



FSP FIN 46-c

September 29, 2003

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Re: Proposed FASB Staff Positions Nos. FIN 46 b, c and d

Thank you for the opportunity to comment on Proposed FASB Staff Positions (FSP) No. FIN 46-b *Consolidation of Variable Interest Entities*, for certain Decision Makers, No. FIN 46-c, Impact of Kick-out Rights Associated with the Decision Maker on the Computation of Expected Residual Returns under Paragraph 8c of FIN 46, *Consolidation of Variable Interest Entities* and No. FIN 46-d, Treatment of Fees Paid to Decision Makers and Guarantors as Described in Paragraph 8 in Determining Expected Losses and Expected Residual Returns of a Variable Interest Entity under FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*.

As indicated in our second quarter Form 10-Q disclosures, and in my comment letter to the FASB dated August 12, 2003, Lincoln National Corporation (LNC) has significant concerns regarding the application of FASB Interpretation 46, *Consolidation of Variable Interest Entities* (FIN 46), to the asset managers of Collateralized Debt Obligations (CDOs). In addition to providing our specific comments relating to proposed FSP Nos. FIN 46 b, c and d, we would like to reemphasize our general concerns with the application of FIN 46 to the CDO asset manager, as well reiterate suggested solutions that we believe are consistent with the FASB's objectives in promulgating FIN 46.

In the typical CDO arrangement, the investment advisor manages the assets held in the CDO collateral pool for the third party investors. The third party investors bear the risk of the CDO assets. In the absence of any specific contractual guarantees by the investment manager, there is generally no recourse to the investment advisor for the liabilities of the CDO. Rather, the investment advisor simply manages the assets under a fee structure, and in accordance with the investment policy agreement, established in negotiation with the third party investor group at the time the CDO was formed.

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In most cases the equity and debt issued by the CDO is sufficiently dispersed so that no single entity is exposed to a majority of expected losses. However, under the proposed FSP FIN 46 guidance, the asset manager would generally be deemed to be the "decision maker" as a result of the execution of asset manager's investment advisory duties as delineated in the CDO agreements. Following the application of the proposed FSP FIN 46 guidance, the inclusion of the fees to the decision maker in the calculation of expected residual returns will typically result in the investment manager being deemed the primary beneficiary and the consolidator of the CDO.

In evaluating whether the proposed FIN 46 FSP guidance creates the appropriate result in the case of the CDO asset manager, it is critical to consider the rationale that FASB set forth as its reasons for changing current accounting practice. In the discussion section of FIN 46 labeled "Differences between This Interpretation and Current Practice" FASB made the following statements: "This Interpretation requires existing unconsolidated variable interest entities to be consolidated by their primary beneficiaries if the entities do not effectively disperse risks among the parties involved. Variable interest entities that effectively disperse risks will not be consolidated unless a single party holds an interest or combination of interests that effectively recombines risks that were previously dispersed."

In this instance, dispersion of the potential risks associated with the collateral pool of assets is the reason the CDO exists, and why the structure is appealing to third party investors. To contend that the CDO asset manager has recombined risks that were previously dispersed and must now consolidate the CDO collateral assets ignores economic reality. As currently contemplated, the proposed FIN 46 FSPs when applied to the CDO asset manager would produce results that are inconsistent with FASB's stated purpose in crafting the variable interest entity concept.

Accordingly, we do not view consolidation by the CDO asset manager to be the right answer under the general concepts of FIN 46, as articulated by FASB. Specific suggestions to correct the proposed FSP FIN 46 mechanics that are driving the conclusion that the CDO asset manager will be treated as the primary beneficiary, regardless of whether the asset manager does or does not have risk of loss associated with the CDO collateral assets, are addressed below.

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Comments Regarding Proposed FSP FIN 46 b, c and d

FSP FIN 46-b proposes to defer the effective date of FIN 46 for decision makers that receive fees paid by the variable interest entity if the fee has no variability, the decision maker has no exposure to expected losses of the entity, and no right to expected residual returns of the entity.

We note that standard market practice for investment advisor compensation is a percentage fee based upon the fair market value of CDO assets. In addition, many times there is a performance incentive providing for additional compensation for the asset manager when certain agreed upon performance criteria have been met. Since the CDO asset manager's fee structure has been negotiated in an arm's length third party transaction, and as the fee represents compensation for services rendered for the benefit of the investor group, we do not see the point in not allowing a CDO asset manager with a performance based asset management fee structure a deferral in the FIN 46 effective date rule.

By limiting deferral to fixed fee arrangements, none of the CDO structures that we are aware of in the marketplace will qualify for the delayed effective date. In light of the serious issues that FIN 46 creates for CDOs, and the critical need for additional guidance to address several significant post consolidation issues, we strongly urge the FASB staff to draft a rule that will result in deferring the effective date for CDO asset managers.

FSP FIN 46-c proposes that the existence of kick-out rights does not affect the status of a decision maker in the application of paragraph 8(c) of FIN 46. We disagree with that proposal, and believe that a facts and circumstance inquiry must be completed to determine whether or not the CDO asset manager is properly characterized as a decision maker for purposes of FIN 46. Because the CDO asset manager must conduct its activities in accordance with prescribed contractual arrangements and specified restrictions on the asset manager's actions, it is clear that the manager is merely providing a service for the investor group, in compliance with the prior decisions made by the investor group in establishing the terms of the investment advisor agreement. Further, if the investor group has the right to replace the asset manager without cause we believe it is the investor group, and not the investment advisor, that is the true CDO decision maker. If based upon the particular facts and circumstances the CDO asset manager is not found to be a decision maker, then the fees paid to the CDO asset manager should not enter into the computation of expected residual returns. We urge the FASB staff to reconsider the proposed guidance included within FSP FIN 46-c, and recommend that additional guidance be provided setting forth the criteria that should be used to determine whether a CDO asset manager should be considered a decision maker.

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In FSP FIN 46-d, FASB staff concludes that fees described in paragraph 8 will always be variable interests in the entity, unless otherwise excluded by other guidance. Rather than this blanket approach, we believe that the relevant analysis should be based upon a review of whether the residual return being paid to the participant in a VIE relates to compensation for the participant's assumption of risk of loss. This is a key FIN 46 principle in the determination of whether an entity has a controlling finance interest, as enumerated by FASB in the summary section of FIN 46. In the case of fees paid to a CDO investment advisor as compensation for asset management services rendered for the benefit of the third party CDO investor group, we do not believe this key FIN 46 principle has been met. We believe that in the case of a CDO, the underlying relationships between the investment advisor and the investor group, including an analysis of whether any risk of loss has been assumed by the investment advisor in exchange for fees, must be completed in order to properly characterize the nature of the investment advisor's fee structure.

Need for Guidance Addressing Issues Arising after Consolidation

If the FASB staff and members ultimately disagree with the points we have presented above, resulting in consolidation by the CDO asset manager under FIN 46, we then believe that until several critical accounting issues that arise after a CDO is consolidated have been addressed, the required transition to the new rules should be delayed. As disclosed in LNC's 2nd quarter 10-Q, the fair value of the LNC's CDO pool assets is approximately \$1.2 billion and the nonrecourse debt that would be recorded is approximately \$1.5 billion as of June 30, 2003. Further guidance is required as to how LNC's financial statements should be adjusted to reflect the fact that the third party investors will absorb these losses.

Without appropriate adjustments, merely consolidating the managed CDO assets and liabilities would not produce the improved financial reporting results that FASB desires. In particular, as discussed in FIN 46, FASB Concepts statement No. 1, *Objectives of Financial Reporting by Business Enterprises*, states that financial reporting should provide information that is useful in making business and economic decisions; completeness is identified in FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, as an essential element of representational faithfulness and relevance; and FASB Concepts Statement No. 6, *Elements of Financial Statements*, defines *assets*, in part, as probable future economic benefits obtained or controlled by a particular entity and defines *liabilities*, in part, as obligations of a particular entity to make probable future sacrifices of economic benefits.

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Requiring the CDO asset manager to record assets and liabilities within its financial statements where the CDO asset manager does not have the potential for future economic benefit represented by the assets, nor the potential to make future sacrifices of economic benefits, will not produce financial statements that exhibit representational faithfulness and will not provide information that would be relevant to making business or economic decisions. If LNC were required to adopt FIN 46 under the proposed guidance that currently exists, without FASB providing the needed guidance to address the critical issues that consolidation by the CDO asset manager would raise, LNC would be required to provide extensive disclosures to enable users of the financial statements to "unwind" the impact of the CDO asset manager consolidation.

In discussions with rating agencies that follow LNC, we have been told that they will make adjustments to back out the CDO asset manager related effects of FIN 46, in order to focus on the underlying economics of LNC's business. These comments by the rating agencies are sending the clear message that in this instance, FIN 46 will not achieve FASB's objective of improving financial reporting. We are concerned that less sophisticated investors would be unfairly disadvantaged by misleading results that would be reflected on the face of the financial statements, under FIN 46. All investors may not have the knowledge or resources necessary to delve fully into the extensive and complex disclosures that would be needed to explain how LNC's financial statements must be adjusted to remove the income statement, cash flow and balance sheet effects of CDO assets and liabilities which have no bearing on LNC's actual results.

Suggestions for Addressing Post Consolidation Issues

To mitigate the issues raised by including the CDO assets and liabilities within the asset manager's consolidated financial statements, we believe there are at least two alternatives deserving of consideration. One is modeled after the accounting treatment of separate account assets and liabilities of life insurance companies. Under this type of approach, the CDO assets would be carried at fair market value, and liabilities would be similarly valued. This would eliminate income statement and balance sheet distortions, by reflecting the fact that the variable interests which will absorb the gains and losses associated with the CDO assets are held by third party investors. The CDO assets and liabilities would be shown as summary totals in the consolidated financial statements. This approach may be particularly applicable to companies such as LNC, which are in the insurance business and already have separate account financial statement presentation and related disclosures.

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An alternative approach is to record CDO assets gains or losses as third-party minority interests. In the case of losses, this would be recorded as either a receivable or a contra-liability, to ensure that the CDO asset manager's net income and shareholders equity reflect the proper allocation of risks associated with the CDO assets and liabilities. For a CDO that carries no guarantees from the asset manager, the debt of the CDO is a pre-funding of any CDO's losses that are in excess of its equity. The fact that debt holders have effectively funded losses in excess of equity provides sufficient support for establishing either a receivable or a contra-liability.

We understand that a potential objection to the recording of a debit balance in a minority interest may be based upon the discussion in paragraph B-34 of FAS 144 that addresses the existence of non-recourse debt. In providing this guidance, FASB clarified that the existence of non-recourse debt financing for an asset does not mean that the asset's owner may avoid recording an impairment of the asset, where the asset has experienced a decline in value. However, we would point out that while FAS 144 deals generally with long-lived assets, specifically excluded from its scope are financial assets. We understand that what FASB was addressing in FAS 144 were situations where long-lived assets, and related non-recourse financing, are supported by the general operating results of the business enterprise. Such a fact pattern is clearly distinguishable from the obligation of an issuer of CDO to allocate to investors the risks and rewards attributable to the financial assets held within the CDO collateral pool. Further, the CDO asset manager's ability to make decisions about the composition of the CDO collateral pool of assets is significantly different than the general management decisions about operating assets that FASB addressed in paragraph B-34 of FAS 144. For these reasons, and because FASB stated that the general guidance under FAS 144 is specifically not applicable to financial assets, and we do not believe this guidance should be extended by analogy to the treatment of CDO assets and liabilities. The differences between long-lived operating assets and the financial assets within the collateral pool of a CDO are significant and require different accounting treatment.

Finally, we also want to point out that the asset manager does not maintain the CDO financial statement information; rather this is typically the responsibility of third party administrators or trustees. In many instances, the CDO asset manager does not have contractual rights to obtain this financial information. In addition, the financial information maintained by these third parties is not necessarily prepared in accordance with GAAP. As such, it may prove difficult and costly to obtain accurate, timely, GAAP information from these third parties. Consideration needs to be given to these matters in crafting a transition period for the adoption of these new rules for structures that were established prior to the FASB's origination of the concept of a variable interest entity.

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We strongly urge the FASB staff and members to give careful consideration to the matters discussed in this comment letter. As disclosed in our second quarter Form 10-Q, LNC is very concerned that the wrong treatment of the CDO asset manager will create significant distortions in future financial filings. Given the importance of these matters to LNC and our shareholders, we request a meeting with the FASB staff to discuss our views on these matters. I will call to discuss the possibility of such a meeting.

Sincerely,



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Enc.



August 12, 2003

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Rc: Consolidation of Variable Interest Entities – Impact on CDO Fund Asset Managers

In light of the discussions scheduled for the August 13, 2003 meeting of the Financial Accounting Standards Board relating to Interpretation No. 46, *Consolidation of Variable Interest Entities*, we would like express our significant concerns regarding informally communicated guidance as to the application of these rules to asset managers of collateralized debt obligation (CDO) funds. Lincoln National Corporation (LNC) recently filed its second quarter 10-Q providing an extensive disclosure concerning these matters. An excerpt from the 10-Q containing this disclosure is attached.

As detailed in our second quarter disclosure, we understand that emerging guidance would require LNC to report significant losses upon adoption of Interpretation No. 46. We currently estimate these losses at approximately \$300 million pre-tax. However, because LNC is not at risk on these losses, in subsequent periods as the CDO pools liquidate LNC would report gains. The fact that the third party investors ultimately bear the economic risk of the losses associated with the underlying invested assets would not be properly reported, under the accounting model being created under Interpretation No. 46, during the long period of time that many of these funds are expected to exist.

Fundamentally, we do not believe the asset manager should fall within the definition of a decision maker, for these purposes, when the third party investor group has the ability to replace the investment advisor without cause. Given these circumstances, our view is that consolidation of the CDO fund with the asset manager is not appropriate. From the asset manager's perspective, the CDO funds are analogous to many other types of assets under management, such as retail mutual funds or institutional retirement plan assets, that clearly should not be reflected on the asset manager's balance sheet.

However, should FASB determine that the asset manager must be considered a decision maker, and where consolidation with the asset manager will then result, the asset manager's financial statements should reflect the fact that any gains or losses on the CDOs are borne by third party investors. An allocation of gains and losses to third party interests should result in the recording of a balance sheet receivable for third party losses,

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or a payable for third party gains, so that the asset manager's shareholder equity balance remains fairly stated.

As our second quarter 10-Q filing indicates, we do not believe that the informal guidance emerging under Interpretation No. 46 would result in financial statements that reflect the economic rights and obligations of the CDO fund asset manager. We urge the FASB to address these matters, so that once Interpretation No. 46 becomes effective, LNC's financial statements will continue to reflect economic reality.

If you would like to discuss these matters in more detail, I can be reached at (215) 448-1408.

Sincerely,



Casey J. Trumble
Senior Vice President Tax & Reporting
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Enc

Accounting for Variable Interest Entities. In January 2003, the Financial Accounting Standards Board issued Interpretation No. 46, "Consolidation of Variable Interest Entities" ("Interpretation 46"), which requires the consolidation of variable interest entities ("VIE") by an enterprise if that enterprise has a variable interest that will absorb a majority of the VIE's expected losses if they occur, receive a majority of the entity's expected residual returns if they occur, or both. If one enterprise will absorb a majority of a VIE's expected losses and another enterprise will receive a majority of that VIE's expected residual returns, the enterprise absorbing a majority of the losses shall consolidate the VIE. VIE refers to an entity in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. This Interpretation applies in the third quarter of 2003 to VIEs in which an enterprise holds a variable interest that is acquired before February 1, 2003. LNC intends to adopt this Interpretation prospectively with a cumulative-effect adjustment as of the beginning of the third quarter of 2003. As key guidance with respect to certain aspects of the new Interpretation is still emerging, LNC has not been able to finalize the expected effect of adoption.

Among the matters that LNC is currently reviewing in connection with the third quarter 2003 effective date of Interpretation No. 46 to existing VIEs is the potential application to Collateralized Debt Obligation (CDO) pools that are managed by LNC. Because the fees earned by LNC for managing these CDOs are required to be included in the analysis of expected residual returns, it is likely that such CDO pools may fall under the consolidation requirements of Interpretation No. 46. If the invested assets within the CDO pools and the liabilities owed by the CDO pools to the third party investors are required to be brought onto LNC's consolidated balance sheet, LNC would disclose that the CDO pool liabilities are nonrecourse to LNC.

Because the fair value of the underlying invested assets in the CDO pools is currently below amortized cost basis, if LNC is required to consolidate the CDO pools, the value of the assets recorded upon initial adoption of the new Interpretation will be less than the amount of nonrecourse debt. Based upon information currently available, LNC estimates that the fair value of the CDO pool assets is about \$1.2 billion and that the nonrecourse debt would be recorded at about \$1.5 billion. LNC has an investment of about \$22.5 million in certain of the CDO pools that it manages; at June 30, 2003 these investments had a fair value of \$21.6 million. So LNC does not bear the economic risk of the loss represented by the approximate \$300 million difference between the value of all of the CDO pool assets and the total amount of CDO pool nonrecourse debt. Yet under this emerging guidance at the time of adopting these new rules LNC's financial statements would not reflect the fact that it is the third party investor group, and not LNC, that bears the economic risk of these losses.

To record the difference between the value of the CDO pool assets and the CDO pool nonrecourse debt on LNC's balance sheet upon the adoption of Interpretation 46, LNC would record a charge to equity through Other Comprehensive Income for the cumulative temporary declines in underlying investment asset values and LNC would record a charge to net income equal to the cumulative declines in value of the underlying investment assets that are considered other than temporary. While LNC has not been able to complete the analysis of all of the underlying investment assets held within these CDO pools in order to determine which of these investments have experienced declines in fair value that are other than temporary, based upon the analysis completed to date it appears likely that 50% or more of the cumulative declines in the fair value of the CDO pool assets may be determined to be other than temporary.

In subsequent periods, when the underlying invested assets are sold and the proceeds are distributed to the investors, LNC would record gains associated with the extinguishment of nonrecourse debt. This reversal of the losses recorded upon the initial adoption of Interpretation 46 as the CDO pools liquidate reflects the fact that it is the third party investors, and not LNC, that ultimately bears the risk of loss from these CDO pools.

The Financial Accounting Standards Board is still considering important guidance relating to these types of investment pools. Until final guidance is issued, LNC is unable to finalize its review of these matters. In addition, LNC does not currently have access to all information necessary to determine the ultimate effects of such a required consolidation, because LNC is not the trustee or the administrator of the CDO pools. Accordingly, the estimated effects of the adoption of Interpretation 46 that are discussed in the preceding paragraphs are subject to change, pending the issuance of final guidance by the FASB and LNC's obtaining the necessary information from the CDO pool trustees and administrators.

Since LNC's role of investment manager for the CDO pools does not expose LNC to risk of loss on the underlying invested assets, LNC management does not believe the accounting model imposed under Interpretation 46 is reflective of the true underlying economics for the investment manager of these types of CDO pool arrangements. However, based upon the current status of this emerging guidance, it appears that LNC will be required to apply this accounting model in order to comply with generally accepted accounting principles.

Although LNC and the industry continue to review the new rules, at the present time LNC does not believe there are other significant VIEs that would result in consolidation with LNC, beyond the managed CDO pools discussed above.