



Letter of Comment No: 19
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July 31, 2003

MP&T Director – File Reference 1200-001
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: File Reference 1200-001: Amendment to FASB Statement No. 140

Dear Sirs:

The American Financial Services Association (“AFSA”) appreciates the opportunity to comment on the “Proposed Statement of Financial Accounting Standards: Qualifying Special-Purpose Entities and Isolation of Transferred Assets” (the “Proposed Amendment”) issued by the Financial Accounting Standards Board (the “FASB”) on June 10, 2003. AFSA represents diversified financial services companies, automotive finance companies, consumer finance companies, mortgage companies, commercial finance companies, credit card issuers and merchandise and department store retailers with significant financial businesses. Among their many financial activities, our members originate automobile loans (including credit for dealers as well as consumers), provide sales financing for consumer goods, and issue credit cards, securitizing the receivables generated by these credit activities via qualifying special-purpose entities (each a “QSPE”). As a result, our members have a strong interest in ensuring that the accounting rules affecting QSPEs are designed to provide the transparency and valuable financial information that financial statement users require without unnecessarily limiting the legitimate uses or diminishing the economic value of the securitization process.

AFSA commends the FASB for undertaking the challenging task of reforming off-balance-sheet accounting rules in the aftermath of the highly publicized abuses of off-balance sheet accounting that have come to general attention in the last few years. We agree that it is vitally important for preserving the integrity of financial reporting, as well as the asset-backed securities market as a whole, that such abuses be addressed. But at the same time, we believe that accounting rules should permit capital markets to function efficiently, enabling financial services firms to seek the most cost-effective means by which to fund their activities. The goals of financial reporting are not furthered when market participants cannot freely select the most efficient structure for legitimate capital funding transactions because of rules designed to address the fraudulent behavior of a few participants.

Such an outcome would have far-reaching disruptive effects – on the institutions that rely on off-balance sheet securitizations to replenish lending capital, on the investors that will no longer be able to purchase securities having risks appropriate to the investors’ risk appetites, on the

consumers that rely on efficient capital markets to keep interest rates low, and on a bank regulatory structure whose safety and soundness calculations are built on the assumption that asset-backed securitization is widely available. Perhaps most importantly, it would erode the information value of the financial reports of companies that engage in legitimate off-balance sheet financing, undermining the fundamental goals that motivated the Proposed Amendment. Statement No. 140 stands for the practical concept that a company's balance sheet should reflect the assets it controls – particularly those assets that would be available to creditors, secured and unsecured, in the event of bankruptcy. In an effort to prohibit a recurrence of the reported abuses of the concept of control, the Proposed Amendment runs the risk of systematically inflating the balance sheets of companies that engage in off-balance sheet transactions. Since the securitization vehicles of many companies may fail to meet the requirements of the Proposed Amendment, but will still meet the legal requirements for bankruptcy remoteness, those assets will appear to a financial statement reader to be available to creditors in the event of a bankruptcy, but in actuality will not be, as they are legally segregated. To solve the problem that QSPEs have been used to systematically under-report liabilities, the Proposed Amendment as currently drafted will in operation result in systematic over-reporting of assets.

These potential disruptions point to the widespread reliance by the asset-backed securities market on the existing form of Statement No. 140. The ability to transfer financial assets to a QSPE, treat the transfer as a sale for accounting purposes, and thereby derecognize the transferred assets is crucial to the effective functioning of capital markets in the United States. Financial assets can be divided into various components, with ownership distributed according to the differing financial needs of the transferor(s) and the various investors. Accounting standards should be able to – and currently for the most part do – accurately reflect this ability to partition assets. The Proposed Amendment, however, would allow significantly less flexibility and would be less able to efficiently accommodate the needs of transferors and investors. For some transferors, this added inefficiency would be sufficient cause to abandon asset-backed securitization in favor of unsecured funding structures where assets remained on-balance-sheet. For transferors dependent on asset-backed securitizations, the added inefficiencies would significantly increase their costs, which would ultimately be passed on to investors and consumers in the form of lower yields and higher credit costs. We strongly believe that the Proposed Amendment would have pervasive effects of this kind, because it would effectively deny QSPE status to many typical securitization structures and some of the most common forms of credit enhancement and risk protection currently used in securitization transactions. Many aspects of “plain vanilla” securitizations that do not involve reissuances of beneficial interests – which appear to be the most significant concern of the FASB in the Proposed Amendment – are implicated by the changes the FASB has proposed, specifically:

- *Derivative Arrangements With Transferors.* Securitization transactions very frequently feature back-to-back swaps as a way to manage risks such as interest rate or currency risk. For example, where a QSPE issues floating rate securities backed by fixed rate assets, the QSPE typically enters into an interest rate swap with a counterparty, such as the agent, a bank, or the transferor itself, to hedge the exposure to interest rate risk within the QSPE created by the mismatch. The counterparty typically then enters into an offsetting swap with a third party, which may also be a bank or the transferor, such that

the counterparty's risk position is neutralized. The Proposed Amendment would affect this very common risk management tool in two ways. First, it would prohibit the QSPE from entering into any derivative financial instrument with the transferor as a swap counterparty, including plain vanilla derivatives such as interest rate or currency swaps. Second, the language of the Proposed Amendment could be read as prohibiting the QSPE from entering into the swap with a bank or other unaffiliated third party because that third party might be considered an agent for the transferor. This would require the transferor to arrange for the QSPE to enter into a swap with a third party otherwise unconnected with the deal, thereby raising the transaction costs, because both third party participants would be forced to take more expensive unmatched risk. Alternatively, QSPEs with fixed-rate assets might simply forego issuing floating rate securities, giving investors fewer alternatives to meet their investment needs and issuers fewer opportunities to take advantage of market preferences. This, too, would increase funding costs. These derivatives, however, do not transfer control over any aspect of the underlying assets or provide a guarantee of any liability of either the QSPE or the transferor (which would jeopardize bankruptcy-remoteness anyway). Consequently, derivatives of this type do not appear to us to be the source of the harm the FASB is seeking to address. We believe the FASB should make clear that derivatives that do not give the transferor control over the QSPE's assets or jeopardize bankruptcy-remoteness, such as plain vanilla passive derivatives or back-to-back swaps, neither of which affect control, should not jeopardize QSPE status. If the FASB reaffirms its intention to limit the use of passive derivatives in connection with QSPEs, we think it should at a minimum make clear how such a limitation affects the common practice of arranging back-to-back swaps as described above.

- *Liquidity Commitments.* It is common for a transferor to provide a limited or capped liquidity commitment to a QSPE, rather than retain a larger subordinated interest or provide a collateral cash fund. Such commitments are an efficient and inexpensive way to deal with any temporary cash-flow problems created by such common issues as a temporary mismatch between cash in-flows on the underlying assets and either cash payments required to be made by the QSPE on its beneficial interests or scheduled payments the QSPE is required to make to its servicer or advisor. Proposed Paragraph 35(e), however, would deny derecognition for transferors that are parties to such commitments. To address liquidity problems, QSPEs would need either to arrange with third parties for liquidity commitments that are almost certain to be more expensive than those that would be provided by the transferor, or fund a cash reserve account for the benefit of the securityholders. Either way, issuers would face a significant increase in the cost of funds as a result of the less efficient use of proceeds, reducing the overall effectiveness of securitization as a viable funding vehicle.
- *Other Commitments to QSPEs.* It is also common for a transferor to provide other limited or capped commitments to a QSPE or its beneficial interest holders, such as credit enhancements in the form of a guarantee against payment default by the QSPE, buyback commitments if individual assets placed in the QSPE do not satisfy representations and

warranties, other representations, warranties and indemnifications that are all part of the ordinary legal requirements typical of a transfer for valuable consideration. It is unclear, however, whether under the language of proposed Paragraph 35(e) any of these routine mechanisms will be compatible with QSPE status – and if so, which types of commitments are favored and which are disfavored. In order to assure QSPE status, to the degree that it can achieve such certainty under the Proposed Amendment, a transferor would have to arrange for more third-party insurance, covering more contingencies, than transferors routinely obtain at the moment. The costs of this third-party protection, though initially paid by transferors, will ultimately be borne by the consumers who must pay the higher interest rates that compensate transferors for these increased securitization overhead costs. Much of this cost could be eliminated if the FASB made clear that customary representations and warranties do not constitute prohibited commitments.

- *Multi-Seller Conduits.* Multi-seller conduits allow transferors to benefit from the efficiencies and economies of scale inherent in pooled vehicles. In many instances, such as multi-seller asset-backed commercial paper conduits, the conduit is not structured as a QSPE. Rather, legal isolation of the assets is accomplished by an initial transfer of the assets to a bankruptcy-remote subsidiary of the transferor. Only then are the assets transferred to the conduit for it to issue beneficial interests. The Proposed Amendment would prevent derecognition for transferors unless a QSPE was the initial transferee, thereby preventing derecognition for many multi-seller conduits. Because these conduits are so commonly the vehicles for issuing asset-backed commercial paper, the limitation on multi-seller conduits embedded in the Proposed Rule appears to prevent many asset-backed commercial paper transactions. We believe that the added inclusion of a QSPE in a Multi-Seller structure will complicate these transactions unnecessarily, increase funding costs because of added complexity and increase time-to-market. We recommend that the FASB reconsider this requirement in arrangements where the transferor is selling assets through a bankruptcy-remote subsidiary to another entities sponsored securitization vehicle.

The effects of the Proposed Amendment become even more pronounced in connection with securitizations of revolving debt that could be characterized as involving the “reissue” of beneficial interests. Specifically:

- *Top-Ups of Securitized Revolving Retail Accounts.* The language concerning the reissuance of beneficial interests is vague as it relates to the securitization of revolving account receivables. When a transferor proposes to securitize receivables generated by active revolving credit accounts, it has a choice as to what to do with “new” debt generated by those accounts after the initial sale date relating to the securitization and during the term of the securitization transaction. Either it can “top-up” the QSPE with the new debts, or it can bifurcate the account at some predetermined point in time and retain the new debt for a later securitization. The latter is a far more expensive and cumbersome choice, and therefore rarely if ever chosen in securitizations of such new debt. But the Proposed Amendment would force transferors to abandon the practice of topping-up revolving securitization transactions and switch to this more expensive,

cumbersome and untried method of dealing with active accounts, in order for their transferees to retain QSPE status. There is no feasible alternative: if the QSPE does not reissue beneficial interests the transferor “may not enter into an agreement ... to deliver additional cash or other assets” to the QSPE at all, and even if the QSPE does reissue beneficial interests the transferor may not deliver “more than half the aggregate fair value of all such commitments” to the QSPE, meaning that at least one half of the accounts would have to be bifurcated. The difficulty and expense resulting from the Proposed Amendment is difficult to estimate, but we think that it will be a significant disincentive to the securitization of revolving receivables. This is particularly significant as some issuers engaged in the extension of revolving credit may rely on off-balance sheet securitization as their only source of funding.

- *Reissuance.* It is often the case that a single QSPE owns a fluid pool of assets – often revolving consumer credit accounts or automobile, light vehicle or heavy equipment dealer floorplan accounts – that supports a series of asset-backed securities. The QSPE very often has the ability to issue different types of securities, e.g. asset-backed commercial paper, medium-term notes and term securities. The Proposed Amendment would deny QSPE status where the transferor has the ability to make decisions about reissuing beneficial interests. Although the lack of definitions in the Proposed Amendment for “decisions” and “reissuing” means that we cannot be certain of the scope of this prohibition, it could extend to situations such as those where a QSPE reissues commercial paper. The Proposed Amendment would prevent QSPEs from reissuing beneficial interests going forward, on penalty of being stripped of their status. The only practical alternatives that the Proposed Amendment leaves open for transferors wishing to maintain these structures are to hire an independent third-party to make decisions with respect to reissuing beneficial interests, or to create a new QSPE each time a new beneficial interest is to be issued. Either alternative involves significant cost, additional complexity and inefficiencies without providing any appreciable benefit to financial statement users as compared to the current rules.
- *Transferor Retention of Subordinate Interests.* Under proposed Paragraph 35(f)(2), if a transferor both makes decisions about the special-purpose entity’s reissuance of beneficial interests and holds junior beneficial interests in the special-purpose entity, it will not qualify as a QSPE. A transferor concerned that its relationship with the QSPE will be deemed decision-making authority to a special-purpose entity that reissues securities under the standard of the Proposed Rule may be required to sell all of its subordinated interest to third parties. But the cost of those enhancements will burden the securitization, and if it becomes widespread will burden the entire securitization process. If it were economically efficient to sell these subordinate beneficial interests, the transferor would already have sold them; a forced sale only serves as a drag on efficiency. Rules aimed at clarifying the reporting of financial transactions should not drive underlying business decisions such as the method of dividing, pricing and marketing an asset. We recommend that the FASB reconsider whether it is practical to

preclude QSPE status in situations where a transferor has decision-making ability and retains interests that are not the most senior.

We have noted points where the Proposed Amendment requires, or because of its ambiguity may be interpreted to require, transferors to change customary securitization practices, including practices commonly associated with such deals structured as discrete and fully amortizing pool securitization transactions, which are generally recognized as harmless. Some practices are under more pressure from the Proposed Amendment than others, of course. Issuances of asset-backed commercial paper by QSPEs, in particular, appear to us to be at significant risk as a result of the Proposed Amendment. Asset-backed commercial paper is often backed by liquidity commitments, other commitments and top-up agreements from the transferor(s), and it often involves reissuances (and reissuance decisions with regard to price and term) because the commercial paper matures faster than the underlying assets that support it. The number and expense of the changes necessary to make a typical asset-backed commercial paper issuer a QSPE under the Proposed Amendment, and the uncertainties as to whether such changes in the end will be adequate, are such that we think they jeopardize the continued issuance of asset-backed commercial paper of any kind.

We can find no clear rationale for why the Proposed Amendment comprehensively disfavors asset-backed commercial paper. It is certainly true that commercial paper issuers retain significant discretion as to the timing and specifics of securities issuances, but that discretion concerns matters such as determining the maturity of commercial paper given current market conditions. That sort of discretion does not appear to us to be the intended target of the Proposed Amendment, and that being the case, we think the changes the FASB ultimately approves to Statement No. 140 can be more narrowly tailored to address the most important abuses without unnecessarily restricting legitimate, economically beneficial asset-backed securitizations.

A few specific improvements to the Proposed Amendment will go a long way towards focusing its effects on the egregious behavior that it should rightly address. We have already noted above carve-outs for benign derivative arrangements and liquidity commitments that convey no control to transferors, as well as for customary representations and warranties. In addition, narrow and clear definitions of what constitutes a "reissue" of beneficial interests, what constitutes a disfavored level of "discretion" or "decision making," and what constitutes a disfavored "agreement to deliver additional cash or other assets" should allow Statement No. 140 to deny QSPE status where control over assets effectively remains with the transferor or bankruptcy remoteness is threatened, without denying QSPE status when the securitization uses the common and justifiable practices we have identified above. Finally, if there are securitization structures that the FASB continues to think should be fundamentally disfavored, it should specify what those structures are.

It may, however, be preferable for the FASB to approach the QSPE problem from a different perspective. Rather than ratcheting up all of the individual requirements for QSPE status, hoping to prohibit bad practices as a side effect of a general toughening of standards, the FASB may wish to consider adopting a separate test of whether, under the totality of the circumstances surrounding the QSPE and its relationship with the transferor, the transferor retains control

MP&T Director -- File Reference 1200-001

July 31, 2003

Page 7

sufficient to destroy bankruptcy-remoteness. Such a test – perhaps disaggregated into financial, managerial and other types of control – may be a way of attacking directly and effectively the ills that we believe the Proposed Amendment should address. Such a test may thereby avoid the negative impact that the Proposed Amendment will have on asset-backed securitizations in general.

If you would like to discuss our thoughts on alternative changes to Statement No. 140, or if we can provide any additional information about any of the issues we have raised in this letter, please do not hesitate to call Monique Gaw, AFSA's Vice President for Federal Government Relations, at (202) 296-5544.

Very truly yours,

A handwritten signature in black ink, appearing to read "Monique Gaw". The signature is written in a cursive, flowing style with a prominent initial "M".

Monique Gaw
Vice-President for Federal Government Relations
American Financial Services Association