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Certified Management Accountant Program
Certified in Financial Management Program

July 30, 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

Letter of Comment No: / 2
File Reference: 1200-001
Date Received: 07/30/03

Re: File Reference No. 1200-001

Dear Mr. Smith,

The Financial Reporting Committee (FRC) of the Institute of Management Accountants (IMA) appreciates the opportunity to comment on the Exposure Draft of the Proposed Statement of Financial Accounting Standards, *Qualifying Special-Purpose Entities and Isolation of Transferred Assets, an amendment of FASB Statement No. 140* (the ED). As users, preparers and auditors of financial statements, IMA members will be significantly affected by the changes proposed in the ED. The FRC generally supports the Board's objectives in taking on this project and understands the FASB's desire to ensure that transaction structures that result in the transferor retaining effective control over the transferred assets do not meet the definition of a QSPE in light of the scope exception provided for them in FASB Interpretation No. 46. However, in our view the ED does not meet these objectives. We believe that the additional restrictions on the activities of QSPEs will significantly reduce the types of structures that can claim QSPE status and will result in an increased number of structures that are subject to consolidation or disclosure under FIN 46. While these may appear to be desirable outcomes to some, we believe that the changes proposed undermine and dilute the concepts underlying SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 140), to a degree that reduces them to a list of permissions and prohibitions. This strategy is not only the antithesis of a principles based approach, it is likely to be a high maintenance endeavor as various new forms of financial support provided to prospective QSPEs are segmented between those that are prohibited and those permitted. These are difficulties that the FASB sought to avoid when it developed the control-based model that is the conceptual foundation of FAS 140. We believe more work needs to be done to eliminate the internal inconsistencies and other problems within the document and we would object

to the issuance of a final standard without substantive changes to address the issues discussed below.

Consistent Application of the Standard

Issue #1: Understanding the Conceptual Framework

The ED places additional restrictions on the relationship between transferors and QSPEs and on the ability of QSPEs to reissue beneficial interests. These new limitations are based on concepts of risk concentration and risk dispersion rather than control. When combined with the original framework of FAS 140, constituents will be required to apply a control model for certain provisions of FAS 140, such as derecognition, and a risks/rewards model for other provisions of FAS 140, such as evaluating whether the QSPE's activities related to reissuing beneficial interests or the financial assets or liabilities retained by the transferor are permitted or prohibited. The principles of derecognition of financial assets that are not controlled and consolidation of entities holding financial assets by transferors who retain risks and rewards of ownership (but do not retain control) are incompatible and contradictory. As a result, the revised model will treat otherwise identical transfers of assets in an inconsistent manner, based on the relationships of the transferor with the QSPE.

If the transferee is a voting interest entity, the transfer is fully within a control model, but if the transferee is a variable interest entity or QSPE, the transaction is subject to a combined control/risk and reward model. The result of this combined model may be desirable to the FASB but we believe the introduction of risk and reward concepts will inappropriately deny structures QSPE status, even though effective control by the transferor is not present. It could also lead to significant practice implementation questions as constituents evaluate different structures with similar economic substance, but taking different forms, as new provisions are developed that are not specifically addressed in the ED. Previously, constituents were able to consistently evaluate new structures developed in the capital markets under a control-based framework. The ED proposes a hybrid model wherein control-based requirements are overlaid with risks and rewards provisions and prohibitions. This is precisely the condition that existed under SFAS No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse*, and which the FASB strongly criticized and undertook to eliminate when it issued SFAS 125, the predecessor to FAS 140. We do not understand why the FASB would choose to reintroduce this inconsistency into its standards after diligently working to eliminate it seven years ago.

The FRC questions whether the perceived benefits of this hybrid model outweigh the complexity and cost of implementing the new requirements, and the lack of comparability in financial reporting that will result from its application. We do not think financial reporting is improved when the form of transactions takes precedence over economic substance in defining the accounting. For example, a third party can provide a guarantee on the beneficial interests in a securitization vehicle that issues term beneficial interests without limitation and without affecting the status of the issuer as a QSPE. However, if the beneficial interests are to be reissued, that guarantee is limited to 50% or less of the total fair values of all guarantees or the status of the issuer as a QSPE will be jeopardized. This creates a situation where the status of the issuer could change based on some event or transaction outside of the transferor's control and result in a requirement for the transferor to apply the guidance

in FIN 46, even though the transferor's level of control over the transferred assets has not changed. For example, Bank A and Bank B provide liquidity support to Trust, which issues commercial paper to purchase long-term interest-bearing receivables. At the date of the transfer, Transferor concludes that it does not control the transferred assets and that Trust meets the conditions to be a QSPE. One year later, Bank A acquires Bank B (or, Bank C acquires Bank A and Bank B) so that 100% of the fair value of the guarantees provided to Trust are from the same consolidated entity. Presumably Transferor should now assess whether it is required to consolidate based on FIN 46.

We also do not understand the concept behind restricting the transferor from agreeing to transfer assets to the QSPE to support the beneficial interests but permitting the transferor to retain a subordinated interest in the transferred assets as the two forms of recourse are economically the same. Although these recourse arrangements are identical from a control perspective and a risk/reward perspective, the proposed ED would treat them differently. We cannot understand why one form of support is permitted and the other is prohibited.

We believe the control model within FAS 140 is a sound model that can be further clarified to prevent structures from qualifying as QSPEs where the transferor retains control, without disqualifying QSPEs where no control is retained. In order to achieve this result, the ED's provisions must be entirely consistent with a control-based framework.

Issue #2: Two Step Securitizations

Paragraph 11 of the ED amends paragraph 83 of FAS 140 to require the second step of a two-step securitization involving the issuance of beneficial interests to be a transfer to a QSPE in order for that transaction to meet the derecognition requirements of paragraph 9b. We do not understand the FASB's objective in adding this requirement and request discussion of the FASB's reasoning in the final statement. Previously, we understood the criteria in paragraph 9a-c of FAS 140 to apply to the evaluation of whether assets should be derecognized and the criteria in paragraph 35 of FAS 140 to apply to the requirements for a QSPE and non-consolidation. This change appears to blur these criteria and we are concerned that this requirement effectively amends paragraph 9b to prevent derecognition of assets by a transferor where beneficial interests are issued in a two-step securitization unless the transfer was to a QSPE, regardless of whether the special purpose entity in the second step has the ability to pledge or exchange the assets. It appears FIN 46 would no longer be applicable to two-step securitizations issuing beneficial interests because a transferor would either achieve sale accounting by establishing a QSPE (and thus achieve non-consolidation) or the transferor would have secured borrowing accounting and there would not be a variable interest entity to evaluate under FIN 46. We recommend that the FASB reconsider the proposed revisions to paragraph 83 to indicate that two-step securitizations can still result in sale accounting if the provisions of paragraph 9 of FAS 140 are met, but these securitizations will be subject to FIN 46 if the transfer does not include a QSPE in the second step.

Scope of Restrictions

Issue #3: Limitations on Derivatives Between the Transferor, Affiliates or Agents and QSPEs

During its deliberations on this project, the FASB had indicated its concerns from a risk/reward perspective of structures where the transferor sold assets into the structure and then entered into a

total return swap with the structure. As the FASB Staff was drafting the ED, the wording appeared to change from restrictions on total return swaps to restrictions on swaps which passed back substantially all the economics to the transferor and, ultimately, to a broad restriction against any derivative between the transferor and the QSPE (paragraph 4). The final language does not appear to be consistent with the FASB's public deliberations, particularly since the basis for conclusions indicates that "risk transfers from a qualifying SPE to a transferor through derivatives are prohibited," which is a different threshold than prohibiting all derivatives. For instance, a contingent call option or clean-up call held by the transferor, its affiliates or agents would not be permitted under the wording in paragraph 4 (assuming the option met the definition of a derivative) but does not violate the principle articulated in the basis for conclusions.

We ask the FASB to reconsider whether restrictions on derivatives held by the transferor should be applied to only certain derivatives, such as total return swaps and similar instruments, or whether the restriction applies to any instrument that meets the definition of a derivative, such as clean-up calls, calls contingent on events out of the transferor's control or removal of accounts provisions. We also ask the FASB to clarify the rationale for eliminating plain vanilla interest rate swaps as permitted derivatives as we do not believe these types of derivatives result in the transferor retaining control. Specifically, we do not understand why a trust or other legal entity would be precluded from being a QSPE when it holds a passive derivative instrument that pertains to the beneficial interests from the transferor, while not precluding the trust or other legal entity from being a QSPE when the passive derivative instrument is entered into with a third party unrelated to the transferor. In both circumstances, the QSPE is holding a passive derivative instrument; only the identity of the counterparty to the arrangement has changed. In addition to the absence of a sound conceptual reason for doing so, a broad restriction on any derivative would create significant practice issues in properly and consistently evaluating whether certain financial instruments meet the definition of a derivative as the focus will generally be on whether the underlying assets are readily convertible to cash, a concept which continues to be debated. We are also concerned that a broad restriction against derivatives will affect numerous securitization structures where the objectives of the ED indicate that only certain structures are the focus of additional restrictions. The number of structures impacted could further increase depending on the final guidance of DIG Issue B12, *Embedded Derivatives: Beneficial Interests Issued by Qualifying Special Purpose Entities*.

The ED's restrictions in this area result in a transferor having the ability to retain 90% (inverse of 10% requirement in paragraph 36 of FAS 140) of the risks and rewards of transferred assets through beneficial interests (cash instruments) but no ability to retain any risks or rewards through a synthetic instrument. We do not believe this distinction is consistent with FAS 140's underlying framework. We believe the most appropriate method to address restrictions on derivatives is to provide guidance on derivatives that may result in control of the transferred assets. However, if the FASB prefers a risks and rewards approach to this issue, we recommend a restriction on derivatives which transfer risks/rewards from a QSPE to a transferor in excess of the risks/rewards the transferor could have retained through a beneficial interest (i.e. a 90% threshold).

Issue #4: Restrictions on Other Commitments

In paragraph 5 of the ED, a transferor is restricted from entering into any agreement with a QSPE that would commit the transferor, conditionally or unconditionally, to deliver additional cash or

assets to the QSPE or its beneficial interest holders. One common provision of nearly all securitizations is a requirement that the transferor will repurchase assets or indemnify the trust if a breach of the standard representations and warranties occurs. These warranties regarding merchantability are designed to protect the trust from fraud in the origination of a receivable, incomplete documentation or unknown delinquent receivables at the date of transfer. If this standard provision would disqualify an entity from QSPE status, then nearly all securitizations, including traditional mortgage securitizations, would be subject to the consolidation provisions of FIN 46. We do not believe this would be appropriate as the FASB states its desire not to subject all QSPEs to FIN 46, as this would render the QSPE provisions of FAS 140 ineffective (paragraph A10). Additionally, paragraph 11 of FAS 140 states that the transferor shall recognize all liabilities incurred upon sale. This paragraph is not amended in the ED. We recommend the FASB modify this restriction to only address commitments that result in the transferor having direct or indirect control of the transferred assets where the transferor can influence the events or conditions that give rise to its ability to regain control of the assets.

Issue #5: Application of the Reissuance Restrictions

The ED contains several restrictions on structures that can reissue beneficial interests. One of these restrictions is applicable only if a structure makes decisions in reissuing beneficial interests, as stated in paragraph 5. However, the ED does not provide guidance to determine whether any party associated with the structure is actually making decisions or is simply performing an administrative function without discretion. No conclusion to this issue was reached under EITF Issue No. 02-12, *Permitted Activities of a Qualifying Special Purpose Entity in Issuing Beneficial Interests under SFAS 140* (EITF 02-12). We do not believe the issues in EITF 02-12 related to QSPEs with long-term assets and short-term beneficial interests were resolved in the ED and request additional guidance from the FASB in order to attain resolution. We also believe guidance is required to determine whether the reissuance restrictions apply to master trust securitizations where the seller continuously transfers assets into the trust, retains an interest and the trust periodically issues beneficial interests to support the new assets or reduce the seller's retained interest.

Transition and Effective Date

Issue #6: Transition

The ED's transition provisions provide a grandfathering for current QSPEs which do not acquire new assets that were not previously contracted for prior to the effective date of the final statement and that do not issue new beneficial interests. The effect on existing structures that are not grandfathered is that they will immediately become subject to the consolidation provisions of FIN 46. We believe modifications to the transition provisions are necessary to clearly indicate that the new guidance is a change to existing GAAP and to clearly grandfather all structures that fully complied with FAS 140. Currently, any structure which does not meet the grandfathering provisions, would then be subject to FIN 46 and would be consolidated by the primary beneficiary but the primary beneficiary would not show the effect on the financial statements as a change in accounting principle. We do not believe this is representationally faithful of the change to GAAP effected by issuance of the final standard. Furthermore, we do not believe this presentation will convey to investors and analysts that these companies were appropriately following GAAP, which

is of high importance in the current environment. We also recommend that the FASB include specific provisions in the final standard to grandfather current structures which have new asset sales that were contracted for prior to the effective date of the amendment and which must reissue beneficial interests to fulfill their contractual obligations until the previously transferred assets mature. We believe transition provisions modified as indicated in the preceding sentences would be appropriate given the inability of constituents to modify these structures without the consent of other parties.

Issue #7: Effective Date

The proposed effective date is the first day of the first fiscal period following the issuance of the final standard. Given the sweeping changes proposed that will affect current structures, the implementation issues as discussed above, and the inability of constituents to unilaterally modify their structures, we recommend the FASB delay the proposed effective date to provide adequate time for constituents to fully understand the ramifications of the standard. A delayed effective date was provided in FIN 46 for existing structures as this guidance significantly changed prior practice. As constituents are still dealing with practice questions and perhaps unintended consequences (i.e. the potential loss of leveraged lease accounting if the equity investor is required to deconsolidate) related to the provisions of FIN 46 six months after its issuance, a delayed effective date would be both prudent and appropriate.

In summary, the FRC supports the Board's objectives in pursuing changes to FAS 140. However, we believe there are issues regarding the overall accounting model, consistency, scope and transition that must be addressed in the issuance of a final standard if it is to achieve the desired improvement in financial reporting. We appreciate your consideration of our comments and welcome the opportunity to work with the Board in addressing the issues discussed above. If you have questions regarding this letter, please feel free to contact me at (203) 373-3563.

Sincerely,



Mitchell A. Danaher
Chair, Financial Reporting Committee
Institute of Management Accountants