable calculations of expected losses and expected residual returns as reflected by the different FSPs issued and proposed to date. An initial proposed FSP on this subject² was issued in April 2003 and subsequently replaced by the proposed FSP FIN 46-d³ in September 2003. FSP FIN 46-d provides an example in which an entity pays fees to a decision maker. We are aware that various

² Proposed FSP—Treatment of fees paid to decision makers and guarantors in determining expected losses and expected residual returns of a variable interest entity under FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*.

³ Treatment of Fees Paid to Decision Makers and Guarantors as Described in Paragraph 8 in Determining Expected Losses and Expected Residual Returns of a Variable Interest Entity under FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*.

constituents have proposed numerous different calculation models in their application of FIN 46. These different calculation models do not all identify the same primary beneficiary even given the same set of facts; and thus, do not achieve the consistency desired by the Board. There could also be situations in which two separate parties to the same variable interest entity reach inconsistent conclusions, resulting in consolidation of the variable interest entity by neither party (each party concludes that the other party is the primary beneficiary) or by both parties (each party concludes that it is the primary beneficiary).

Moreover, while the basic example provided in Exhibit A of FSP FIN 46-d is helpful in illustrating the form of the calculations (even though many comment letters have viewed the form of the calculation as flawed because it “double-counts” the variability of the fee), it does not adequately address real life transactions in which a variable interest entity faces numerous risks simultaneously and different variable interest holders bear these risks differently. Thus, the form of the calculation provided may not be operational in many cases. For example, there may be many different possible scenarios (i.e., different combinations of outcomes of different risk variables) in which the “expected loss outcome” can occur. Which scenario(s) should be identified as the “expected loss outcome” and used to identify the primary beneficiary? Although the comment period ended on October 10, 2003, the Board has yet to publicly discuss this proposed FSP in any substance. Given the effective date for the application of FIN 46 was February 1, 2003, reporting companies are already well into their implementation of FIN 46 without significant concepts regarding the single most critical calculation required in FIN 46 being conveyed. The complexity of the expected loss and expected residual return model exemplifies that the preparer and auditor communities need more time to analyze the calculation to ensure a robust adoption within the financial statements. We are further concerned that consolidation decisions may be based on an approach that differs from how the economics are assessed for business decisions and submit that the basis for consolidation be simplified.

Bias against Fees in Calculation of Expected Residual Returns is Unjustified

In January 2003, the ASF noted to the Board that the inclusion of gross fees paid to decision makers in the calculation of expected residual returns (as compared with the *variability* of the returns to other variable interest holders) would generally result in the collateral manager of a collateralized debt obligation (“CDO”) being identified as the primary beneficiary of the CDO and required to recognize the assets and the liabilities of the CDO as their own. The ASF noted that this would be the case even when the collateral manager owned no other variable interests and demonstrated that the equity of a CDO embodies a dominant share of the economic risks and rewards of the CDO. We continue to believe that the conclusion resulting from this bias is unjustified and will lead in many cases to an inappropriate consolidation requirement.

This decision to define “expected losses” and “expected residual returns” for purposes of consolidation very differently than any economic analysis of risk and reward was destined to create inexplicable results. It is inconsistent with how the capital markets evaluate risk and return and how business decisions are executed; thus, we believe it is not a meaningful basis for presenting financial information. In recent filings, certain collateral managers have concluded that FIN 46 requires that they consolidate CDOs in which they have little or no exposure to the economic gains and losses of the CDO. The lack of significant exposure to the economic risks and rewards of the CDO should, at a minimum, raise questions as to whether the collateral manager should recognize the assets and the liabilities as their own.

The financial results reflected in the income statement are also problematic. As a result of this consolidation, the CDO managers report losses (or gains) in their consolidated financial statements in circumstances in which it is *impossible* for those companies ever to incur such losses (or obtain such gains). These losses (or gains) will be reversed in future periods. We do not understand the merits of requiring that a company report losses (or gains) to which it has no exposure (or benefit). Research analysts have begun to explain to investors how to reverse the effects of this accounting rule in order to derive financial information that they believe to be more relevant than that being presented.

Furthermore, we do not see how CDO arrangements are much different than the mutual funds arranged as trusts and other trusts held in bank trust departments that the Exposure Draft proposes to provide a scope exception for in paragraph 3.c. sub-h. which modifies paragraph 4 of FIN 46. As further noted by the Board in paragraph A13 of the Exposure Draft, the trusts described in paragraph 3.c. sub-h. are not for the benefit of the trustee; we contend that neither are CDOs for the benefit of the collateral manager.

“Mismatch” Between Fair Value and Accrual Accounting Must Be Resolved

The distortions to the income statement described above are not limited to those situations in which the inclusion of fees in the calculation of expected residual returns requires consolidation of a variable interest entity by the manager. These results will occur for any consolidated variable interest entity that holds financial assets where unrelated holders of the liabilities are exposed to a portion of the economic risks and rewards, even in those cases where consolidation of a variable interest entity by a primary beneficiary is appropriate. In these circumstances, the liabilities are accounted for on an accrual basis while the financial assets are recognized at fair value. The use of accrual accounting for the liabilities of a consolidated variable interest entity does not accurately depict the economic reality of these transactions where the holders of the liabilities are exposed to the economic risks of the entity. We assert that this “mismatch” in accounting recognition does not result in more meaningful or transparent financial reporting. This issue should also be addressed comprehensively during any deferral period.

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In summary, we believe that the Board should delay the effectiveness of FIN 46 in its entirety, including involvement with variable interest entities post-January 31, 2003, until it has completed a more complete modification. This more complete modification should address all the major implementation issues identified. At a minimum, the modification should provide clarification of the concepts embedded in the calculation of “expected losses” and “expected residual returns” and provide a solution to the accounting “mismatch” between fair value accounting for financial assets held by variable interest entities and accrual accounting for the liabilities of variable interest entities that are recognized by a primary beneficiary.

In Canada, the Accounting Standards Board (“AcSB”) considered several constituent concerns arising from the efforts to implement Accounting Guideline AcG-15, *Consolidation of Variable Interest Entities*, which corresponds to FIN 46. In light of the significance of these concerns, the AcSB decided to defer the effective date of AcG-15 to annual and interim periods beginning on or after November 1, 2004, except for certain disclosures. We recommend that the Board adopt a similar deferral.

We would be pleased to discuss our comments with the Board or the Staff. Please contact Staci Lublin at (212) 537-2456, Karen Dealey at (212) 537-2452 or Doug Van Ness at (212) 761-1779 with questions or comments.

Sincerely,

/s/ David S. Moser
Managing Director,
Principal Accounting Officer

APPENDIX A

Specific Comments on the Exposure Draft

- The Exposure Draft contains two paragraphs numbered 3.
- Paragraph 11 of the Exposure Draft amends paragraph 16 by adding the phrase *de facto principals*. This term is never defined. The discussion of a *de facto principal* in paragraph A28 of the Exposure Draft should be expanded.
- The reference in paragraph A13 of the Exposure Draft to “paragraph 4(g)” should be to “paragraph 4(h).”
- The reference in paragraph A20 of the Exposure Draft to “paragraph 5” should be to “paragraph 9”.
- Paragraph A23 of the Exposure Draft refers to the Board’s decision to delete paragraph A5. Only the last sentence in paragraph A5 is proposed to be deleted.