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

Dear Sir/Madam:  

Re: FASB Staff Position on FIN 46(R)-c  

Thank you for the opportunity to provide comments on the proposed Financial Accounting Standards Board (FASB) Staff Position, *Determining the Variability to be Considered in Applying FASB Interpretation No. 46(R)* (the "FSP").  

Comments  

We appreciate the opportunity to comment on the proposed FSP given that there has been diversity in the application of the FASB Interpretation No. 46(R) ("FIN 46(R)"). Although the FSP provides some clarification on the application of FIN 46(R), there are a few concerns we would like to bring to the attention of the Board. Firstly, we would like to comment on the shift from a rule-based approach under which FIN 46(R) was released, to the principle-based approach suggested in the FSP. Secondly, although guidance is provided on certain variable interest entity ("VIE") arrangements, we find some inconsistencies between FIN 46(R) and the proposed FSP, specifically in the consideration of interest rate swaps as variable interests. The implications of swaps in the design of the entity are also discussed. In addition, the nature of the relationship(s) of potential VIE holders with the entity is assessed in relation to seniority of interests. Finally, we would like to comment on the risk of non-comparability resulting from the differing treatment applied to entities created before and after the issuance of the FSP.  

Principle-based vs. Rule-based Approach  

It is understood that the FASB has considered adopting a more principle-based approach to U.S. standard-setting in recent years. However, due to complexities and attempts to maintain comparability of financial information, FIN 46 (R) was developed under a rule-based
approach. This approach may have been taken to limit the amount of judgment applied by companies and auditors. The proposed FSP suggests using a principle-based approach to determine the purpose for creating a potential VIE, including the risks/variability it was designed to pass to its interest holders. Although a systematic process is suggested, this assessment requires substantial judgment and interpretation. Given that there has been much disparity in the application of FIN 46 (R), there is a risk that the proposed FSP will further contribute to this diversity as a result of the judgment required.

It can be argued that originally, FIN 46(R) was too rule-based and that insufficient emphasis was put on the qualitative analysis required. However, it is important to acknowledge that traditionally, the rule-based approach has been required to address exceptions in accounting standards and to assist in the interpretation and complex implementation of accounting standards. It is our opinion, that a rule-based approach is more suitable for highly complex areas and transactions. In interpreting FIN 46(R), it is difficult to determine whether a derivative absorbs or creates variability and divergent practice can emerge if there is not clearly defined rules. This FSP itself has divergent conclusions regarding the treatment of derivatives further complicating a preparer's interpretation of FIN 46(R). Therefore, the principle-based approach suggested in the proposed FSP may be too simplistic, and may compound the challenge of diverse interpretation of the standard.

Analysis of Derivatives as Variable Interests

Typically, when guidance has been provided after accounting standards are issued, the guidance focuses on specific types of transactions or circumstances. There appears to be an inconsistency between the original standard and the FSP with regards to derivatives.

Par. B14 of FIN 46(R) indicates that "if the instrument absorbs or receives variability, in the sense that it reduces the exposure of the entity to risks that cause variability, the instrument is a variable interest." An interest rate swap ("IRS") reduces the exposure to interest rate risks resulting from the fluctuation of interest rates. Therefore, it can be argued that an IRS is a variable interest, and that the counterparties are holders of the variable interest.

However, the analysis of Example 1(b) of the FSP indicates that the interest rate swap ("IRS") is a creator of the entity's variability rather than an absorber, and therefore is not a variable interest. It is unclear whether this conclusion is reached on the basis that the swap counterparty is senior to the debt and equity holders (this is further discussed in the section "Nature of the Relationship of Potential VIE Holders"), or because the entity is no longer exposed to interest rate risk associated with changes in the periodic interest payments received on the floating rate investment portfolio by virtue of the swap. The FSP and Example 1(b) do not sufficiently clarify the approach taken to reach this conclusion. We recommend that the approach taken to determine this position be explicitly stated in the example.

Approach to Determining Design of Entity

The FSP indicates that the purpose for the design of the entity should be considered (par. 10 of the FSP) to determine what relationships are variable interests. In assessing the design
of the entity described in Example 1(b) of the FSP with regards to the interest rate swap, the FSP states “The notional amount and contractual term of the swap are designed, from the perspective of the debt and equity investors, to modify the assets so as to reduce or eliminate the floating versus fixed interest rate mismatch [i.e. risk (d) described in par. A6 of the FSP] between the assets and the liabilities,” thereby absorbing interest rate risk. It is unclear why the analysis is made from the perspective of the debt and equity investors. If viewed from the standpoint of the swap counterparties, the entity is exposed to interest rate risk, i.e. risk (d), which is absorbed by the swap counterparties through the swap. It is also unclear why the FSP concludes that the interest rate swap is considered a creator of the entity’s variability. This appears contradictory to the statement that the swap is designed to “reduce or eliminate the floating versus fixed interest rate mismatch between the assets and the liabilities.” We propose that in assessing the design of an entity, each relationship with each interest holder be assessed independently to determine if risks are being absorbed or created. It is our opinion that the counterparty of an IRS absorbs interest rate variability and therefore is a variable interest holder.

As indicated in footnote 4 of the FSP “it is the role of the item [i.e. assets, liabilities, equity and other contracts] – to absorb or receive the entity’s variability – that distinguishes a variable interest. That role, in turn, often depends on the design of the entity.” Par. 9 of the FSP indicates that interests that absorb risk from the entity are variable interests. Consider the following arrangement under this argument. The entity raises debt to purchase fixed rate securitized assets. When floating rate debt is issued, variability is created in the form of interest rate risk. The entity then receives the fixed rate assets transferred by the seller. This creates variability in the form of credit risk. The entity enters into the interest rate swap to absorb the interest rate risk between the fixed and floating rates. The entity has a liquidity facility which absorbs variability in the form of credit risk.

Footnote 5 of par. 10 of the proposed FSP states the following:

“...in the case of interest rate risk associated with periodic interest payments received or paid by the entity, it may be appropriate to exclude such periodic interest receipts/payments from the variability to consider if the reporting enterprise determines that the entity was not designed to create and pass along interest rate risk associated with such interest receipts/payments to its interest holders.”

It is unclear why this variability would be excluded. The entity is clearly exposed to interest rate risk upon the purchase of fixed rate assets and the issuance of floating rate debt. In the design described above, the variable interest holders absorbing this variability are the counterparties to the IRS, who absorb the interest rate risk, and the provider of the liquidity line and the debt holders who absorb credit rate risk. As all counterparties absorb variability, they can all be considered holders of variable interest. Under this argument, the derivatives are variable interests and the counterparties are holders of variable interests.
Nature of the Relationship of Potential VIE Holders

The proposed FSP indicates that the exposure to expected losses and residual returns is dependent on the interests held and their seniority. In interpreting the FSP, a preparer who holds a senior interest in the vehicle could reach the conclusion that without an additional subordinated interest, they do not hold a variable interest that absorbs expected losses and residual returns. We believe that the FSP should clarify the impact of substantive subordination on the determination of variable interests.

Currently it is unclear why there is a difference between the conclusion reached in Example 2 and Example 1(b). Example 2 indicates "If...the entity had entered into an explicit interest rate swap with the equity investor, that interest rate swap would have been considered a variability interest and combined with the equity interest for purposes of determining the entity's primary beneficiary." In Example 1(b) discussed above, presumably the interest rate swap is not considered a variable interest because the swap holders have senior interests. If substantive subordination is the decisive factor in concluding if an instrument is a variable interest, all examples should include discussions to demonstrate this point.

An inconsistency is also noted from footnote 8 of the FSP which states "If the swap counterparty...also held a debt or equity interest in the entity, an analysis of the design of the entity may lead to a conclusion that the swap counterparty was designed to absorb variability that otherwise would have been absorbed by the debt or equity investors, absent the swap transaction." This suggests that the purpose of the swap is to preclude the absorption of variability from the debt/equity holders rather than to mitigate risks. In our opinion, regardless of the other relationships between the entity and the swap holder, the purpose of the swap is to reduce or eliminate variability to the entity. In other words, the swap passes risk exposure from the entity to the holders of the swap.

Comparability

The minutes of the September 7, 2005 FASB meeting (dated September 29, 2005) state that the proposed FSP was drafted to reduce the diversity that resulted from different interpretations of FIN 46(R). However, increased comparability may not be achieved as the principle based approach prescribed by this FSP permits broad interpretations.

Conclusion and Recommendations

We strongly recommend that the proposed amendments to the FASB Staff Position on FIN 46 (R) be delayed until: 1) the FASB considers the implications of companies applying judgment to determine the purpose for design of a potential VIE; 2) the FASB addresses the inconsistencies noted relating to the assessment of interest rate swaps as variable interests; and 3) the FASB assesses the risk of increased non-comparability as companies apply the proposed FSP to new VIE's while maintaining the original treatment for VIE's established before release of the FSP. Furthermore, additional examples and clarifications need to be incorporated into the FSP. Specifically, the treatment of derivatives should be clarified as the current examples are unclear as to whether they are variable interests.
We believe that in order to increase comparability of financial information within companies and between companies, and to address the complex nature of the accounting standard, the approach discussed in the proposed FSP should be revisited. A more rule-based guidance may be beneficial for appropriate application of the FSP.

It is also our opinion, as demonstrated in the various arguments above, that interest rate swaps can be considered as variable interests, regardless of the seniority of the interests. We agree that all relationships between the entity and the swap holders must be examined in determining which party is the primary beneficiary.

Please do not hesitate to contact me should you wish to discuss this matter further.

Sincerely,

[signed]

Cally Hunt
Vice-President and Chief Accountant
BMO Financial Group