Please include the attached paper for consideration at the September roundtable discussion. I would very much like to be a participant at this event. Please let us know if that will be possible. Thank you.

(See attached file: zfas0820.pdf)
Fitch Ratings

Financial Institutions

Financial Services—USA
Special Report

FASB ARB 51 Implications
Across Structured and
Corporate Finance Ratings

Analysts

Financial Institutions
Eileen A. Fahey, CFA
1 312 368-5468
eileen.faheuy@fitchratings.com

John Olert
1 212 908-0663
john.olert@fitchratings.com

James E. Moss
1 312 368-3213
james.moss@fitchratings.com

Asset-Backed Securities
John Roglieri
1 212 908-0723
john.roglieri@fitchratings.com

Brian D. Gordon
1 312 368-2068
brian.gordon@fitchratings.com

Corporates
Mark Oline
1 312 368-2073
mark.oline@fitchratings.com

Summary

The Financial Accounting Standards Board (FASB) issued an exposure draft for the consolidation of special-purpose entities (SPE) on June 28, 2002, and has requested comments by Aug. 30, 2002. The interpretation will be effective immediately for SPEs created after the final issuance date that is expected some time late in the fourth quarter. SPEs created before the issuance date must apply the provisions of the interpretation beginning with the first fiscal period on or after March 15, 2003.

The purpose of this publication is to discuss the potential effects of the interpretation on many of the asset classes that carry a Fitch rating. It is important to note that this discussion is based on the existing document and does not factor in the effects that continued evolution of structures or lobbying may have on the final outcome.

The document is divided into two parts. The first contains Fitch’s assumptions on interpretation and ratings effects. The second is the more technical portion, Appendix A, which provides some detail and definitions surrounding FASB accounting research bulletin (ARB) 51.

The exposure draft for asset-backed commercial paper (ABCP) programs is difficult to interpret and lacks specific guidance for various structural forms. Therefore, in many instances, Fitch’s pro forma application is rather conservative and may ultimately represent the extreme case. Nevertheless, Fitch’s intent is to place some parameters around the discussion and outline the various effects that implementation of FASB ARB 51 may have on Fitch’s credit ratings for sponsors and active users of SPEs.

Importantly, Fitch believes that its current analytical practices largely incorporate the economic risks (including operational, liquidity, funding and credit) resulting from the use of SPEs by the seller of assets or the sponsoring institution. As a result, Fitch does not expect that these potential accounting changes will affect most corporate ratings.

August 20, 2002

www.fitchratings.com
ABCP Conduits

At this point in time, Fitch is unable to determine the direct intent of the exposure draft. As Fitch interprets the document, if the SPE is not a qualifying special-purpose entity (QSPE) and if sufficient equity is not deemed to exist, each transferor and administrator will have to determine their consolidation requirement based on an assessment of “variable interests.” Consolidation in any form may force a review of the regulatory capital requirements, which may negatively affect the economics of these structures vis-à-vis current earnings and pricing. It is important to note that, concurrent with the issuance of FASB ARB 51, bank regulators are revising capital requirements for SPE sponsors, which may have a greater effect on financial institutions, as users or sponsors of SPEs, than the potential change in accounting.

Single-Seller Programs

Interpretation

Fitch believes the transferor in a single-seller program that does not transfer assets to a QSPE will be required to consolidate the SPE onto its balance sheet. While currently these assets are reported off-balance sheet, Fitch’s credit analysis of the sponsoring entity already captures the related risks.

For example, in rating a number of single-seller conduits (Dollar Thrifty, Bishop’s Gate), Fitch considers the program’s leverage and any liquidity triggers in the analysis since this short-dated funding can terminate based on a credit rating of the company. In Fitch’s credit evaluations of credit card receivable transactions, both bank and monoline card originators are evaluated on a managed-asset basis. For finance companies, Fitch’s capital evaluations heavily weight capital requirements for residual assets and include a liquidity charge for securitizations. Under different scenarios, the original transferor has supported various receivable programs including credit card securitizations, auto loans, home equity loans and other similar types of single-seller programs. All users of single-seller conduits are aware of the moral hazards in not supporting their programs and view investor acceptance as critical in maintaining access to the asset-backed securitization markets.

It is important to note that while it is widely believed that ARB 51 excludes qualifying SPEs, the exposure draft does contain language that seems to suggest QSPE consolidation may be required by other entities. This topic is explored in the “Commercial Mortgage-Backed Securities (CMBS)” section on page 4 where Fitch believes this possibility is more significant.

Conclusion

Fitch does not believe that the consolidation of single-seller programs will result in any credit rating changes for sponsors of such programs.

From the sponsor’s perspective, the severity of consolidation is somewhat mitigated by the lower funding costs available in the commercial paper market as well as continued access to this alternate funding source.

Multiseller Programs

Interpretation

For multiseller programs, the outlook is more opaque. While the language of paragraph 17 appears to support a silo concept (there is no single party that has sufficient variable interests to qualify as the primary beneficiary, and therefore each transferor must consolidate the assets they contribute), the language does not eliminate the possibility that the administrator of a program may hold the most significant variable interest and therefore, may be required to consolidate. In contrast, language in paragraphs 22 and 23 suggest that a new class of SPE may emerge that will facilitate multiseller programs and not require consolidation by any party. Until further guidance is provided by the FASB, the effect to multiseller programs remains unclear.

Conclusion

Conservatively, Fitch’s analysis ignores potential exclusions provided by select paragraphs and assumes that multiseller program sponsors or administrators will be required to fully consolidate their programs. Citigroup, Bank One, Bank of America, J.P. Morgan Chase, U.S. Bancorp and Wachovia are the financial institutions with the greatest exposure to ARB 51 consolidation, as sponsors and administrators of several large multiseller conduits that are fully or partially supported by the banks themselves.

In most cases, to the extent a conduit provides funding for pools of bank loans, these loans are originated by the bank charter and sold into the conduit. Additionally, the conduit may purchase
Adj. Cap Ratios for Fitch ABCP (as of March 31, 2002)

<table>
<thead>
<tr>
<th>Bank Name</th>
<th>ABCP=100% RWA</th>
<th>Fitch $ (as of June 30, 2002)</th>
<th>Adjusted Tier 1 RBC (%)</th>
<th>Adjusted Total RBC (%)</th>
<th>Adjusted Leverage Ratio (%)</th>
<th>Change in Tier 1 (%)</th>
<th>Change in Total RBC (%)</th>
<th>Change in Lvg. (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Citigroup, Inc.</td>
<td>79,154,000</td>
<td>8.18</td>
<td>10.38</td>
<td>5.48</td>
<td>0.95</td>
<td>1.21</td>
<td>0.41</td>
<td></td>
</tr>
<tr>
<td>Bank One Corporation</td>
<td>42,389,000</td>
<td>7.72</td>
<td>10.84</td>
<td>7.42</td>
<td>1.32</td>
<td>1.84</td>
<td>1.20</td>
<td></td>
</tr>
<tr>
<td>Bank of America Corporation</td>
<td>28,661,000</td>
<td>8.02</td>
<td>12.22</td>
<td>6.43</td>
<td>0.48</td>
<td>0.71</td>
<td>0.29</td>
<td></td>
</tr>
<tr>
<td>J.P. Morgan Chase &amp; Co.</td>
<td>28,411,000</td>
<td>8.09</td>
<td>11.74</td>
<td>5.23</td>
<td>0.52</td>
<td>0.74</td>
<td>0.21</td>
<td></td>
</tr>
<tr>
<td>U.S. Bancorp</td>
<td>17,290,000</td>
<td>6.95</td>
<td>11.19</td>
<td>6.67</td>
<td>0.76</td>
<td>1.22</td>
<td>0.74</td>
<td></td>
</tr>
<tr>
<td>Wachovia Corporation</td>
<td>13,071,000</td>
<td>7.14</td>
<td>11.01</td>
<td>6.24</td>
<td>0.35</td>
<td>0.00</td>
<td>0.00</td>
<td></td>
</tr>
</tbody>
</table>

Source: Fitch data and SNL Regulatory Data.

Adj. Cap Ratios Adding ABCP and Unused Commitments

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Citigroup, Inc.</td>
<td>165,000</td>
<td>18,000</td>
<td>35,995,000</td>
<td>35,995,000</td>
<td>8.67</td>
<td>11.01</td>
<td>8.70</td>
<td>0.46</td>
<td>0.68</td>
<td>0.10</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bank One Corporation</td>
<td>1,320,000</td>
<td>40,637,000</td>
<td>1,366,000</td>
<td>43,793,000</td>
<td>7.69</td>
<td>10.78</td>
<td>7.38</td>
<td>1.35</td>
<td>1.89</td>
<td>1.24</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bank of America Corporation</td>
<td>3,560,000</td>
<td>34,545,000</td>
<td>U</td>
<td>35,995,000</td>
<td>7.87</td>
<td>12.00</td>
<td>8.33</td>
<td>0.51</td>
<td>0.93</td>
<td>0.39</td>
<td></td>
<td></td>
</tr>
<tr>
<td>J.P. Morgan Chase &amp; Co.</td>
<td>3,401,000</td>
<td>26,400,000</td>
<td>4,817,000</td>
<td>34,218,000</td>
<td>7.99</td>
<td>11.59</td>
<td>5.19</td>
<td>0.62</td>
<td>0.89</td>
<td>0.25</td>
<td></td>
<td></td>
</tr>
<tr>
<td>U.S. Bancorp</td>
<td>5,046,000</td>
<td>9,521,000</td>
<td>0</td>
<td>14,967,000</td>
<td>7.04</td>
<td>11.34</td>
<td>6.86</td>
<td>0.87</td>
<td>1.07</td>
<td>0.66</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wachovia Corporation</td>
<td>14,065,000</td>
<td>8,969,000</td>
<td>0</td>
<td>23,035,000</td>
<td>6.89</td>
<td>10.63</td>
<td>6.05</td>
<td>0.60</td>
<td>0.93</td>
<td>0.46</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Unused standby letters of credit (SBLC) + subordinated securities + maximum contractual credit exposure related to credit enhancements that the bank has provided to conduits that it sponsors. **Unused cnmrs. (asset purchase agreements included) provided by the bank that function as liquidity facilities to conduits sponsored by the bank. Source: Fitch data and SNL Regulatory Data.

assets from the transferor (either the originator or bank sponsor) and provide enhancement via credit or liquidity protection.

Most bank sponsors acknowledge that these conduits began as a regulatory arbitrage enabling them to remove the most heavily risk-weighted assets from the balance sheet. Despite this existing arbitrage, banks have not ignored the economic capital required by these assets nor the obligations they may face if a credit within the conduit deteriorates. In most cases, transactions are structured such that asset deterioration is sufficiently protected by overcollateralization or the assets are removed from the conduit. Assets may be removed via asset purchase agreements, sometimes provided by the administrator or the transferor (the originator). Assets purchased by the administrator return to the banks' financial statements and are thus reflected in the individual institution's financial performance.

To determine the capital effect of consolidation, Fitch adjusted regulatory capital ratios to capture current outstandings and liquidity commitments of these programs and applied a 100% risk weight to total dollars of ABCP outstanding for programs sponsored by each bank. Fitch believes this is a very conservative assumption for two principal reasons.

First, historical performance of the conduits and overcollateralization in the structures easily argue for a lower risk weight. Secondly, banks do not generally provide 100% of their conduits' credit and liquidity enhancement, as certain levels of risk are assumed by other support providers either through transaction-specific asset purchase agreements, insurance wraps or liquidity commitments. As seen above, despite the heavy weighting, each institution in the survey remains well-capitalized under regulatory requirements.

In addition, Fitch also stressed regulatory capital ratios by considering contingent liquidity, unused commitments and the maximum credit exposure for committed credit enhancements provided by the banks to the conduits they sponsor. Again, this is very conservative particularly for the sizable unused commitments when compared to other shorter dated commitments. Current regulatory risk weights are 0% for those commitments less than 365 days. However, there are current proposals pending which would adjust these levels.

Despite the fact that these onerous risk weights are more punitive, bank regulatory ratios for each of the six U.S. banks remains "well-capitalized." As such, it
Fitch Ratings

is doubtful that there would be an effect on bank ratings.

Fitch believes, however, that consolidation (and perhaps changes in regulatory capital requirements) would result in an evaluation of the economics of the conduit business. Such evaluations will certainly include expectations of returns by shareholders as well as investors in the money market funds.

Money Market Investors—Asset-backed conduit programs have been important sources of short-term product for money market investors, particularly given the recent volatility of the corporate commercial paper market. If, as a result of FASB's actions, ABCP becomes a less attractive funding source and business line for conduit sellers and sponsors, respectively, Fitch foresees a potential limiting of financing options for small and large companies alike.

Term Structures

Commercial Mortgage-Backed Securities (CMBS)

Interpretation

Fitch believes that CMBS transferors would not have to consolidate based on the provision of Statement 140 that precludes consolidation of a QSPE by a transferor.

Conclusion

Fitch does, however, believe that investors in the equity and subordinate debt classes of CMBS are an essential part of the CMBS market who may have to consolidate the structures. While the transferor would likely pass the QSPE test, the language in the exposure draft states that, “another party may be required to consolidate a qualifying SPE if it holds an interest or combination of interests that effectively recombines risk.” The amount of equity common in these transactions is not sufficient under the 10% ruling. Therefore, the equity classes would likely be evaluated based on the variable interest method, and equity holders may be forced to consolidate.

Although seemingly remote, if equity or support class holders, such as Allied Capital or LNR, were deemed the primary beneficiary and had to consolidate these assets, there could be confusion given the significant increase in leverage which would result. Unlike the banks and traditional finance companies where Fitch often looks at these off-balance-sheet exposures and analytics on a managed basis, for the entities with mortgage REIT-type characteristics, Fitch has only looked at the risks they have purchased. If investing in these classes were no longer economical, the effect on the CMBS market would be significant.

Investment banks are the largest transferors in this market that are often persuaded by the purchasers of residual and B tranches to hold a remainder as “protection” for investor interests. As of year-end 2001, many of the U.S.-based investment banks provided some detail on residual assets currently held. The residual assets on a stand-alone basis were not large. Consolidation, however, would result in significantly larger leverage across the board. Virtually all of these firms consider their residuals holdings as illiquid investments and allocate 100% cash capital to support these assets. Fitch does not believe that investment banks have any intention of fully supporting such deals.

Residential, Credit Cards, Auto, Home Equity Loans

It seems that these asset classes will be relatively unaffected by the proposed interpretation, as transactions in these classes rely on the use of QSPEs and the originating institution typically retains the first-loss piece. While this raises questions about the dispersion of risk assumptions for QSPEs, they have clearly been exempt in the present document.

Collateralized Debt Obligations

Collateralized debt obligations (CDOs) are securitizations of corporate debts (such as bonds and loans) and derivatives. In a typical CDO, an SPE issues debt and uses the proceeds of the issuance to purchase assets, either in the open market or from a sponsor. The capital structure of many CDOs contains 90%-96% senior and mezzanine debt. The remainder of the capital structure is the residual position providing a “first-loss” protection to the debt holders. Because of the heavy use of SPEs and the high levels of leverage, there has been a lot of concern about the extent to which existing and future CDOs will have to be consolidated back on to the balance sheet of a primary beneficiary.

From the perspective of Fitch’s CDO analysis, there are two issues to understand. The first is the extent to which the new accounting rules will require CDOs to be consolidated, and the second is the rating implications of such consolidations. The current exposure draft indicates that a CDO should be
consolidated if a primary beneficiary can be identified. In Fitch’s opinion, the large majority of CDOs will not be consolidated because there is no primary beneficiary, as defined in the exposure draft.

One of the most common forms of CDO is created for the purpose of exploiting the arbitrage opportunity created by the positive difference that exists between the yield on the underlying assets and their financing cost. An SPE is created to hold assets that are typically purchased in the open market from a number of different sources and sell the notes used to finance those purchases. Since the SPE has no operations of its own, it is administered by a trustee who hires an asset manager to choose the assets and manage the portfolio. The mere fact that an asset manager is actively making decisions about the composition of the portfolio does not, under the current definitions, make that manager a primary beneficiary as long as the manager is receiving a market-based fee for the service provided to the SPE.

The investor in the first-loss position, as the owner of the residual interests in the SPE, is more likely to be identified as the primary beneficiary but generally only if that investor owns a substantial amount of the equity and/or the mezzanine notes. If the asset manager also owns a significant portion of the equity, this might indicate that party could be identified as the primary beneficiary. However, in today’s CDO marketplace, it is common for the assets to be managed by one party and the ownership of the first-loss position to be divided among several other distinct parties. In this situation, there would be no primary beneficiary, and the CDO would not be consolidated on the balance sheet of any party to the transaction.

The most likely case where a primary beneficiary would be identified and would be required to consolidate is a balance-sheet collateralized loan obligation (CLO). The typical scenario in this case is that a bank, which may be seeking regulatory capital relief, sells a portion of its loan portfolio to an SPE, which issues notes to investors. The bank may own all or a large part of the first-loss position and actively manage the portfolio. In this case, the bank as seller, manager and residual interest owner would qualify as a primary beneficiary and would have to consolidate the CLO.

From the perspective of analyzing the risk to the rated noteholders in the CLO, the consolidation requirement of the CLO back to its primary beneficiary will not, by itself, have negative rating implications for the CLO. The consolidation decision does not affect the bankruptcy remote status of the SPE. The consolidation decision has accounting implications but does not change the economic risks to the rated debt holders. This would not be true if the SPE were to lose its bankruptcy remote status, which is not contemplated at the current time.

The majority of U.S. CDOs are arbitrage vehicles. Because of their structure, they are likely to have a number of parties that have substantial stakes in the performance of the CDO but are less likely to have a single party that would qualify as a primary beneficiary, as currently described. The CDOs that are most at risk for consolidation are the ones created for balance-sheet purposes. While there are a number of these vehicles in the United States, the majority of the issuance for this type of transaction has been in Europe. So, while there is an increased potential for CDO consolidation as a result of the new exposure draft, its effect is currently not expected to be dramatic on the CDO market.

### Corporate Ratings

**Financial Institutions**

Fitch has already considered the potential of rating changes for banks, the largest sponsors of ABCP conduits. While CDO is another sector Fitch believes will face interpretations similar to ABCP, the exposures to CDO consolidation are significantly less and would not affect ratings at this point. Fitch continues to evaluate these structures’ effectiveness in removing risks from banks’ balance sheets.

**Finance and Leasing**

Given that the most active users of securitization and SPEs across the finance and leasing sectors engage in transactions and structures that would qualify for QSPE treatment, FASB ARB 51 is not expected to have an effect on their reporting. However, Fitch has evaluated the performance of these institutions on a managed basis for some time, which provides a perspective on performance had these assets been consolidated. In addition, enhanced risk-based capital modeling techniques are being utilized, which factor in the risks of retaining the higher risk portions of such transactions more accurately as well as consider the effect of being active users of securitization on liquidity.
The establishment of FASB ARB 51 could provide beneficial clarity to the financial statements of corporate entities but, in general, should have little effect on the credit standing of companies that employ SPEs. Fitch's methodology already incorporates operating lease payment streams into adjusted leverage figures, particularly as they grow to be meaningful components of a company's operating profile or adjusted capital structure. In this manner, financial flexibility and debt capacity assessments are made inclusive of financial obligations associated with SPEs (including those for ABCP) whether on- or off-balance sheet. Accordingly, in order to arrive at total fixed-payment obligations and to analyze debt-service capacity, rent payments are incorporated as a financial cost similar to interest expense.

However, the added clarity provided by the new guidelines could point out cases where there are meaningful variances between the method used to capitalize operating lease obligations, at 8 times (x) the gross rent expense of the previous year, and the true financial obligations associated with lease transactions. There are clear shortcomings to the 8x method of capitalization, most notably the implicit interest rate assumption and the timing and term of payments. For example, the 8x methodology may underestimate the financial flexibility and ability to downsize the cost structure of a company with very short-dated asset-lease obligations as compared to one with longer term lease obligations. Placing these obligations on-balance sheet would provide a more accurate assessment of the amount of the obligation and make the analysis consistent with other debt obligations.

In other examples, such as those of highly structured, tax-oriented SPEs, payment streams may be lumpy or very extended, thereby understating or overstating associated leverage using the 8x capitalization method. Certain SPEs may have extended maturities with little or no payment streams in the short term, with payments heavily weighted toward the latter portion of the term. Using the 8x capitalization method may, in this case, completely miss a financial obligation with no associated rental expense in a given year. This would be avoided if the transaction were to be placed on-balance sheet.

In most cases, however, the use of SPEs and the extent of variance between existing capitalization measures and placing the transactions on-balance sheet will not be meaningful enough to affect the credit quality of the company. However, in certain cases, book leverage metrics may be incorporated into various financing agreements thereby affecting financing flexibility if transactions were brought on-balance sheet. If a company has engaged in significant levels of these transactions, whereby bringing them back on-balance sheet meaningfully inflates the balance sheet and leverage measures (namely debt-to-capital measures), covenant issues may come into play. However, Fitch expects that these cases would be relatively rare as prudent financial documentation typically incorporates the credit implications of off-balance-sheet financing through limitations on the extent of asset sales and/or off-balance-sheet transactions.

Perhaps the most significant effect may occur at manufacturing companies with large captive finance operations. At these entities, certain off balance sheet transactions that would typically be footnoted as operating lease payments, in the case of standard third-party transactions, may be incorporated in other intracompany transactions. In other words, companies may be looking to shift financing arrangements to captive finance companies to benefit from lower capital application rather than place the financial obligations at the manufacturing level where they might more appropriately be categorized. If the new guidelines result in significant amounts of new debt being allocated back to the manufacturing arm, this could have credit implications.
Interpreting FASB ARB 51

ARB 51 Intent
The intent of FASB ARB 51 is to address what the FASB views as shortcomings in the existing requirements for consolidation of subsidiaries. Under FAS 94 and FAS 140, an enterprise which has a controlling interest based on a majority voting ownership is required to consolidate the entity. The current standards do not, however, require consolidation of SPEs that are not structured in terms of traditional voting interests but are, in the view of FASB, effectively controlled through other financial interests.

The intent of FASB ARB 51 is to explain how to identify an SPE that, absent voting interests, is otherwise controlled by the financial support given to it by an outside entity. As this type of support varies and can be provided by many parties, the provider of the greatest amount of support, or as the FASB defines it, the largest holder of a variable interest, is deemed to be the primary beneficiary and, as such, is required to consolidate the assets of such SPE.

FASB Decision Framework

QSPEs and the Newly Defined Equivalents
The first step in determining whether to consolidate an SPE is to determine an entity's status pursuant to FAS 140. It is important to note that the proposed interpretation would not amend the provisions of FAS 140, which precludes consolidation of a QSPE by the transferor, as FASB indicates that "entities qualifying under 140 are examples of SPEs" that effectively disperse risks.

At the same time, the exposure draft also indicates that while the transferor is exempt from consolidation, "another party may be required to consolidate a qualifying SPE if it holds an interest or combination of interests that effectively recombines risk." The topics of recombining risks and evaluating an SPE's effective dispersion of risks are quite subjective and open to debate among certain asset classes. Moreover, a strict reading of this section also suggests the possibility of consolidation of QSPEs—a result with effects that could only be considered with further clarification and guidance.

In addition to exempting the QSPE transferor, the document provides for a new, modified QSPE or financial special purpose entity (FSPE) that is defined as an SPE that is either:

1. A QSPE that does not hold equity securities; or
2. An SPE that meets all of the conditions of FAS 140, paragraph 35, except that:
   - It may hold equity securities only temporarily and only if they are obtained as a result of collecting financial assets held by the SPE.
   - It is not necessarily restricted to acquiring its assets by transfer from a transferor as described in FAS 140.
   - It is not necessarily subject to the restrictions on sales of assets described in paragraphs 42-45 in FAS 140.

The document further provides that if an enterprise is engaged with an SPE that is determined to be an FSPE, the enterprise is considered to provide significant financial support only if it also meets two of the following three conditions:

1. It has authority to purchase and sell assets for the SPE and can significantly affect the revenues, expenses, gains and losses of the SPE.
2. It provides a guarantee, back-up lending arrangement, or liquidity, credit or support that is subordinate to other interests.
3. It receives a fee that is not market-based, presuming fee is not market-based unless there are comparable fees in similar observable arm's-length transactions.

Overall, it appears that a transferor involved with a QSPE or an enterprise involved with an FSPE that does not meet two of the above listed conditions will be exempt from consolidation.

Non-QSPEs and Non-FSPEs
In determining which SPEs may be affected and which transaction participants may be required to consolidate a non-QSPE, distinguishing between consolidation based on voting interests and consolidation based on variable interests is critical. In this evaluation it is important to understand the definitions and application of "variable interests."
Fitch Ratings

“primary beneficiary” and “sufficient equity interests.”

Variable interests are similar to equity interests in that they represent the means through which financial support is provided to an SPE and therefore, the means through which the support providers gain or lose from a change in value of the assets and liabilities of the SPE. The draft cites several forms of variable interests including contractual rights and obligations (such as those that result from loans or debt securities), guarantees, residual interests in transferred assets, management contracts, options to acquire assets, purchase contracts, credit enhancement and service contracts.

The primary beneficiary refers to an enterprise that has a controlling financial interest in an SPE that is established by means other than the holding of voting interests. The primary beneficiary provides significant financial support to an SPE and benefits from its activities by holding a majority of the variable interests in the SPE or a significant portion of the total variable interests that is significantly more than the variable interest held by any other entity.

The decision to require consolidation on the basis of variable interests versus the voting majority rule is addressed through the FASB definition of “sufficient equity,” which incorporates the concepts of variable interests and primary beneficiary. If the equity interest in an SPE is deemed to be sufficient (defined below), the voting interest method is used and the party that must consolidate is the majority voting interest holder. If, however, the equity is not sufficient, the primary beneficiary must be determined through a variable interest assessment and is then required to consolidate the SPE.

The table below summarizes the required elements of the voting interest and controlling financial interest tests that determine whether an entity should consolidate an SPE.

In any instance where the variable interest level is determined to be the same among transaction participants, the relative size of the variable interests should be determined by comparing the expected future losses that may arise from the interests with heavier weighting assigned to the interest that is most subordinate.

All factors influencing consolidation decisions shall be reconsidered at each reporting date using all evidence that the enterprise possesses or would reasonably be expected to possess at that time.

### Voting Interest

One or more parties must hold equity investments that meet all of the following conditions:

- The amount of equity must be sufficient to fund the operations of the SPE—10% of assets as a floor with difficult exceptions.
  - The equity holders must have voting rights sufficient to make decisions and manage the SPE's activities.
  - The equity must be subordinate to all other interests.
  - The assets exchanged for equity are not interests in another SPE.
  - Equity must be provided by a true unrelated party.

### Controlling Financial/Variable Interest

The party determined to provide the greatest level of support via a variable interest is the party that either:

- Is the only party to provide support.
- Provides the majority of variable interest support.
- Provides significantly more support than other parties.

Effective dispersion of risk makes it inappropriate for any party to consolidate the assets and liabilities of the SPE.