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Ms Suzanne Bielstein Director of Major Projects and Technical Activities Financial Accounting Standards Board 401 Merritt 7, P.O. Box 5116 Norwalk, Connecticut 06856-5116

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Dear Ms. Bielstein:

The Canadian Bankers Association (CBA) thanks the Financial Accounting Standards Board (FASB) for the opportunity to comment on the Exposure Draft (ED) of the Proposed Interpretation on Consolidation of Certain Special-Purpose Entities.

FILE REFERENCE 1082-200 - CONSOLIDATION OF CERTAIN SPECIAL-PURPOSE ENTITIES

#### A. General Comments:

The CBA supports FASB's effort to improve financial reporting by issuing the ED, which clarifies consolidation rules for Special Purpose Entities (SPEs) in order to improve comparability between enterprises, and to provide meaningful and relevant information to financial statement users. We agree that financial statement users require more meaningful information about an enterprise's involvement with SPEs. In particular, the risks and rewards and rights and obligations associated with the SPE should be presented in an enterprise's financial statements when the enterprise has a controlling financial interest in the SPE.

We believe that to achieve this goal of improving financial reporting, FASB should ensure that the final Interpretation achieves a balance between form and substance of a transaction. We believe that rules that attain this balance will consistently result in the recognition of assets and liabilities in which an enterprise has rights to the rewards or has exposure to risks. With a well-crafted standard, professional judgement will prevail in finding a reasonable and fair representation of both the legal and economic nuances of an enterprise's involvement in an SPE.

# **B. Specific Comments:**

#### 1 Definition of SPEs is too broad

We believe that the current definition of SPEs is too broad and will create inappropriate results. Since SPEs are all enterprises that do not meet the definition of a substantive operating enterprise as stated in paragraph 7 a, many structures which currently are used as vehicles for assets being managed or administered on behalf of unrelated parties such as Mutual Funds, Investment Funds, Hedge Funds, and Employee Compensation Trusts may meet the definition of SPEs. If administrators of these entities are viewed as the primary beneficiary, the activities of these entities would be presented in administrator's consolidated financial statements. We believe this would misrepresent the economic nature of these business operations to financial statement readers since administrators usually only earn a fee. Administrators of these entities do not receive any further benefits from the entities' assets and are not responsible for providing any financial support to the entities' unit holders.

Recommendation: We recommend that FASB clearly define SPEs and explicitly exclude from the final Interpretation investment pools such as Mutual Funds, Investment Funds, Hedge Funds and Employee Compensation Trusts.

Another example of entities currently defined within the ED as SPEs are venture capital and private equity investments that are typically carried out through limited partnerships (LPs). These LPs pool capital from various investors who take on limited partnership interests in the LPs. The general partner of the LP typically manages the investment pool for a fee and a residual share in profits, typically 20%. There could be situations where the LPs are wholly owned by a substantive operating entity, which also is the managing general partner as well as a limited partner investing no more than 25%. The interests as a general partner when combined with the interest as a limited partner could result in the substantive operating entity being looked upon as the primary beneficiary. However, there are no guarantees or any downside protection provided to the partnership or any limited partner. The LP is a true pooling of risks of unassociated investors where one investor has a base and an incentive fee arrangement to encourage the maximization of results for all limited partners. Categorizing the substantive operating entity as the primary beneficiary would result in the creation of a large minority interest on the balance sheet of the substantive operating entity. This result would be contrary to the intended effect of the ED, which is to make the provider of significant financial support to an SPE consolidate the SPE. In this situation, no financial support is being provided to the SPE by any party.

Recommendation: We recommend that the definition of variable interest be clarified to ensure that situations where a substantive operating entity has no direct or contingent obligation to provide financial support to the SPE other than its commitment of capital on terms and conditions similar to all other limited partners, are not considered to be variable interests. This would ensure that we satisfy condition e in paragraph 9 of the ED and consequently, evaluate the LP for consolidation based upon voting interests. Alternatively, we recommend that FASB explicitly exclude from the final Interpretation Venture Capital Limited Partnerships.

## 2. Nature and level of equity invested in an SPE

Paragraph 9 b requires an entity to determine if the level of equity is sufficient to permit the SPE "to finance its activities without relying on financial support from variable interest holders". Although we understand the underlying rationale for determining the sufficiency of the level of equity, we feel that FASB should provide greater clarification to whether the equity in the SPE must be equity in legal form or capital that could be "equity-like" in substance. For instance, an SPE may issue notes that have equity-like characteristics (i.e., in terms of rate of return, first-loss position absorbed, etc.). In accordance with the conclusions reached to date on FASB's current project on *Liabilities and Equity*, such notes would be accounted for as an equity instrument.

Recommendation: We recommend that equity-like instruments be considered as equity in accordance with the conclusions reached to date on FASB's current project on *Liabilities and Equity*.

In addition to defining the nature of the equity in an SPE, paragraph 11 indicates that an enterprise should "compare the amount of the equity investment [in an SPE] with the amount of the equity invested in substantive operating enterprises with similar assets and liabilities, similar activities, and similar risks" in order to determine if the level of equity is sufficient. Given that certain types of financial activities are only undertaken within the construct of an SPE, we believe it will be difficult to find comparable substantive operating entities that would prove helpful in appropriately evaluating this criterion. An alternative suggestion would be to look to the credit rating assigned by a third-party agency (such as Moody's or S&P) to the SPE's financing instruments. For example, if a credit rating agency assigns at least an investment grade credit rating to the capital or funding which ranks ahead of the equity or equity-like capital of an SPE, it is generally assumed in practice that there is sufficient equity in the vehicle to cover future expected losses over the life of the SPE. We feel that looking to the rating assigned by the third party agency may be a practical alternative in determining the sufficiency of the equity invested in the SPE.

Recommendation: As it will be difficult to find comparable substantive operating enterprises with similar activities to the SPE, we recommend that in determining the sufficiency of an equity investment, FASB consider the fact that a third-party rating agency has assigned at least an investment grade credit rating to the capital or funding which ranks ahead of the equity or equity-like capital in an SPE as evidence that the SPE satisfies condition b of paragraph 9.

## 3. Consolidation based on majority interest

We believe that in requiring an enterprise that provides either (1) a majority of the variable interests or (2) a variable interest that is a significant portion of the total variable interest, and that is significantly more than the variable interests held by any other individual party to consolidate the SPE may result in companies consolidating SPE activities where the entity owns less than a majority interest. This approach is inconsistent with existing consolidation rules where an enterprise is only required to consolidate a subsidiary if it holds a controlling financial interest, which is usually determined as 50% or more in voting control. Under ARB 51.2, controlling financial interest is "ownership of a majority voting interest" and over 50% of the outstanding interest is a condition pointing to consolidation. In addition, the need to consolidate an enterprise that has "significantly more" of a variable interest as stated in paragraph 13 c, will result in additional reporting and testing as entities will need to monitor whenever any entity with a variable interest alters its holdings or commitments to the SPE.

Recommendation: We recommend that the final Interpretation restrict the definition of a primary beneficiary to the entity holding the majority of the variable interests.

#### 4. Multi-seller conduits

Asset backed commercial paper conduits are an example of SPEs that hold financial assets. The variable interests reside with sellers who bear the risk of first loss and earn the gains associated with the financial assets. While most administrators to these conduits provide program credit support, which under the standard is a variable interest, program supports do not represent a material risk to the administrator as the first loss guarantee resides with the seller. Therefore, it would be inappropriate for the conduit administrator to consolidate the SPE.

Recommendation: We recommend that paragraph 23 b should be clarified such that a credit or asset support or facility should be a first loss bearer. We propose wording as follows: "It provides a guarantee, a back-up lending arrangement, or other form of liquidity, credit, or asset support that is subordinate to all the interests of all other parties".

## 5. Qualifying special purpose entity

We believe that there are legitimate business reasons to use SPEs such as to obtain lower cost of funds. However, the ED does not allow an entity to properly reflect the risks and rewards of such transactions. For example, the ED may result in the administrator of a multi-seller conduit becoming the primary beneficiary and consolidating the multi-seller conduit in cases where the structure incorporates a qualifying special purpose entity (QSPE) between the transferor and the multi-seller conduit that issues commercial paper. We believe this accounting result is inappropriate and misleading as the administrator is only at risk for its "spread" or fee income, and not the risks and rewards of asset ownership of the assets and liabilities that will appear on its consolidated financial statements.

Recommendation: We recommend that FASB provide further guidance concerning QSPE multi-seller relationships, and consider in more detail the risks and rewards of such SPEs.

#### 6. Silos

With respect to silos, the ED states in paragraph17 that an enterprise with rights and obligations substantially restricted to specifically identified assets of an SPE, shall treat those assets and the portions of the SPE's liabilities attributable to those assets as a separate SPE. In our opinion this leads to an erroneous and unintended application of the SPE consolidation criteria. For instance, where a participant has provided overall liquidity support to an SPE, but is protected by a more subordinate support albeit at a silo level, it would be misleading to conclude that the participant is the primary beneficiary of the overall SPE by virtue of providing liquidity support that is subordinate at the overall SPE level, assuming that one of the remaining two conditions in paragraph 23 is also met. Instead such a participant should be allowed to evaluate its interest in each silo giving due consideration to the various levels of subordinate protection available to it within each silo.

Recommendation: We recommend that the treatment of an SPE's silos as separate SPEs should be consistently extended to all participants involved with the SPE, whether on a silo-specific basis or on an overall basis.

## 7. Determining if an enterprise provides financial support to a financial SPE (FSPE)

Paragraph 23 provides three conditions of which at least two must be met in order to conclude that an enterprise involved with the SPE is considered to provide significant financial support to the SPE. Paragraph 23 a cites the "authority to purchase and sell assets for the SPE and... in exercising that authority to significantly affect the revenues, expenses, gains, and losses of the SPE" as one condition which could indicate financial support.

Recommendation: We recommend that FASB outline under what circumstances "discretion" could be exercised when using derivatives to manage the profitability and overall risk profile of the financial assets held in the SPE.

In addition to paragraph 23 a, paragraph 23 c also points to the receipt of a fee that is not market based as another condition. Furthermore, the additional guidance provided under paragraph 19 calls for an enterprise to assume that "its fee from an SPE is not market based unless it can be demonstrated to be comparable to fees in similar observable arm's length transactions or arrangements".

Recommendation: Since the type of activities undertaken by an FSPE would rarely occur within a significant operating enterprise, we recommend that FASB consider looking to the service fees charged by other comparable SPEs as the most practical alternative in determining if the fee is "not market based".

Recommendation: We recommend that FASB provide more guidance for paragraphs 22 and 23.

## 8. Regulatory capital implications

Certainly in the case of financial institutions, the ED could mean substantial increases in the total balance sheet assets resulting in increased capital charges. SPEs have always existed for their valid purposes and regulators have not required financial institutions to hold additional capital for the assets held by the off-balance sheet SPEs except to the extent of risks directly undertaken by the financial institution. Consolidation of the SPE could mean additional capital requirements under the existing rules that use balance sheet assets to determine adequate capital. These additional capital charges would seem unwarranted and may also result in altering the business fundamentals of certain secondary capital market activities.

Recommendation: We recommend that the implementation of the final Interpretation be delayed until financial institution regulators have assessed the impact of the ED, and modified the current capital adequacy requirements to accommodate and offset the increased assets resulting from the consolidation of the SPEs which were previously not consolidated.

## 9. Implementation and measurement issues

We believe that the requirement to quantify variable interests and determine which entity has the majority of the variable interest presents significant modelling and measurement issues. Most SPEs are structured to diversify risk such as credit risk, foreign exchange risks, liquidity risks, operational risks and first loss risks. Therefore, variable interests such as guarantees, management contracts, credit enhancements and derivative instruments represent these different risks. As a result it is not clear how these various risks will be quantified or weighted when an enterprise determines whether or not it has a majority of the variable interests. For

example, how do management fees rank in relation to transaction or program liquidity facilities in a multi-seller conduit when quantifying variable interests?

Recommendation: We recommend that FASB provide additional guidance or clarification on how to calculate and weight different risks as represented by different variable interests in an SPE.

The ED emphasizes an analysis of risk based on loss as illustrated by the definition of variable interests that are defined in the ED in paragraph 7 as "the means through which financial support is provided to an SPE". In addition, paragraph 20 states that variable interests are quantified by "comparing expected future losses from the interests."

Recommendation: To ensure that financial statement users are provided with a proper reflection of an enterprise's economic involvement and an understanding of the rewards as well as the risks associated with an SPE, it is recommended that FASB provide guidance to ensure quantification of both the rewards and the losses when determining the relative size of an enterprise's variable interest.

# 10. Additional reporting and information requirements

Entities will require extra resources to effectively monitor all SPEs that they have a relationship with. Because the definition of primary beneficiary includes an entity that holds either (1) a majority of the variable interests or (2) a variable interest that is a significant portion of the total variable interests and is significantly more than the variable interests held by any other individual party, the ongoing monitoring and requirement to calculate and report the fair value of an SPE's assets and liabilities, and expected losses and the sharing of these losses could be quite onerous. The costs for this will be significant.

Recommendation: If consolidation is not restricted to a majority variable interest holder as suggested at item 3 above, then we recommend that FASB require all entities to re-evaluate their need to consolidate the SPE using an event based approach as opposed to every reporting period.

# 11. Recognized gains from a previous sale

The ED does not provide guidance for situations where a transferor is required to consolidate an SPE, but recognized gains from sales to the SPE in the past. It is unclear whether the appropriate accounting for these previously recognized gains would be to consider it a change in accounting policy and require a retroactive adjustment through retained earnings.

Recommendation: We recommend that FASB provide guidance for the accounting for gains from previous sales to an SPE that now has to be consolidated.

# 12. Business implications

The proposed effective date of the final Interpretation is unreasonable given the significant impact of the ED on businesses and the changes that would be required to adhere to the new Interpretation. Initially, entities may not be considered the primary beneficiary of an SPE. However subsequent events and circumstances may result in changes to this conclusion. As a result, entities will be required to constantly monitor all SPEs that they have a relationship with to determine whether consolidation is required. This is a complex process that requires time to implement.

Recommendation: We recommend that the effective date of the final Interpretation should be at least one year from date of issuance. Should that not be the case, all existing SPEs should be grandfathered in order to allow entities to have sufficient time to review and implement the final Interpretation for SPEs created after the effective date.

#### Conclusion

In conclusion, we commend FASB for their expeditious approach to addressing a current financial reporting and accounting need. We agree that new guidance on the consolidation of SPEs is required to ensure consistent and comparable financial reporting. We would like to ensure that new standards and interpretations meet FASB's stated objectives and we encourage FASB to consider our comments.

Should you have any questions or need any clarifications on these issues, please do not hesitate to contact me.

Sincerely,

Original signed by Kelly Shaughnessy

RKS/ File: CAC/Special Purpose Entities