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## Consolidation of Certain Special-Purpose Entities, an interpretation of ARB No. 51 File Reference No. 1082-200

We appreciate the opportunity to provide our comments on the above referenced Proposed Interpretation. We support the Financial Accounting Standards Board's (FASB) efforts to improve the quality of financial reporting and disclosure related to special purpose entities (SPEs). However, we believe the current exposure draft is a significant departure from current GAAP guidance. The Proposed Interpretation calls for analysis of SPEs for consolidation based upon the concept of variable interests. This concept conflicts with previously issued GAAP guidance which was based upon control and risks and rewards. We believe that the introduction of a new paradigm such as variable interests establishes new generally accepted accounting principles and should be subject to the full analysis, deliberation, and due process of a Statement.

We believe the FASB should consider an interim approach that would involve improvement of footnote disclosures related to SPEs. We also recommend the FASB work to codify existing SPE consolidation accounting guidance included in the various EITFs (Topic D-14, 90-15, 96-21). This would allow the FASB to undertake a long term project that would examine the entire accounting and reporting model for SPEs and provide additional recognition and measurement criteria in a new Statement. This Statement should be a principles based model that takes into consideration the control over the operations of an SPE as well as the potential of an organization to participate in the risks and rewards of the SPE's operations.

In the event the FASB decides against our recommended approach above, we believe the staff should more clearly address the following specific issues related to the Proposed Interpretation.

## Financial Special Purpose Entities (FSPEs)

We believe the existing GAAP guidance for beneficial interests and proposed guidance on guarantees would, if appropriately followed by SPE participants, result in a fair representation of their exposure to SPEs. As such, we support the general concept of FSPEs. The intent of the FSPE guidance appears consistent with the Board's belief stated in the introduction that the "proposed interpretation would require existing unconsolidated SPEs to be consolidated by primary beneficiaries if they do not effectively disperse risks among parties involved." However, we believe the definition of an FSPE as included in the Proposed Interpretation should be modified because in its current form, it will result in the consolidation of many common and market accepted risk-dispersing SPEs. We have attached an example in Appendix A which illustrates the implementation of the new FSPE guidance. In this example Company B must consolidate the FSPE because they are an investment manager and own a minority residual interest in the structure.

We believe the consolidation of these types of structures will result in significant confusion, present a distorted picture of the economic interests of the participants in these structures, and result in diminished transparency in the financial statements. While we understand the FASB's concern about entities using SPEs to avoid reflecting economic exposures on their financial statements, there should also be concern about an entity's financial statements being misleading where it has consolidated assets it does not control and liabilities for which it has no obligation to pay. Such consolidation will create an inaccurate picture of a company's financial condition and may also create situations where an entity's debt covenant and financial ratios are impacted. This could have a direct effect on an entity's ability to obtain liquidity for operations or issue debt to paragraphs 22 and 23 of the Proposed Interpretation that we believe will appropriately classify certain structures as FSPE's and allow entities to fairly present their risks and exposures:

We propose to add the following two conditions to paragraph 22.b.:

- (4) They may hold derivative financial instruments, other than derivative instruments that pass along the total return of the SPE to a third party, that relate to and partly or fully counteract some risk associated with (i) beneficial interests issued or sold to parties other than a transferor or (ii) the related assets held by the SPE.
- (5) They may hold derivative financial instruments, other than derivative instruments that pass along the total return of the SPE to a third party, that serve to allocate cash flows within the SPE in order to provide for risks and cash flows to the beneficial interest holders that are consistent with the substantive terms of the beneficial interests.

We also propose to replace the three conditions utilized in determining the significance of the financial support through a variable interest, as provided in paragraph 23, with the following two conditions, both of which must be met before consolidation would be required:

- The entity has the authority to both purchase and sell assets for the SPE and has
  sufficient discretion in exercising that authority to affect the revenues, expenses,
  gains and losses of the SPE in a manner that benefits the entity substantially more
  than any other party, other than through changes in the volume of the SPE's assets
  or transactions intended to protect beneficial interest holders from losses.
- The entity holds a majority of the variable interests by virtue of one of the following:
  - a. The entity holds interests in the form of liquidity, credit or asset support that is subordinate to the interests of other parties and are expected to bear losses in the projected scenario. Interests that are issued as a class or otherwise subject to assignment of syndication will be excluded if the entity under consideration does not own a majority of such interests.
  - b. The entity receives a fee that is not market-based.

In connection with these recommended changes, we believe the Board should revise the presumption outlined in Paragraph 19 of the Proposed Interpretation that fees received from an SPE are not market based. We do not believe a negative presumption is necessary and that the establishment of an objective standard would be adequate. The negative presumption imposes significant burden on companies to demonstrate that fees are consistent with those of competitors. The lack of readily available information may result in companies inexperienced in certain transactions having to contact competitors to determine and support market based fees. This is not only impractical, but also could present price fixing (antitrust) concerns.

We believe these changes are necessary to ensure the provisions of the Proposed Interpretation are applied in a manner consistent with the Board's stated purpose and intent. Without these changes, we believe many investors would report distorted balance sheets by inappropriately consolidating SPEs that diversify risk among participants.

#### Other Recommended Clarifications and Comments

We see several potential problems that may result from the evaluation process required by the Proposed Interpretation. These problems may lead to errors in financial reporting and confusion among the users of financial statements. Therefore, we offer the following comments on various other aspects of the Proposed Interpretation.

• Determination of Variable Interests - The Proposed Interpretation introduces a new concept, that of the determination of the primary beneficiary of an SPE through the concept of variable interests. This concept departs significantly from previous consolidation guidance, which focused on control and risks and rewards. While past guidance has required a review of the facts and circumstances of a transaction, a reasonable expectation in most situations was that control over an entity was presumed only by holding a majority of that

entity's voting interests. Under the Proposed Interpretation, no controlling interest is necessary to require consolidation. The rule established by the Proposed Interpretation requires that if no party holds a majority of the variable interests in an SPE, then any other party that holds a "significant" variable interest that is "significantly larger" than any other party's is required to consolidate. We believe that this new concept requires further clarification or its application will result in many misinterpretations and conflicting conclusions.

- Undue Administrative Hardship Due to the significant amount of information and analysis required to evaluate whether an SPE should be consolidated under the provisions of the Proposed Interpretation, we believe that an undue hardship will be placed on entities in order to make this evaluation on a quarterly basis. Many SPE structures involve multiple unrelated parties that have varying interests in the SPE. Due to the quarterly evaluation requirement, the sharing of timely information and conclusions regarding variable interests among the involved entities would be difficult, especially considering varying reporting deadlines of the participants. An entity's ability to meet reporting deadlines may be compromised due to the inaccessibility of information needed on a quarterly basis. Therefore, we recommend that an entity's consolidation assessment of an SPE be performed annually as part of the year end reporting process, absent any known material changes to the SPE.
- Credit Tenant Loans & Other Real Estate Loans A Credit Tenant Loan (CTL) is a mortgage loan that is made primarily in reliance on the credit standing of a major tenant and is structured with the assignment of rental payments to the lender in the amount necessary to meet all debt service coverage obligations of the borrower (the SPE). SPE's are widely used in CTL transactions for the purposes of providing a bankruptcy-remote lessor and insulating the SPE's owners from liability. Lenders have also insisted on segregating the assets to minimize the risk of claims from other creditors in the event of bankruptcy. Finally, rating agencies have uniformly required a bankruptcy remote SPE in order to rate transactions based on the credit of the We believe that current accounting rules for CTL transactions in accordance with Statement No.13 Accounting for Leases are appropriate with the lessor showing the asset and related debt on its balance sheet and the lender simply showing the loan as an asset on its balance sheet. Similar to a mortgage loan or direct loan, the lender does not share in the increase of value of the underlying collateral property. Subjecting the lender to consolidation would result in misleading financial statements for the lender. recommend that the credit tenant loans be excluded from the scope of the Exposure draft.

Many commercial real estate properties are leveraged through multiple layers of debt utilizing senior/subordinate structures, including second mortgages and pledges of voting interests. Overall leverage may approach or exceed 90% on a combined basis. Again, subjecting the lender to consolidation would result in

misleading financial statements for the lender. We recommend a "safe harbor" should be provided for mortgage lenders whose senior loan, taken alone, was originated at a specified, prudent loan to value ratio.

- Potential for Inconsistent and Conflicting Conclusions The involvement of
  multiple unrelated parties in SPE structures may result in inconsistencies in
  conclusions. The participating entities will likely make the determination of the
  SPE's primary beneficiary independent of the other participants. This, along
  with the degree of judgment and subjectivity involved in determining what
  constitutes "a significant portion of" or "significantly more" variable interests
  will potentially result in situations where an SPE is inappropriately consolidated
  by no one, or inappropriately consolidated by multiple parties.
- Impact of Consolidation and Unconsolidation Situations will arise that will require SPEs to be consolidated and unconsolidated from one reporting period to the next. Each period, this may result from parties to an SPE other than the reporting entity changing their interests and risk exposure to the SPE. This may cause a passive investor to change its consolidation determination as a result of changes made by other participants that are outside the investor's control. This situation could result in a passive investor consolidating or unconsolidating the SPE from period to period although the investor has not actively changed its relationship with the SPE. This raises several questions regarding the accounting for the "unconsolidation" and "reconsolidation" of the SPE that are currently not addressed in the Proposed Interpretation. It also adds a degree of financial statement volatility that may result in confusion and misinterpretation by users of the statements and which is not representative of the actual economics of the transaction.
- Financial SPE Provisions If the Board does not make the changes recommended above regarding expansion of the FSPE definition and exclusions, we believe several items must be addressed with regards to paragraphs 22 and 23 of the Proposed Interpretation. Without further clarification and specific guidance regarding the application of these paragraphs, we believe diversity and errors in practice are likely to occur.
  - We believe clarification is needed to describe the types of fees that will be included in the test outlined in paragraph 23c of the Proposed Interpretation. Many participants are interpreting this as servicing and administrative fees because investment management and guarantees/liquidity support fees are addressed in paragraphs 23a and 23b. Others are applying this to all fees associated with an SPE, including fees resulting from investment management and guarantees that are addressed in paragraphs 23a and 23b. We believe that the interpretation should clarify that item c only applies to those fees not already covered by items a and b to avoid "double counting" in the evaluation process.

- We believe clarification is needed around the phrase "asset support that is subordinate to the interests of other parties" as stated in paragraph 23b. It is unclear whether this is intended to include any subordinated tranche below the most senior tranche (for example, AA and below) or only lower rated tranches (BB or below). It is also unclear if this subordination evaluation should be performed based upon legal or economic subordination.
- Paragraph 22 restricts FSPEs to the definition of a Qualifying Special Purpose Entity (QSPE) per paragraph 35 of FASB 140, with certain exceptions. While a QSPE is allowed to hold passive derivative instruments that relate to beneficial interests sold to third parties in accordance with Statement No. 140, the current proposed amendment to Statement No. 133 would limit the ability of a QSPE (and therefore an FSPE) to hold hedging derivative instruments and to issue beneficial interests with embedded derivatives. We believe the ability to hold passive derivative instruments is critical to the mitigation of risk and should be an acceptable financial instrument for an FSPE to hold, even if the FSPE has issued beneficial interests with embedded derivatives. We therefore recommend adding additional wording to paragraph 22 to allow FSPE's to issue beneficial interests with embedded derivatives.
- Accounting for Asset Impairment The Proposed Interpretation does not address the accounting for impairment of assets of a consolidated SPE. Assuming the financial assets of a consolidated SPE were accounted for as available-for-sale investments under Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities, losses that were determined to be other than temporary would be reflected in earnings. The primary beneficiary is only exposed to economic losses to the extent of its variable interest because the other variable interest owners economically absorb all remaining losses. The Proposed Interpretation is not clear whether the primary beneficiary could adjust its liability to-the other variable interest holders to reflect the asset impairment.
- Determination of Consolidation Based on Voting Interests Paragraph 9e and paragraph A2(f) of the Proposed Interpretation indicate that an SPE cannot be evaluated for consolidation based on voting interests if any part of the equity investment was provided by a holder of variable interests in the SPE (through fees, ownership of beneficial interests, etc). This appears to impose a significant administrative burden requiring evaluation of the SPE for consolidation under the variable interest rules, especially in instances where the variable interest holder has a small minority equity interest in the SPE. We recommend that a percentage of equity limitation be established which a variable interest holder may hold in an SPE without violating the provisions of this test.
- De Facto Agency Relationship An entity is required to consider related parties when assessing its variable interests in an SPE. Paragraph 15e of the Proposed Interpretation introduces the concept of a "de facto" agency

relationship in situations in which an enterprise provides significant amounts of professional services or similar business arrangements. This "de facto" agency relationship may require the entity to treat that service provider as a related party for purposes of applying this Proposed Interpretation. We believe the concept of "de facto" agency relationship requires further clarification in the form of examples to ensure consistent application, especially as it may or may not apply to organizations such as investment bankers and broker/dealers involved in the structuring of SPE transactions.

- Impact of Valuing at Fair Value at Transition The transition provisions of the Proposed Interpretation require that an entity initially consolidate an SPE's assets, liabilities, and noncontrolling equity interests at fair value. This approach will create issues with the current and subsequent accounting for the difference between the carrying amount and fair value of the items consolidated. To avoid these issues, where SPE financial reporting data is available, we believe the FASB should allow an option for the transition adjustment to be made using asset, liability, and equity values that would have resulted if the SPE had been consolidated at its inception.
- Effective Date We believe that the proposed timetable for implementation is
  too aggressive for many constituents due to the extensive changes required in
  the way business is conducted that will result from the Proposed Interpretation.
  Therefore we request an extension of the Proposed Interpretation's effective
  date to the first fiscal period ended after December 15, 2003, with the possible
  expansion of footnote disclosures for material existing structures during the
  interim period.

#### Conclusion

We appreciate the opportunity to express our views on the Proposed Interpretation. As both a user and supplier of financial information, we certainly appreciate the FASB's continued efforts to improve the transparency of financial statements related to SPEs. However, for the reasons detailed above, we believe the Proposed Interpretation will not accomplish this goal. As such, we request the Board take the following action:

- Recommend improved financial statement disclosures related to SPEs.
- Codify existing guidance under Statement No. 140 and various EITFs.
- Undertake a long-term project to address all aspects of SPE accounting, resulting in the issuance of a new Statement, subject to the full due process of the Board, based on a risks and rewards model and consistent with existing GAAP guidance.

If the Board rejects this action, we recommend an extension of the effective date and significant revision and clarification of the provisions of the Proposed Interpretation, especially as they relate to FSPEs. This would allow the Proposed Interpretation to be

adopted in a manner consistent with the Board's stated purpose without significant and undue hardship to participants in SPEs and increased confusion to users of financial statements.

We would be pleased to discuss any aspect of our comments with Board members or the FASB staff.

Sincerely,

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## Attachment

#### APPENDIX A

# Example of changes in the balance sheet presentation caused by the implementation of the Proposed Interpretation Guidance

#### Scenario:

- Company A contributes cash of \$845 million and receives Class A senior beneficial interests of a high
  yield bond portfolio in return
- Company B contributes cash of \$70 million and receives Class B beneficial interests in return
- Company C contributes cash of \$75 million and receives Class B beneficial interests in return
- Company A contributes cash of \$6 million and receives equity interests in return
- Company B contributes cash of \$4 million and receives equity interests in return
- Company B is the Investment Advisor and receives a fee of 25 bp +20% return of asset appreciation
- Waterfall works such that the equity holders take the first loss, then Class B and finally Class A.
- · There are no guarantees or liquidity support in the structure
- Companies A, B & C are not affiliated with each other.

## Current Accounting - Assume no change in market value:

Company A		Company B		Company C	
Assets:		Assets:	1	Assets:	
Bonds	845	Bonds	70	Bonds	75
Stock	6	Stock	4	Stock	0
Liabilities:		Liabilities:		Liabilities:	
Debt	0	Debt	0	Debt	0

## Proposed Accounting - Assume no change in market value:

Company A		Company B		Company C	
Assets:		Assets:		Assets:	6.700
Bonds	845	Bonds	1,000	Bonds	75
Stock	6	Stock	0	Stock	0
Liabilities:		Liabilities:		Liabilities:	
Debt	0	Debt**	920	Debt	0
		Minority Int	6		

<sup>\*\*</sup> These liabilities would be valued at market but because they are not true liabilities of Company B, it is difficult to determine the valuation.

Conclusion: Current accounting rules appropriately address the economic risk of all three companies. Company B will never be obligated to pay out the \$926 in debt and minority interests it was forced to recognize in its financial statements under the proposed accounting rules. In addition, if there are more than \$155 million of losses in the structure, Company B will have written off its investment value completely and should not be required to continue to recognize the assets and liabilities of this structure in its financial statements