November 30, 2005

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

Re: Proposed FASB Staff Position No. FIN 46(R)-c, “Determining the Variability to Be Considered in Applying FASB Interpretation No. FIN 46(R)”

Dear Mr. Smith:

Citigroup is pleased to comment on the Proposed FASB Staff Position No. FIN 46(R)-c, “Determining the Variability to Be Considered in Applying FASB Interpretation No. FIN 46(R)” (the Proposed FSP). We participated with ISDA in raising these questions to the FASB in March 2004 and have been actively involved since that time with the EITF working group on FIN 46(R). We support the FASB’s efforts to clarify these issues and reduce diversity in practice with respect to determining the variability to be considered in applying FASB Interpretation No. 46, Consolidation of Variable Interest Entities (FIN 46(R)).

We strongly agree with the Proposed FSP’s focus on types of risks (credit, interest rate, etc.) that should be considered rather than on the forms of risks (cash flow and fair value). That focus is consistent with Citigroup’s implementation of FIN 46(R), has proven to be operational in practice and has yielded results that are consistent with the underlying economics of transactions. However, we remain concerned that the principles underlying the Proposed FSP are not well articulated and that the analyses in certain examples are inconsistent. Without clarification of these issues, we are concerned that the adoption of the Proposed FSP may not increase consistency in practice, and that it will be very easy for various constituents to identify and support a wide variety of conclusions for any single fact pattern.¹

We also agree with the transition provisions of the FSP. We have noted that a retrospective transition of the Proposed FSP would require essentially a third implementation of FIN 46(R) and the associated costs would be significant. We agree that prospective application to new entities and future reconsideration events is appropriate. We believe that the effective date should allow a minimum of three months

¹ In contrast, the approach we have presented to the FASB staff and the FIN 46(R) working group has been proven operational in a wide variety of fact patterns and generally results in conclusions similar to those reached in the Proposed FSP, except as we have identified differences in this letter. We believe this approach can be more simply articulated and does not suffer from the inconsistencies that we see in the logic in the examples included in the Proposed FSP. We would be happy to discuss our proposed approach again with Board members or the FASB staff.
from the final issuance of the Proposed FSP to permit constituents to evaluate and communicate the revised requirements, consider how the Proposed FSP will apply to common fact patterns, and ensure consistent application of the Proposed FSP throughout their organizations.

Our most significant comments on the Proposed FSP relate to three issues:

1. The Proposed FSP enumerates the types of facts and circumstances to be considered but provides no guidance on how to use those facts and circumstances to determine a single "design" of an entity. In our experience, most entities within the scope of FIN 46(R) do not have a single "design" - each investor or counterparty has individual reasons for entering into the transaction and the entity is designed to facilitate these various objectives. The Proposed FSP appears to identify one single "design" of the entity by elevating the objectives of certain parties above the objectives of other parties. However, the Proposed FSP provides no conceptual basis to identify which potential variable interest holders to "elevate" and it is not clear from the examples that the FASB staff has a specific framework in mind. Without explanation, the analyses in the examples appear to focus on:

   - Cash investors rather than synthetic instrument counterparties (each example discusses how the transaction was marketed toward debt investors, but is silent on how the transaction was presented to other counterparties).²
   - Senior investors rather than subordinate investors (Examples I(a), I(b), I(c), 2, and 5 each include a subordinate equity investor, but the analyses focus solely on how the transaction was marketed toward the senior debt investor with no mention of the subordinate investor).
   - Investors with more than one variable interest in the entity (Footnote 8 and Example 2 suggest that a different analysis is required if a party has multiple involvements with the entity.)

   If the Board intends those principles to be used, then we believe they need to be more clearly articulated and the basis for that conclusion should be more clearly explained. However, we disagree with the concept that cash investors should be viewed differently than synthetic instrument counterparties, as we believe that there is little substantive difference between cash instruments and synthetic instruments as it relates to the creation or absorption of variability. The examples that suggest that this distinction should cause a different accounting treatment set a significant precedent that may require different consolidation conclusions for economically similar transactions simply due to the form of the transaction.

2. We disagree strongly with the conclusions in Example 6, as we believe that the logic applied to that example implies that offsetting risk positions may simply be netted as offsetting "creators" of variability. This is an incredibly powerful

² Although paragraphs 10 and 12 sometimes refer generically to potential interest holders or parties associated with the entity, paragraph 10j and the examples specifically focus the analysis on an "investor,"
concept and when applied to other very similar fact patterns, may result in subordinate positions being viewed as merely "offsetting" other risks, thus leaving the only variability to be considered to be the senior credit and counterparty risk absorbed by senior debt holders. Because this senior debt is typically and easily widely distributed, the flawed logic applied in Example 6 effectively means that SPEs will not be consolidated by any counterparty or investor, regardless of their risk position. We have significant reservations about the implications of such logic, and request that the Board reconsider this logic, or at a minimum more clearly articulate the lesson to be learned from Example 6 and why that lesson would be applied or rejected in other very similar fact patterns.

3. We believe that the inclusion of examples in the Proposed FSP is critical. We found the text of the Proposed FSP helpful only in the most general aspects of the framework (for example, the consideration of risk by type of risk), but not helpful in the articulation or application of any useful framework or concept. Indeed, any understanding we have of the Proposed FSP was derived primarily from the examples rather than from the text itself.

We believe that examples are useful when they demonstrate a consistent logic applied to multiple fact patterns, and when each fact pattern presented offers a useful lesson that may be applied more broadly. However, the examples in the Proposed FSP appear to use inconsistent logic to reach conclusions, and it is often not clear what aspects of the fact patterns are driving these differences. In addition, the examples often focus on certain facts while ignoring other facts. Without understanding why certain facts or characteristics were elevated, and others were ignored, it is not clear what lesson is intended to be derived from each example. The examples would be more instructive if they were to articulate an opposing view of the "design" of each entity and articulate why that view was rejected in the FASB staff's analysis.

In addition, it is important to step back from the details presented in the text and examples of the Proposed FSP and recall that the foundation of FIN 46(R) is to acknowledge that for certain entities, voting interest holders do not necessarily "control" the entity, but rather "the controlling financial interest may be achieved through arrangements that do not involve voting interests." Paragraph E7 also explains that "the [primary beneficiary] may receive benefits similar to those received from a controlling financial interest ... without holding a majority voting interest." We believe it is important for the Board to demonstrate that the conclusions that would be reached using

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3 For example, Example 5 focuses on the benefits of the entity to the lessee (obtaining an operating lease), while ignoring the benefits to the debt investors (who often prefer the use of an SPV in order to isolate the lease obligations servicing the debt from other potential creditors of a more substantive lessor entity). The benefits to the lessee could be obtained with an operating lease with any lessor; it is the debt investor's objectives that appear to actually require the use of a VIE. Example 6 focuses on the objectives of the debt investors (to earn an enhanced yield) while ignoring the objectives of the financially distressed producer (to monetize an in the money derivative position without incurring debt on its own balance sheet) or other parties to the transaction.

4 FIN 46(R), paragraph 1.
the text and the examples of the Proposed FSP are consistent with that goal. We remain concerned that in some cases, a party may be identified as the primary beneficiary due to contracts that distribute risk on a notional basis (for example, interest rate and foreign exchange risks) rather than on a subordinate basis.\(^5\) We continue to question whether a counterparty to such a contract truly is somehow controlling the VIE through that contract. We believe it is more likely that the parties exposed to subordinatable risks exercise this implicit control, and believe that the analysis under FIN 46(R) should focus on those types of risks.

We elaborate on these issues in Appendix I.

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We would be pleased to discuss our comments with you at your convenience.

Sincerely,

Robert Traficanti  
Vice President and Deputy Controller

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\(^5\) As we have previously explained, interest rate risk and foreign exchange risk are unique in that they exist in some form in every funded financial instrument. A party can change the form of that risk (cash flow or fair value), but nothing can protect an investor from some form of those risks. In contrast, other risks such as credit, price, or commodity risk exist on a subordinate basis — an investor can be protected from those risks through seniority or other contractual provisions. In other words, a $100 investment in any instrument will always have some type of variability due to interest rate and foreign exchange risks, depending on the perspective used to measure those risks; however, the investment’s exposure to credit, price or commodity risk may vary dramatically based on its seniority and other contractual rights.
Appendix I

Interest Holders with Multiple Variable Interests

Example 2 provides a fact pattern including fixed rate assets, floating rate liabilities and equity, in which an interest rate swap (investor receives fixed and pays floating) is embedded in the return to the equity investor. That example concludes that the fair value interest rate risk associated with the fixed rate assets (but not the cash flow interest rate risk associated with the floating rate liabilities) is deemed to be part of the design of the entity.

In contrast, Example 1(b) provides a fact pattern that includes floating rate assets, fixed rate liabilities, an interest rate swap, and equity. In that example, it is concluded that both the cash flow interest rate risk associated with the floating rate assets and the fair value interest rate risk associated with the fixed rate liabilities are NOT part of the design of the entity.

The principle to be derived from this difference is not clear to us. Is the difference due to the fact that:

- the swap in Example 2 is embedded, but the swap in Example 1(b) is freestanding?
- the swap in Example 2 is subordinate in the waterfall, but the swap in Example 1(b) is senior?
- The swap counterparty in Example 2 has multiple involvement, while the swap counterparty in Example 1(b) has no other variable interest in the entity?

Footnote 8 of the Proposed FSP suggests that the identity of the swap counterparty may in fact inform the design of the entity itself, and that the multiple involvements of the swap counterparty is driving the distinction between Examples 1(b) and (2). Thus the conclusion in Example 2 may have nothing to do with the fact that the swap is embedded in the equity, but merely that a single investor is both a cash investor and a derivative counterparty.

We disagree with the concept that multiple involvements *prima facie* should cause a difference in the identified “design” of the entity. Consider the application of that concept to a collateralized debt obligation (CDO) transaction. A VIE may purchase a variety of floating rate assets, issue both fixed and floating liabilities in a tranch ed structure. The subordinate interest (which absorbs a majority of the credit risk of the VIE) receives a floating rate of interest. In addition, the entity may enter into a pay-floating, receive-fixed interest rate swap to match the profile of its cash assets and funded

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6 The alternative fact pattern presented in Example 2 suggests this is not the case.
7 We acknowledge that footnote 8 indicates that multiple involvements “may” (not will) lead to a different conclusion. However, the sole example illustrating this concept is Example 2, and does not articulate any specific factors that led to its conclusion to include interest rate risk, or that would differentiate the fact pattern in Example 2 from any other fact pattern where a single party has multiple involvements with an entity.
liabilities. A single entity may be both an investor (either temporarily as underwriter or as a principal investor) in the most senior notes of the entity and the counterparty in the interest rate swap. Footnote 8 and Example 2 may suggest that for that entity, both the credit risk and the interest rate risk are part of the “design” of the entity and should be measured. Because interest rate variability typically quantitatively overwhelms credit risk variability, it is very possible that the senior investor and swap counterparty may be deemed to be the primary beneficiary of the entity, rather than an investor who holds even 100% of the subordinate tranche of the CDO.

We disagree with that conclusion, and do not see the conceptual boundary of the statements in Footnote 8 and Example 2 regarding multiple involvements. Whatever the basis for the conclusion in Example 2, the concept (and any conceptual boundaries) needs to be better articulated as a principle that can be applied consistently to various fact patterns.

**Offsetting Contracts within an Entity**

Example 6 reaches the conclusion that certain contracts may “create” offsetting variability in the entity, and that a risk may exist in an entity that is not “absorbed” by any variable interest holder. This conclusion was shocking to us, as it implies that offsetting positions may simply be netted, and the associated risks simply ignored in the consolidation analysis. Such a concept is incredibly powerful when applied to both the fact pattern in Example 6 as well as to other similar fact patterns.

The conclusion in Example 6 appears to be based, at least in part, on the statement that the entity was “designed to be in a neutral position with respect to electricity risk.” It is important to recognize that every entity itself is neutral to all risks. Through cash and synthetic long positions (assets) and cash and synthetic short positions (liabilities and equity), all risks are distributed to various parties. For example, consider various forms of creating and distributing credit risk:

- A long position in credit risk can be achieved by purchasing cash assets, or synthetically by writing protection through a credit default swap or by entering into a total return swap to receive the return on a specified asset.
- A short position in credit risk is created by issuing funded liabilities (debt and equity interests) or through unfunded positions, such as purchasing a guarantee or purchasing protection through a credit default swap.

We believe it is sufficiently clear from FIN 46(R) that a long position in credit risk cannot be simply “offset” by a funded short position. For example, in analyzing a CDO transaction (which has both cash and synthetic long positions, and issues funded liabilities in a tranch ed structure) it is not appropriate to “net down” the credit risk that is absorbed by a cash investor in the more subordinate tranche of the entity and determine that the entity was “designed” to pass on only the residual credit risk to more senior investors. Instead, all of the credit risk of the CDO’s cash and synthetic assets are deemed to be creators of variability, and all of the liabilities (including the subordinate interest) are absorbers of that variability.
Similarly, we believe it is clear from FIN 46(R) that a cash asset position could not be “offset” by an unfunded short position. That is, if the CDO VIE purchased a guarantee or purchased credit protection through a credit default swap, credit risk would remain part of the “design” of the entity, and the guarantee provider or the credit default swap counterparty would need to consider whether it absorbed a majority of the VIE’s variability. Paragraph B10 of FIN 46(R) is explicit in this regard.

However, Example 6 suggests that the long and short positions (the forward contracts) may be offset and only the remaining risks (credit risk from the derivative counterparties) are part of the “design” of the entity simply because the entity is designed to be in a “neutral position with respect to the commodity risk.”

It is not clear to us what the substantive difference is between Example 6 and the CDO examples discussed above (and for that matter, any VIE with both cash and synthetic positions). Can commodity or energy price risks be considered offsetting, but not other types of risk? Can synthetic long and short positions be considered offsetting, but not cash positions?

Consider a more simple example in which a VIE holds a fixed rate corporate loan asset and purchases a guarantee from an independent third party (to reimburse the VIE for any shortfalls in payment from the loan asset). The VIE then issues fixed rate notes to investors to fund the loan and pay the guarantee fee. One could reason that in that fact pattern, as in Example 6,

- the entity was designed to be in a neutral position with respect to the corporate loan’s credit risk, through a combination of the cash asset and the purchased guarantee
- the debt was marketed to the investors as a fixed rate investment with an enhanced yield due to the risk of possible default by both the corporate obligor and the guarantee counterparty

The logic used in Example 6, applied to this very similar fact pattern, would lead one to the conclusion that the corporate credit risk should be netted against the guarantee, and the entity is designed to pass on only the guarantor’s default risk to the debt investors. The guarantor would then not be required to consolidate the entity, and the VIE’s notes would be the sole variable interest. We believe that this conclusion is clearly inconsistent with paragraph B10 of FIN 46(R) and our entire understanding of “variable interests.” However, we do not see any conceptual boundary between the fact pattern in Example 6 and other situations involving long and short positions.

As we have discussed at length with the FASB staff, we believe that the distinction between cash positions and synthetic positions should not drive different consolidation conclusions. We continue to believe that permitting the offsetting of risk positions outside of the design of the entity is a powerful concept and that the Board should consider very carefully the potential implications of that concept.
If the Board decides to proceed with this concept, the basis for conclusion in Example 6 needs to be more clearly articulated so that the intended principle can be applied in similar fact patterns in a manner consistent with the Board’s intent. If the conclusions in Example 6 are based on the view that synthetic positions are different than cash positions, it should be clarified whether this applies to a synthetic liability (guarantee) “offsetting” a cash asset position, or only to synthetic liabilities that “offset” synthetic assets.

**Elevation of Certain Positions**

Paragraph 10(j) suggests that among the factors to be considered are “how the entity’s interests were marketed to potential investors” (implicitly excluding an analysis of other potential variable interest holders). The examples generally narrow this further to discuss only how the transactions are marketed to potential *senior debt* investors, while ignoring how the transactions may have been presented to potential *equity* (or subordinate) investors, or to synthetic instrument counterparties. Thus, it implicitly elevates the objectives of senior cash investors above the objectives of other potential variable interest holders.

In applying FIN 46(R), we have placed more reliance on paragraph B4 of FIN 46(R), which suggests to us that the identification of variable interests should be based on the economics of a transaction and without a preconceived notion about which interests are significant variable interests. However, the Proposed FSP suggests to us that the variability of the entity should primarily be viewed from the perspective of the senior debt investors and the variability from which those investors are protected is likely to be part of the design of the entity. If that is the Board’s intent, that principle should be more clearly articulated.

**Foreign Exchange Risk**

Example 1(c) addresses how to consider foreign exchange risk in an entity and again uses the concept of netting offsetting risks to eliminate foreign exchange risk from the design of the entity (“Risks (d) and (e), when combined, should result in the elimination of foreign exchange risk from the perspective of the debt and equity investors.”)

Again, we disagree with this netting concept. In addition, the italicized language suggests that the “perspective” of the debt and equity investors (presumably, whether those investors are USD functional-currency entities, or have some other functional currency) would help dictate the “design” of the entity. We do not believe that is an operational concept, as the perspective of the debt and equity investors (that is, their functional currency) may be unknown to other investors evaluating the VIE and may vary between various investors with different functional currencies.

The problems with considering foreign currency variability are crystallized for us in the following example: A corporation wishes to issue USD-denominated debt, and a certain class of investors prefers EUR-denominated debt. A VIE is established and issues EUR-
denominated debt, enters into a cross-currency swap, and purchases USD-denominated
debt from the corporation.

What is the “design” of this entity? Some may conclude that the purpose of this entity is
for the corporation to effectively issue EUR denominated debt, and that the entity may
allow the corporation to not separately account for the cross-currency swap (assuming the
VIE is not consolidated by the corporation). Others may conclude that the purpose of the
entity is for the investors to obtain a debt investment in the corporation, and the entity
may allow the investors to convert a USD denominated instrument to EUR without
separately accounting for the cross-currency swap.

We simply do not understand how the Proposed FSP would be applied to this simple fact
pattern, because we believe that the principle of the design of the entity is not sufficiently
clear as it relates to foreign currency risk.\(^8\)

**Focus on Economics over Accounting or Legal Form**

Paragraph 9 of the Proposed FSP requires that “the role of a contract...rather than the
legal form or accounting classification ...should dictate whether that interest should be
treated as creating risk for the entity or absorbing risk from the entity.” We agree with
this concept, but believe it should be more clearly articulated how this concept is applied
to Example 5 and other situations.

Example 5 concludes that the price risk of the underlying asset and associated credit risk
related to the lease receivable are part of the “design” of the entity. The fact pattern
explains that the lessee considers the transaction to be an operating lease, but the lessor
considers the transaction to be a direct financing lease. Are these facts important to the
conclusions reached? If so, how does that reconcile to the statement in paragraph 9? It
would be helpful if the reasoning in Example 5 more explicitly addressed these issues.

In addition, it would be helpful if the statement in paragraph 9 were expanded to provide
a more complete articulation of the concept of whether (or when) accounting
classification of the entity’s transaction matters to the design of the entity. A common
fact pattern is a transaction in which financial assets are transferred to a VIE which in
turn issues notes to third parties. If the transfer is accounted for as a sale, it is clear that
the variability of the transferred assets is considered in the FIN 46(R) analysis. However,
if the transfer is accounted for as a secured borrowing the transferred assets are merely
collateral for the borrowing. Does the variability of the entity relate to the underlying
collateral or to the loan receivable from the transferor? Paragraph 9, Example 5, and the
basic economics of the transaction suggest to us the former – that the accounting for the

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\(^8\) The issue is complicated by paragraph B7 (and the analogy to trust-preferred securities), which would
suggest that even though the purpose of the entity is to raise funding for the corporation, the corporation
may not be deemed to have a variable interest in the entity at all. This may lead one to conclude that the
corporation should in fact not consolidate, and the debt investors and swap counterparty remain as the only
potential variable interest holders.
transfer does not affect the FIN 46(R) analysis.\textsuperscript{9} We believe that illustration of the concept in paragraph 9 would be helpful in this regard.

**Other Issues**

- It is not clear to us that all potential variable interest holders will be in a position to know the necessary facts required to apply the Proposed FSP. For example, if the identity or characteristics of the potential variable interest holder matters (for example, if multiple involvements change the analysis, or if the functional currency or intent of certain investors change the analysis), certain investors even at inception may not be able to ascertain the facts that Proposed FSP considers relevant to the design analysis. The Board's resolution of these issues may significantly affect the operationality of the Proposed FSP and we urge the Board to consider those issues in its final deliberations on these matters.

In addition, preparers may need to apply the Proposed FSP at a reconsideration event. It seems to us that the "design" of the entity is by definition established at the inception of the entity and does not change when a variable interest holder acquires a new or additional variable interest in the entity. Such a variable interest holder may be at a further information disadvantage because that party was not associated with the establishment or design of the entity at all. It may be helpful if the Proposed FSP provided an example where the analyses is being performed subsequent to inception of the entity, to illustrate that the design of the entity should be considered using facts at inception, rather than the facts at the date of acquiring new or additional interests.

- Paragraphs 4 through 6 elaborate on the fair value and cash flow methods and simply note that those methods do not "result in a clear determination." There is no further rejection or even mention of those methods further in the text and examples of the Proposed FSP. We found this silence to be confusing. We suggest that these paragraphs either be deleted in their entirety (since the Proposed FSP requires an evaluation by type of risk, rather than by form of variability) or that their purpose be better explained.

We note that if interest rate risk were determined to be part of the "design" of the entity (as in the alternative fact pattern presented in Example 2), then choosing between cash flow versus fair value approach would be critical to measuring the amount of variability absorbed by each variable interest holder. The Proposed FSP should explicitly state whether one method is required over the other, or whether this is an elective accounting policy decision to be made by each preparer.

\textsuperscript{9} Such a conclusion would be consistent with paragraph A22 of the Exposure Draft, *Accounting for Certain Hybrid Financial Instruments*, in which the Board stated that it "believes that there should be no accounting distinction for a purchaser of a beneficial interest, depending on whether the transaction creating that interest was accounted for as a sale or as a financing under Statement 140."
• The analyses in Step 1 of the examples appear inconsistent in their identification
of interest rate risk. Certain examples (Examples 1(a) and 2, for instance) identify
only interest rate risks from assets as a “risk of the entity.” Other examples
(Examples 1(b), 1(c), and 4, for instance) focus more holistically and identify
interest rate risks from both assets and liabilities of the entity, as well as legs of
derivative contracts (potential variable interests).

The analyses in Step 2 of the examples also appear inconsistent. Certain examples
(Examples 4 and 5, for instance) address a risk in Step 2 (interest rate on a
liability) that is not even identified in Step 1. In addition, certain examples
(Example 4, for instance) dismiss the interest rate risk associated with liabilities
(potential variable interests) because the variability is not directly caused by
changes in the value of net assets exclusive of variable interests (presumably
because those liabilities are variable interests). Other examples (1(b), for
instance) do not. Still others (Example 1(c), for example) are entirely silent on
the interest rate risk identified in Step 1.

We recommend that the Board eliminate or explain the basis for these
inconsistencies.

• In Example 2, the entity purchases fixed rate securities that mature in three years.
At the end of three years “all the investments will be sold.” It is not clear why
such a sale is required, as the securities will naturally provide the required
proceeds to repay the entity’s liabilities.

• In Example 5, the fact pattern indicates that the lessee “will retain all of the risks
and rewards from appreciation or depreciation in value of the leased property,”
but accounts for the transaction as an operating lease. We found these statements
inconsistent, as we understand that paragraph 7 of FASB Statement No. 13,
Accounting for Leases, would require a lessee to account for the transaction as a
capital lease if the present value of the minimum lease payments exceeded 90% of
the fair value of the equipment. That is, in order for the lessee to have an
operating lease, the lessee must not protect at least 10% of the value of the leased
property.