

October 2, 2003

Director, TA&I-FSP  
Financial Accounting Standards Board  
of the Financial Accounting Foundation  
401 Merritt 7  
P.O. Box 5116  
Norwalk, Connecticut 06856-5116

**Re: Proposed FASB Staff Position No. FIN 46-c "Impact of Kick-Out Rights Associated with the Decision Maker on the Computation of Expected Residual Returns under Paragraph 8(c) of FASB Interpretation No. 46, Consolidation of Variable Interest Entities"**

Dear Director:

We appreciate the opportunity to comment on proposed FASB Staff Position No. FIN 46-c "Impact of Kick-Out Rights Associated with the Decision Maker on the Computation of Expected Residual Returns under Paragraph 8(c) of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*" (FSP FIN 46-c). We appreciate the FASB's efforts to provide clarifying guidance relating to the complex provisions of FASB Interpretation No. 46 (FIN 46) and recognize the value of improving financial reporting by enterprises involved with variable interest entities. With respect to proposed FSP FIN 46-c, however, we are concerned that the conclusions reached by the FASB will result in the inappropriate consolidation of assets to which Federated has no claim, title or interest and debt to which Federated has no obligation or recourse. We believe consolidation will ultimately lead to illogical financial statements that do not accurately reflect Federated's operations or financial position.

Federated is the investment manager of three collateralized bond obligations (CBOs), all of which meet the definition of a variable interest entity (VIE) pursuant to FIN 46's provisions after considering their corporate governance. The CBOs are leveraged investment vehicles created for the sole purpose of issuing collateralized debt instruments pursuant to an indenture. The assets under management in the CBOs represent the collateral for the CBO notes and were purchased with the proceeds collected by the CBO from the issuance of debt. As of June 30, 2003, total assets under management in the CBOs approximated \$1.0 billion. Federated's obligation to the CBOs is strictly limited to managing the collateral for which Federated earns a management fee on a fixed-rate basis. Federated also holds a minor investment in each CBO, which expose it to risk of loss to the extent of the carrying value of the investments. As of June 30, 2003, the remaining \$0.6 million carrying value of these investments represented Federated's maximum exposure to loss over the remaining life of the CBOs.

Proposed FSP FIN 46-c states: "The existence of kick-out rights does not affect the status of a decision maker..." We interpret this to mean that the VIE investors' ability to remove the decision maker at any time does not impact the determination of the decision maker under FIN 46 until such time as this right is exercised. The application of this guidance would likely result in Federated having to consolidate the CBOs which is inappropriate for the following reasons:

- Federated has no current or future claim to the CBOs' assets or any obligation for the CBOs' debt. The CBO asset and debt balances did not originate as a result of a transfer from Federated to the CBO.
- The accumulated losses of two of the CBOs exceed their equity investment. As a result of consolidating the CBOs, Federated's equity and net income would be burdened by net losses that would be contractually borne by the CBOs' note holders upon liquidation of the CBOs. These net losses would be reversed by Federated upon such liquidation.
- Federated does not have the discretionary authority over most of the management decisions relating to the CBO (such as retention of service providers, expense management, and amending the investment policy, indenture document or capital structure).
- As investment manager, Federated acts as an agent of the CBOs. Its duties and responsibilities are limited to providing investment advice in accordance with the strict investment policies of the CBOs. The investment policies significantly restrict Federated's ability to trade the portfolios. As a result of these restrictions, Federated may be unable to buy or sell securities or to take other actions which it might consider to be in the best interest of the CBOs and their investors.

Given the relative size of the CBOs' asset and debt balances as compared to Federated, the consolidation of the CBOs would grossly distort Federated's financial condition. Total assets on the balance sheet would grow by more than 325% (from \$490 million at June 30, 2003 to more than \$1.6 billion) with the addition of cash and the underlying assets in the CBO portfolios as well as debt issuance costs and interest receivables. Similarly, total debt would increase from \$60 million at June 30, 2003 to more than \$1.0 billion with the addition of nonrecourse CBO debt. These changes to the balance sheet would be accompanied by numerous lengthy and potentially cumbersome disclosures to make clear the fact that Federated does not have title or interest in the CBO assets and does not have any recourse to the CBO debt or liabilities. Consolidation of the CBOs would prove to be extremely challenging as we strive to present transparent reporting of Federated's results of operations and financial position.

Aside from the inappropriate and illogical consolidation results for Federated, we take issue with the conclusion of the proposed FSP for the following reasons. First, the proposed guidance of FSP FIN 46-c is inconsistent with the concept of control as provided by EITF 96-16 and 98-6. The underlying concept in each of these EITFs is the notion that, under the voting-interests consolidation model, the ultimate measure of control is the extent of an entity's uncontested decision-making authority. EITF 96-16 concludes that consolidation by the investor with a

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majority voting interest is not appropriate if the decision-making authority of the majority owner can be overridden by a vote of a minority interest shareholder as a result of its substantive participating rights. Similarly, EITF 98-6 concludes that ultimate control does not reside with the general partner of a limited partnership if the limited partners can ultimately remove the general partner at will. We believe the fundamental concept of control should be consistent among the voting-interests and variable-interests consolidation models.

In addition, we believe the proposed FSP could lead to a case where the entity's decision maker identified in determining whether the entity is a VIE is different from the entity identified as the VIE's decision maker when determining whether to include fees in the expected residual returns calculation. For example, assume that the equity owners of a VIE were deemed to have substantive decision-making authority over the VIE including the exclusive right to remove the investment manager at any time. Also assume that the entity was deemed to be a VIE because the equity investment at risk was not sufficient to cover the expected losses of the entity. We believe it would be inconsistent to state that the equity owners have substantive decision-making ability in evaluating whether the entity is a VIE, only then to assign the service provider as the VIE's decision maker for purposes of completing the expected residual returns calculation.

Please feel free to contact us at 412-288-7712 to discuss these specific concerns at your convenience.

Sincerely,



Thomas R. Donahuc  
Chief Financial Officer



Denis McAuley III  
Principal Accounting Officer