

ISDA North America Accounting Committee
FIN 46R Working Group
Analyzing Derivative Instruments under FIN 46R
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EXECUTIVE SUMMARY

FIN 46R clarifies that assets held by an entity almost always create variability and, thus, are not variable interests; however, assets of an entity that take the form of derivatives may be variable interests. The difficulty in evaluating derivative instruments under FIN 46R is that derivatives are designed to both absorb and create variability. The analysis is further complicated as interpretations of FIN 46R appear to be conflicting.

ISDA North America Accounting Committee members are aware of two approaches that are being developed in practice and which are still evolving: a “fair value model” and a “cash flow model.” While neither is clearly set forth in FIN 46R, this document describes ISDA’s understanding of these two approaches in addition to offering two alternative views, each of which considers aspects of both the fair value and cash flow concepts.

To facilitate discussion on the issue, the following is a summary of the current interpretations of the application of FIN 46R to derivatives:

View A - Proponents of this view believe that a derivative instrument is only a variable interest when it absorbs variability attributable to changes in the **fair value** of a VIE’s assets.

View B - Proponents of this view believe that a derivative instrument is only a variable interest when it absorbs variability attributable to changes in the **cash flows** of a VIE’s assets.

ISDA’s View – Members of ISDA believe that there are weaknesses with applying either View A or View B in isolation and that there are two alternative approaches (View C and View D) which ISDA believes would result in a superior application of FIN 46R. Members of ISDA believe that both changes in fair value and changes in cash flow are relevant to the variable interest analysis and that derivatives should be evaluated by focusing on an *economic* analysis of the rights and obligations of an entity’s assets, liabilities, equity and other contracts. The derivative analysis will depend on the facts and circumstances, will entail judgment, and should consider the following factors:

- The entity’s activities and design
- The terms of the derivative contract and its role with the VIE
- The expectations of the variable interest holders
- Whether the derivative contract creates and/or absorbs variability

While ISDA members agree on this conceptual approach to analyzing derivatives, within ISDA, there is a difference of opinion on which derivative contracts create and/or absorb variability.

View C - View C is premised on the belief that the primary concept in FIN 46R is to focus on the role of the derivative with the design of the entity in determining whether a derivative creates and/or absorbs variability. Proponents of View C believe that the analysis should focus on the economic variability of the entity and each party’s interests in it. In performing this analysis under

FIN 46R, View C supporters believe that derivative positions that absorb the economic risks and returns of a VIE that have been created synthetically by other derivative positions should be analyzed in a similar manner to derivative positions that absorb the economic risks and returns of a VIE that physically owns the underlying cash asset (e.g., physical commodities). Accordingly, the distinction between a VIE owning a derivative position versus physically owning the underlying cash asset should not result in a different consolidation conclusion.

View D – View D is premised on a comprehensive economic analysis of each party’s rights and obligations when evaluating whether a contract creates and/or absorbs variability. That analysis includes evaluating the design of the entity. The View D approach believes that certain derivatives will both create and absorb variability in a single contract and thus generally are not variable interests (e.g., vanilla, at-market, forward-based derivatives are not variable interests unless, for example, they relate to the sale of cash assets held by the VIE). View D supporters also believe that the economic risks and returns of owning a cash asset (e.g. physical commodities) can be and often are different than the economic risks and returns of owning a forward contract to purchase that asset and, therefore, the distinction between a VIE owning a forward contract versus physically owning the underlying cash asset may result in a different consolidation conclusion.

The intent of this paper is to lay out the framework for several different approaches and provide examples to stimulate discussion and to illustrate the potential impact of implementation. The examples and analysis included in View A and View B were compiled from feedback from various supporters of either view, but do not necessarily reflect any firm position.

View A

Proponents of View A believe that a derivative instrument is only a variable interest when it absorbs variability attributable to changes in the fair value of a VIE’s assets.

Supporters of this view note that paragraph 8 of FIN 46R defines expected losses of an entity as “the expected negative variability in the *fair value* of its net assets exclusive of variable interests.” An entity’s expected residual returns are defined in the same paragraph as “the expected positive variability in the *fair value* of its net assets exclusive of variable interest.” Furthermore, paragraph B2 of FIN 46R reinforces the concept of fair value when it states “variable interests are contractual, ownership or other pecuniary interests in an entity that change with changes in the fair value of an entity’s net assets exclusive of variable interests.” Finally, paragraph D26 of the Basis for Conclusions clarifies that “the expected variability in the entity’s net income or loss and the expected variability in the fair value of the entity’s assets if it is not included in net income or loss” should be considered in determining the expected losses and expected residual returns of a variable interest entity.

Based on the above, one could conclude that the intent of the Board is to assess variable interests based on changes in the fair value of an entity’s assets and liabilities that are not variable interests.

One of the difficulties noted with View A is that it does not differentiate between when fair value changes will or will not impact the overall net cash flows of the entity. For example, while certain market factors can change the value of an asset over time, if the VIE has a buy and hold strategy and the maturity of the asset matches the maturity of the VIE’s liability, some believe it is conceptually difficult to understand the relevance of interim fair value changes in determining whether an entity is a Primary Beneficiary.

The following examples illustrate the concept of how the changes in fair value of the net assets affect the variable interest analysis:

Example 1

Assume that an entity is formed and financed with \$100 debt from an investor. The interest payments on the debt are LIBOR-based. The entity has no equity and is a VIE. The entity's only asset is a high credit quality, fixed rate bond with a par and fair value of \$100, paying fixed interest of 5 percent. The VIE enters into an interest rate swap under which it makes 5 percent fixed payments and receives LIBOR-based payments. Assume all other critical terms of the debt, bond, and swap are the same and that this entity does not meet one of the requirements for being deemed a QSPE.

Analysis

The investor and interest rate swap counterparty each have variable interests in the entity. The entity has expected losses and expected residual returns because the bond's fair value will change with changes in both the benchmark interest rate (i.e. LIBOR) and the bond issuer's credit spread. The swap counterparty absorbs the risk that the bond's fair value will change as a result of changes in the LIBOR swap curve through the receive fixed-rate of the swap. The investor absorbs the risk that the bond's fair value will change as a result of changes in the issuer's credit spread. The determination is therefore whether the potential fair value changes in the bond due to interest rate risk are more significant than the credit risk (both default risk and changes in fair value due to issuer credit spreads) absorbed by the investor. With assets of high credit quality, it may be the case that the interest rate variability will be more significant than credit risk, thereby requiring the swap counterparty to be considered the primary beneficiary.

Note: Given a different fact pattern - the VIE holds a floating-rate asset, issues fixed-rate debt and has entered into a receive fixed-rate/pay floating-rate interest rate swap - the swap counterparty would not have a variable interest in the VIE since it receives a floating rate under the interest rate swap which is not exposed to changes in fair value.

Example 2

Assume that an entity is formed and acquires fixed rate Japanese Government Bonds ("JGBs") from the market and issues \$100 of fixed-rate debt to one investor to fund the asset purchase. The entity has no equity and is a VIE. The VIE enters into a foreign currency swap under which it makes fixed Yen payments and receives fixed USD payments. Assume all other critical terms of the USD denominated debt, JGBs, and foreign currency swap are the same and that this entity does not meet one of the requirements for being deemed a QSPE.

Analysis

The variability of the net assets is determined by measuring changes in fair value of the net assets relative to the funding currency. Therefore, the variability of the net assets is measured relative to USD. The assets of the VIE, the JGBs, have variability due to Yen/USD foreign currency risk as well as Yen interest rate risk. The fixed rate nature of the Yen payments received by the swap counterparty would typically be viewed as a variable interest that exposes the swap counterparty to interest rate risk and foreign currency risk, however, in this case the swap counterparty also

pays fixed rate USD payments to the VIE. Therefore, the swap counterparty is viewed as holding a variable interest that retains the variability due to changes in the exchange rate and Yen interest rates, while passing the variability due to changes in USD interest rates back to the VIE.

The investor absorbs the variability from changes in the fair value of the fixed rate USD payments. The receipt of fixed rate USD exposes the investor to variability from changes in USD interest rates and the credit risk of the swap counterparty. Therefore, the determination of the primary beneficiary would depend on the variability of swap counterparty's foreign currency risk and Yen interest rate risk relative to the investor's USD interest rate risk. The variability due to credit risk would be minimal due to the generally high credit rating of the swap counterparty.

Example 3

Assume that a VIE holds one bushel of wheat financed with debt that matures in 90 days. The VIE also holds a fixed price forward contract to sell the bushel of wheat to a dealer in 90 days.

Analysis

The forward contract is a variable interest because it absorbs the variability of the price of a bushel of wheat owned by the VIE. The dealer absorbs all of the variability in the VIE's asset, even though the dealer's cash flow is fixed. The dealer absorbs the variability because the value of the asset the counterparty receives varies based on market prices while the price it pays for that asset does not vary. Accordingly, the dealer would likely be the primary beneficiary because it absorbs all the variability in the fair value of the VIE's asset.

Example 4¹

Assume that a distressed producer wishes to monetize its current \$100 gain position in an existing forward contract where it agreed to sell commodity X to an end user at fixed prices. A VIE is formed and purchases the existing forward contract from the producer by issuing \$100 of debt to one investor. The interest is payable on the debt at a fixed rate. In order to purchase commodity X and lock in the cash flows to service the debt, the VIE enters into an at-market forward purchase contract for commodity X with a dealer. Both forward contracts will be physically settled and all other critical terms (except price) of the two forward contracts are the same. Both forward contracts will have rights senior to those of the investor.

Analysis

The investor and the end user each have a variable interest in the entity. The VIE's forward purchase contract, a synthetic long position in the underlying asset creates variability and is not considered a variable interest for the dealer. It exposes the entity to variability in the fair value of that contract due to changes in the price of commodity X and the credit worthiness of the dealer. As the volatility in commodity prices is expected to be greater than the variability of the dealer's credit worthiness, the end user would likely be deemed the primary beneficiary.

¹ There are four parties involved in the transaction in Example 4: 1) the distressed producer, 2) the end user, to which the VIE has a forward sale, 3) the investor, and 4) the dealer, from whom the VIE has a forward purchase.

View B

Proponents of View B believe that a derivative instrument is only a variable interest when it absorbs variability attributable to changes in the cash flows of a VIE's assets.

View B supporters believe that FIN 46R is fundamentally a cash flow model. They note that although paragraph 8 of FIN 46R defines expected losses of an entity as "the expected negative variability in the fair value of its net assets exclusive of variable interests," the Board clarified its intent with respect to the meaning of "fair value" in paragraph D26, indicating that changes in fair value only matter to the extent that such changes impact the cash flows distributed to variable interest holders. They further note that the expected loss and expected residual return calculations included in Appendix A, referencing to Concept Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, illustrate that FIN 46R is inherently a cash flow model.

Based on the above, one could conclude that the intent of the Board is to assess variable interests based on cash flows of an entity's assets and liabilities that are not variable interests. Changes in fair value of entity's net assets would be considered only to the extent that they impact the cash flows distributed to variable interest holders and to the extent they are not included in the expected variability resulting from the operating results of the entity (paragraph 8).

The following examples illustrate the concept of how the changes in the cash flows of net assets affect the variable interest analysis:

Example 1

Assume that an entity is formed and financed with \$100 debt from an investor. The interest payments on the debt are LIBOR based. The entity has no equity and is a VIE. The entity's only asset is a high credit quality, fixed-rate bond with a par and fair value of \$100, paying fixed interest of 5 percent. The VIE enters into an interest rate swap under which it makes 5 percent fixed payments and receives LIBOR-based payments. Assume all other critical terms of the debt, bond, and swap are the same and that this entity does not meet one of the requirements for being deemed a QSPE.

Analysis

The investor has a variable interest in the entity. The interest rate swap counterparty does not have a variable interest as the cash flows from the receive leg of the swap are fixed and not subject to changes in cash flow value of the specified assets of the entity. In addition, the swap effectively creates cash flow variability in the entity by paying in variable cash flows. In this example, the investor is the primary beneficiary as that party is exposed to the entity's ability to pay (both through the asset held by the entity and the credit risk of the swap counterparty) and variable cash flows of the entity created by the combination of the bond and the swap.

Note: Given a different fact pattern – the VIE holds a floating-rate asset, issues fixed-rate debt and has entered into a receive fixed-rate/pay floating-rate interest rate swap - the swap counterparty would have a variable interest in the entity as the swap absorbs the interest rate variability caused by the floating rate assets. The question is which is greater – the variability due to the credit risk of the underlying asset of the vehicle that is absorbed by the investor or the interest rate variability absorbed by the swap counterparty.

Example 2

Assume that an entity is formed and acquires fixed rate JGBs from the market and issues \$100 of fixed-rate debt to one investor to fund the asset purchase. The entity has no equity and is a VIE. The VIE enters into a foreign currency swap under which it makes fixed Yen payments and receives fixed USD payments. Assume all other critical terms of the USD denominated debt, JGBs, and foreign currency swap are the same and that this entity does not meet one of the requirements for being deemed a QSPE.

Analysis

The investor and the foreign currency swap counterparty have a variable interest in the entity. The design of the entity is to provide USD returns to the investor while giving it JGB credit exposure. The variability of the VIE's cash flows is impacted by JGB credit risk and USD exposure. The foreign currency swap exposes the swap counterparty to USD variability of the VIE; hence, the foreign currency swap is a variable interest that must be assessed for consolidation. If the variability associated with the foreign currency swap is greater than the variability of the credit risk associated with the JGBs, the swap counterparty would be deemed the primary beneficiary.

Alternatively, the Cash Flow Model can be applied in relationship to the functional currency of the entity. The entity holds Yen assets acquired from the market and issues USD debt. The determination of the functional currency of the entity is a policy decision. If the functional currency of the entity is USD, the cash flows of the entity are exposed to variability by the currency and credit risk of the Yen assets. The swap counterparty, by receiving fixed Yen payments absorbs the cash flow variability attributed to foreign currency. If the variability associated with the foreign currency swap is greater than the variability of the credit risk associated with the JGBs, the swap counterparty would be deemed the primary beneficiary.

Example 3

Assume that a VIE holds one bushel of wheat financed with debt that matures in 90 days. The VIE also holds a fixed price forward contract to sell the bushel of wheat to a dealer in 90 days.

Analysis

The design of the entity is to sell the bushel of wheat in 90 days at a fixed price to the dealer, who will in turn liquidate the asset into cash or consume the asset for its production purposes ultimately resulting in cash flows at the end of its production and sales cycle. The fixed payments received from the forward contract are used by the entity to pay off the investor. The forward contract is a variable interest because it receives the bushel of wheat and its respective variability in future cash flows in lieu of a cash distribution from the VIE. Thus, the dealer absorbs all of the variability in cash flows attributable to the VIE's asset, even though the counterparty's cash payments to the VIE are fixed. Accordingly, the dealer would likely be the primary beneficiary because it absorbs all the variability in the cash flows of the VIE's asset.

Example 4²

Assume that a distressed producer wishes to monetize its current \$100 gain position in an existing forward contract where it agreed to sell commodity X to an end user at fixed prices. A VIE is formed and purchases the existing forward contract from the producer by issuing \$100 of debt to one investor. The interest is payable on the debt at a fixed rate. In order to purchase commodity X and lock in the cash flows to service the debt, the VIE enters into an at-market forward purchase contract for commodity X with a dealer. Both forward contracts will be physically settled and all other critical terms (except price) of the two forward contracts are the same. Both forward contracts will have rights senior to those of the investor.

Analysis

The investor and the end user each have a variable interest in the entity. The VIE's forward purchase contract, a synthetic long position in the underlying asset creates variability and is not considered a variable interest for the dealer. It exposes the entity to cash flow variability due to changes in the spot price of the commodity X to be delivered to the VIE via the pay leg of the forward. The forward purchase contract also exposes the VIE to the risk of default of the dealer. As the volatility in commodity prices is expected to be greater than the risk of default of the dealer, the end user would likely be deemed the primary beneficiary

ISDA's Concerns with View A & View B

Members of ISDA believe that there are weaknesses with applying either View A or View B in isolation and that there are two alternative approaches (View C and View D), each containing aspects of fair value and cash flow in the variable interest analysis, which ISDA believes would result in a superior application of FIN 46R. ISDA notes that there are various references throughout FIN 46R that advocate the importance of both fair value and cash flow and believe that the standard does not unequivocally support either View A or View B.

ISDA members believe that paragraph D26 contradicts the view put forth in View A as the Board clarified its intent that it is relevant whether changes in fair value of a VIE's assets could actually impact the variable interest holders. To broadly apply a framework such that any change in market value of an asset, regardless of how that change is distributed to variable interest holders, is overreaching. ISDA also notes that, it is not clear that paragraph D26 unequivocally supports a cash flow model as illustrated in View B – the paragraph simply says that if an asset is distributed in lieu of cash, one must consider the net (fair value) change in the asset.

Paragraphs A3 and B9 illustrate the importance of both fair value and cash flow in the FIN 46R model. Paragraph A3 requires expected losses to be based off of estimated cash flows, but it also states that in performing the expected loss calculation the “interpretation uses the term expected losses to refer to the expected losses based on fair value.” The importance of both fair value and cash flow is also evident in paragraph B9 which states:

“However, senior beneficial interests and senior debt instruments with fixed interest rates or other fixed returns normally would absorb little of the entity's expected variability, and therefore, a holder of only the most senior interests of a variable interest entity likely would not be the

² There are four parties involved in the transaction in Example 4: 1) the distressed producer, 2) the end user, to which the VIE has a forward sale, 3) the investor, and 4) the dealer, from whom the VIE has a forward purchase.

primary beneficiary of that entity, unless the subordinated interests of the variable interest entity are not large enough to absorb the entity's expected losses (or unless there are provisions such as embedded derivatives that expose the senior interests to losses). ”

*The above conclusion would appear to indicate that **variability in cash flows** is relevant, concluding that a fixed-rate of interest with no variability is not the driving factor for consolidation. Rather, credit risk would be the determinative factor, since the risk of default could clearly impact the cash flows allocated to the beneficial interest holder.*

However, the second to last sentence of paragraph B9 indicates that “The variability of a senior interest with a variable interest rate is usually not caused by changes in the value of the entity's assets and thus would usually be evaluated in the same way as a fixed-rate senior interest.”

*In this conclusion, the Board has focused on **changes in fair values**, not cash flows, to conclude that the floating-rate interest should be evaluated similarly to fixed-rate interests.*

Based on the above, ISDA believes that both changes in fair value and changes in cash flows are relevant to the variable interest analysis and that derivatives should be evaluated by focusing on an *economic* analysis of the rights and obligations of an entity's assets, liabilities, equity and other contracts (paragraph B2). The derivative analysis will depend on the facts and circumstances and should consider the following factors:

- The entity's activities and design
- The terms of the derivative contract and its role with the VIE
- The expectations of the variable interest holders
- Whether the derivative contract creates and/or absorbs variability

These factors are essential in performing an economic analysis of the rights and obligations of the variable interest holders and should be the primary focus in determining whether the derivative counterparty is the primary beneficiary.

While ISDA members agree on this conceptual approach to analyzing derivatives, within ISDA, there is a difference of opinion on which derivative contracts create and/or absorb variability. The two different views are listed below.

View C

In assessing the role of the derivative with the design of the entity and whether that derivative creates and/or absorbs variability, proponents of View C believe that the analysis should focus on the economic variability of the entity and each party's interests in it (Paragraph B2). In performing this analysis under FIN 46R, View C supporters believe that derivative positions that absorb the economic risks and returns of a VIE that have been created synthetically by other derivative positions should be analyzed in a similar manner to derivative positions that absorb the economic risks and returns of a VIE that physically owns the underlying asset. View C supporters acknowledge that there may be differences between a VIE where the economic risks and returns are created synthetically versus a VIE that physically owns the underlying asset; however, these differences—such as dealer credit risk and/or costs associated with maintaining, storing and/or transporting the underlying asset—generally do not impact whether the derivative position

is creating variability that is ultimately absorbed by a variable interest holder of the VIE, and therefore, should not result in a different consolidation conclusion.³

View C supporters believe derivatives should be evaluated in a manner consistent with their economic characteristics as follows:

- Derivatives that **create** variability – Not Variable Interests⁴
 - Add fair value and/or cash flow risk unrelated to the underlying assets of the VIE
 - Act as a long asset position with similar economics to cash funded assets
 - Example - dealer enters into a credit default swap with a VIE and purchases credit default protection through a credit-linked note issued by the VIE to investors (i.e., VIE has written a credit default swap that is embedded in the credit-linked notes issued to investors) [B11, B15]

- Derivatives that **absorb** variability – Variable Interests
 - Instruments that absorb the variability of the VIE’s long asset positions (whether cash or synthetic positions).
 - Examples – counterparty written puts (i.e., VIE has purchased a put), sold credit protection and total return swaps against the specific assets held by the VIE [B10]
 - Analysis must be completed under paragraph 12 to determine whether the derivative related to specific assets held by the VIE is considered a variable interest in the entity

- Derivatives that both **create** and **absorb** variability – Variable Interests
 - Certain derivatives exist that both create and absorb the *same or substantially similar* type of risk and are used to address mismatches between the overall asset/liability profile of the VIE—such as at-market plain vanilla interest rate and foreign currency swaps
 - Other derivatives exist that both create one type of risk and absorb a *different* type of risk

Certain derivatives will create the same, or substantially similar, type of risk as it absorbs and the risk will relate to mismatches between the overall asset and liability profile of the VIE due to the funding mechanism chosen of the VIE, which is typically driven by investor demand. Since the derivative is merely allocating the same or substantially similar risk between two parties, the derivative counterparty and the investor, the consolidation conclusion in these instances may be determined by who bears the credit risk of the underlying collateral. View C supporters believe that derivatives that create and absorb the same or similar risk are limited to at-market plain vanilla interest rate swaps and foreign currency swaps, which by their design are used to address mismatches between the overall asset and liability profile of the VIE. Accordingly, as demonstrated in the examples, View C supporters do not believe these derivatives should cause the derivative counterparty to be the primary beneficiary of the VIE.

³ View C supporters acknowledge that there are certain situations where FIN 46R clearly and explicitly prohibits the application of viewing a derivative position similar to a cash position (for example, paragraph B16’s requirement that certain embedded derivatives not be bifurcated and separately analyzed). However, View C supporters believe those situations articulate a specific rule, rather than a general concept to be applied broadly, since that would conflict with the economic analysis that is fundamental to FIN 46R.

⁴ FIN 46R states that derivative contracts that create variability are not variable interests. View C supporters observe that a derivative counterparty may be contingently exposed to the credit risk of the assets held by the VIE or to the credit risk of other derivative counterparties to the VIE. This degree of risk absorbed will depend on the specific facts and circumstances, including where the derivative counterparty ranks in the VIE’s capital structure and the credit quality of the VIE’s assets. If after analyzing this absorbed risk, it is determined that the derivative contract primarily creates risk, that derivative contract may not be deemed a variable interest.

For all other derivatives that both create and absorb risk, View C supporters believe that the risk created will be different than the risk absorbed. In these situations, the distribution of these risks to the swap counterparty and the other variable interest holder(s) should be assessed in conjunction with a qualitative analysis of all facts and circumstances, to determine which party, if any, absorbs a majority of the total risk.

The following examples illustrate the concept of View C and its affect on the identification of a variable interest:

Example 1

Assume that an entity is formed and financed with \$100 debt from an investor. The interest payments on the debt are LIBOR based. The entity has no equity and is a VIE. The entity's only asset is a high credit quality, fixed-rate bond with a par and fair value of \$100, paying fixed interest of 5 percent. The VIE enters into an interest rate swap under which it makes 5 percent fixed payments and receives LIBOR-based payments. Assume all other critical terms of the debt, bond, and swap are the same and that this entity does not meet one of the requirements for being deemed a QSPE.

Analysis

The design of the entity is to meet the request of the investor, who is seeking a specific investment profile (often based on the credit of a particular issuer for whom instruments of similar coupon or tenor are unavailable in the marketplace), whereby the investor specifies the asset, term, and type of coupon to be received in the investment issued by the VIE. The economics of the swap contract are that it acts as a fixed-rate liability (absorbing), while creating a floating rate asset in the VIE to meet the investor's request, and by design allocates the mismatches of both fair value and cash flows between the assets of the VIE and the debt funding (liability) of the VIE. The swap contract both absorbs risk (fair value interest rate risk) and creates risk (cash flow interest rate risk). The VIE thus has several risks to distribute to its variable interest holders: the fair value interest rate risk of the bond; the cash flow interest rate risk from the swap; the credit risk of the bond (if any) and the credit risk of the swap counterparty.

The swap counterparty absorbs the risk of changes in the bond due to fair value and creates cash flow risk for the VIE. The investor absorbs (a) the cash flow interest rate risk from the swap, (b) the risk of change in the bond due to credit risk and (c) the credit risk of the swap counterparty.

The credit risk absorbed by the investor may be small (if the bond and swap counterparty are of high credit quality), but both sources of credit risk still outweigh the contingent credit risk borne by the swap counterparty (typically senior in the waterfall). Therefore, the investor will be the primary beneficiary.

Note: Given a different fact pattern – the VIE holds a floating-rate asset, issues fixed-rate debt and has entered into a receive fixed-rate/pay floating-rate interest rate swap – the swap counterparty would reach the same conclusion.

Example 2

Assume that an entity is formed and acquires fixed rate JGBs from the market and issues \$100 of fixed-rate debt to one investor to fund the asset purchase. The entity has no equity and is a VIE. The VIE enters into a foreign currency swap under which it makes fixed Yen payments and receives fixed USD payments. Assume all other critical terms of the USD denominated debt, JGBs, and foreign currency swap are the same and that this entity does not meet one of the requirements for being deemed a QSPE.

Analysis

The design of the entity is to meet the request of the investor, who is seeking a specific investment profile, whereby the investor specifies the type of asset and credit exposure it wants the VIE to own. The economics of the foreign currency swap are that it acts as a Yen-denominated liability (absorbing), while creating a USD asset in the VIE. The foreign currency swap both absorbs risk (Yen risk) and creates risk (USD risk). The foreign currency swap serves to allocate cash flows due to the mismatch between the Yen denominated asset and the USD denominated debt, which was introduced to the VIE because of how the VIE elected to fund itself. As the swap has a fair value of zero at inception, this is indicative of the fact that the Yen risk that the swap counterparty absorbs is equal to the USD risk it creates for the entity. The VIE thus has several risks to distribute to its variable interest holders: the Yen risk of the bond; the USD risk from the swap; the credit risk of the bond (if any) and the credit risk of the swap counterparty.

The swap counterparty absorbs the Yen risk of the bond. The investor absorbs (a) the USD risk from the foreign currency swap, (b) the risk of fair value change in the bond due to credit risk and (c) the credit risk of the swap counterparty.

The credit risk absorbed by the investor may be small (if the bond and swap counterparty are of high credit quality), but both sources of credit risk still outweigh the contingent credit risk borne by the swap counterparty (typically senior in the waterfall). Therefore, the investor will be the primary beneficiary.

Example 3

Assume that a VIE holds one bushel of wheat financed with debt that matures in 90 days. The VIE also holds a fixed price forward contract to sell the bushel of wheat to a dealer in 90 days.

Analysis

Variability is created in the entity by its asset holdings of one bushel of wheat. The forward contract is a variable interest because it absorbs the variability of the price of a bushel of wheat owned by the VIE. The dealer absorbs all of the variability in the VIE's asset, even though the dealer's cash flow is fixed. The dealer absorbs the variability because the value of the asset that it receives varies based on market prices while the price it pays for that asset does not vary. Accordingly, the dealer would be the primary beneficiary because it absorbs all the variability in the fair value of the VIE's asset.

Example 4⁵

Assume that a distressed producer wishes to monetize its current \$100 gain position in an existing forward contract where it agreed to sell commodity X to an end user at fixed prices. A VIE is formed and purchases the existing forward contract (“Contract 1”) from the producer by issuing \$100 of debt to one investor. The interest is payable on the debt at a fixed rate. In order to purchase commodity X and lock in the cash flows to service the debt, the VIE enters into an at-market forward purchase contract (“Contract 2”) for commodity X with a dealer. Both forward contracts will be physically settled and all other critical terms (except price) of the two forward contracts are the same. Both forward contracts will have rights senior to those of the investor.

Analysis

View C supporters apply the same analysis that was used in examples 1-3. Risk is created in the entity by the entity’s long position in commodity X (created through its forward contract to purchase commodity X at a fixed price from the dealer (“Contract 2”). There are two variable interests in the VIE: the debt contract and the contract for an end user to purchase commodity X from the VIE (“Contract 1”). (Paragraph B13 notes that a forward contract to sell assets that are owned by the entity at a fixed price will usually absorb the variability in the fair value of the asset that is the subject of the contract. In this case, commodity X is “owned” *economically* by virtue of the forward purchase contract, rather than as a funded position).

The two variable interests should be evaluated to determine which risks are absorbed. Contract 1 absorbs changes in fair value of commodity X. The debt contract absorbs the credit risk of the two forward contract counterparties. Those two risks should be measured, and it is likely that the end user (counterparty to Contract 1) will be deemed the primary beneficiary.

Note the conclusion in Example 4 is similar to the conclusion in Example 3 – in both cases, the end user is the primary beneficiary, which seems like an appropriate application of the FIN 46R model because the derivative position is absorbing the economic risks and returns of the VIE, whether the VIE physically owns the underlying asset (in wheat) or whether the asset is synthetically created via a derivative position (in commodity X).

With regards to the guidance provided in paragraphs B12 and B13 for forward contracts, View C supporters believe that the words “most” and “usually” in paragraphs B12 and B13 were intentionally added, and indicate that there are situations where forward contracts to sell assets that are not owned by the entity are in fact variable interests in the entity. View C supporters believe the Board’s objective in B12 and B13 was to articulate a principle to be applied to many types of transactions, rather than a specific rule to be applied to all transactions. That principle is that in situations where a forward sale contract relates to an asset that the VIE does not have economic ownership in, through a cash position or a derivative instrument, that forward sale contract is not a variable interest, since it introduces a new risk into the VIE (i.e., creates variability). Such a situation may be uncommon in VIEs created to facilitate structured transactions, but may be more common in VIEs that have characteristics of businesses, where there are many sources of cash flows that could support such a forward sale contract.

⁵ There are four parties involved in the transaction in Example 4: 1) the distressed producer, 2) the end user, to which the VIE has a forward sale, 3) the investor, and 4) the dealer, from whom the VIE has a forward purchase.

View C supporters note that although they believe this is the appropriate application of FIN 46R as written, they do not believe that this result that the end user consolidates the VIE yields a meaningful financial reporting result for the end user, nor does it reflect the fact that the entity and its activities were designed specifically for the investor and the producer, allowing the producer to monetize its position. In this respect, View C supporters agree with View D concerns. However, View C supporters believe that this result reflects a broader conceptual issue inherent in the FIN 46R model.

View D

Similar to View C, proponents of View D believe that most derivatives both create and absorb variability.⁶ Identifying whether a *derivative* with a VIE is a variable interest in that entity (or in specified assets) requires an economic analysis of the rights and obligations of an entity's assets, liabilities, equity and other contracts (paragraph B2) and often depends on the design of the entity (B4). Proponents of View D believe it may not be possible to deem a specific type of derivative as a contract that solely absorbs risk in all situations (i.e. a variable interest).⁷ As stated in paragraph B4, “[i]t is the role of the item—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.”

View D proponents believe that FIN 46R distinguishes between assets that are “owned” or “held” by the entity (i.e., not variable interests) and contracts that represent “synthetic” assets or rights of an entity. View D supporters point to paragraph B17 of FIN 46R that states: “[A]ssets **held by an entity** almost always create variability and, thus, are not variable interests. However...**assets of the entity** that take the form of derivatives...may be variable interests.” View D supporters believe that the economic risks and returns of owning a cash asset (e.g., physical commodities) can be and often are different than the economic risks and returns of owning a forward contract to purchase that asset. View D supporters also believe that the Board intentionally made a distinction between instruments that meet the CON 6 definition of an asset⁸ (i.e., always an economic asset to the VIE) and represent probable benefits to the owner (VIE) and instruments (e.g., a VIE’s forward purchase or sale contract) that do not or may not meet that definition because, for example, it embodies a conditional obligation of the counterparty to transfer assets (i.e. may result in either an economic asset or liability for the VIE). In addition, View D proponents observe that viewing derivative contracts as creating “synthetic” assets or cash instruments was an approach rejected by the Board in its deliberations on FAS 133 surrounding synthetic instrument accounting.

Though View D proponents believe that FIN 46R was designed to be largely a principles based standard that requires evaluation based on the facts and circumstances of each situation, presented below are some general observations about how derivatives may be evaluated under FIN 46R:

- Derivatives that **create** variability – Not Variable Interests
 - Add fair value or cash flow risk unrelated to assets held by the VIE
- Derivatives that **absorb** variability – Variable Interests

⁶ Variability includes changes in fair value as well as changes in cash flows and often may only be defined after consideration of the design of the entity.

⁷ By extension, View D supporters believe that it also may not be possible to deem a specific type of derivative as a contract that solely *creates* risk in all situations.

⁸ That definition is based on the existence of probable economic benefits and the concept of ownership.

- Relate to the inherent risk of the specific asset(s) held by the VIE (Example 3 below)
 - Analysis must be completed under paragraph 12 to determine whether the derivative related to specific assets held by the VIE is considered a variable interest in the entity
- Derivatives that both create and absorb variability – Usually Not Variable Interests⁹
- Relate to mismatches between the overall asset/liability profile of the VIE due to the investment profile chosen by the VIE’s investors (see Examples 1 and 2 below)
 - Both create and absorb offsetting variability related to the same risk (e.g., LIBOR) or risks that are interdependent (e.g., FX) through a single derivative transaction
 - Generally have symmetrical economic profiles. That is, the derivative is equally likely to result in a recorded asset or liability for the entity and has commensurate upside and downside potential given an equal change (increase or decrease) in the underlying (e.g. rate or price).

The following examples illustrate the View D concepts and their affect on the variable interest analysis:

Example 1

Assume that an entity is formed and financed with \$100 debt from an investor. The interest payments on the debt are LIBOR based. The entity has no equity and is a VIE. The entity’s only asset is a high credit quality, fixed-rate bond with a par and fair value of \$100, paying fixed interest of 5 percent. The VIE enters into an interest rate swap under which it makes 5 percent fixed payments and receives LIBOR-based payments. Assume all other critical terms of the debt, bond, and swap are the same and that this entity does not meet one of the requirements for being deemed a QSPE.

Analysis

The swap counterparty does not have a variable interest in the entity as it both absorbs fair value variability and creates cash flow variability in a single contract. The swap counterparty’s interest in the entity relates to both the VIE’s asset and debt. From the swap counterparty’s perspective, it absorbs fair value variability by receiving fixed cash flows on the swap while the LIBOR pay leg of the swap creates cash flow variability for the entity. From the VIE’s perspective, the swap transforms the fixed cash flows of the asset to variable cash flows (risk creation) that are absorbed by the investor. The substance of the swap, taken in context of the entity’s design, is to transform cash flows for the purpose of bridging the entity’s inherent asset/liability mis-match. Assuming the maturity of the VIE’s swap, asset and debt all match, the only variability of the entity is due to the original credit default risk associated with the issuer of the asset and/or the additional credit default risk of the swap counterparty. The cash assets in the VIE are upfront collateral that have been segregated for the benefit of both the swap counterparty and the investor in the VIE, providing protection to both parties in the event of bankruptcy by either party. However, the swap counterparty generally has a senior claim on the assets, relative to the investor. Accordingly, the investor is exposed to the credit risk of the asset held by the VIE and the swap counterparty. The swap counterparty is only contingently exposed to the credit risk of the asset held by the VIE. That risk is insignificant to the primary credit risk borne by the investor. Therefore, in this example, the investor is the primary beneficiary.

⁹ For example, at-market plain vanilla interest rate and foreign currency swaps would not be variable interests. Alternatively, derivatives that absorb and create variability that are not offsetting would likely be variable interests (e.g. certain structured IR, FX and basis swaps).

View D proponents believe this analysis is consistent with its economic profile and the fact that such a structure is usually designed at the request of a investor (a client of the dealer) seeking a specific investment profile (often based on the credit of a particular issuer for whom instruments of similar coupon or tenor are unavailable in the marketplace) whereby the investor specifies the asset, term, and type of coupon to be received via its investment in the VIE's debt.

Example 2

Assume that an entity is formed and acquires fixed rate JGBs from the market and issues \$100 of fixed-rate debt to one investor to fund the asset purchase. The entity has no equity and is a VIE. The VIE enters into a foreign currency swap under which it makes fixed Yen payments and receives fixed USD payments. Assume all other critical terms of the USD denominated debt, JGBs, and foreign currency swap are the same and that this entity does not meet one of the requirements for being deemed a QSPE.

Analysis

The foreign currency swap is not a variable interest as it both absorbs risk (Yen risk) and creates risk (USD risk). The foreign currency swap serves to transform cash flows due to the mismatch between the Yen denominated asset and the USD denominated debt. The investor is exposed to USD versus Yen exchange rates as well as the credit risk of the assets held by the VIE and the swap counterparty. While the swap counterparty is also exposed to USD versus Yen exchange rates, it is only contingently exposed to the credit risk of the JGB asset held by the VIE. The cash assets in the VIE are upfront collateral that have been segregated for the benefit of both the swap counterparty and the investor in the VIE, providing protection to both parties in the event of bankruptcy by either party. However, the swap counterparty generally has a senior claim on the assets, relative to the investor. Thus, the investor's exposure to credit risk is greater than that of the swap counterparty. Therefore, in this example, the investor is the primary beneficiary.

View D proponents believe this analysis is consistent with the economic profile of each of these parties and the fact that such a structure is usually designed at the request of the investor (a client of the dealer) seeking a specific investment profile whereby the investor specifies the asset (JGBs), term, and type of coupon (fixed USD) to be received via its investment in the VIE's debt.

Example 3

Assume that a VIE holds one bushel of wheat financed with debt that matures in 90 days. The VIE also holds a fixed price forward contract to sell the bushel of wheat to a dealer in 90 days.

Analysis

The forward contract is a variable interest because it absorbs the variability of the price of a bushel of wheat held by the VIE (B13). The dealer absorbs all of the variability in the VIE's asset, even though the dealer's cash flow is fixed. The dealer absorbs the variability because the value of the asset the counterparty receives varies based on market prices while the price it pays for that asset does not vary. Accordingly, the dealer is the primary beneficiary because it absorbs all the variability in the fair value of the VIE's cash asset.

Example 4¹⁰

Assume that a distressed producer wishes to monetize its current \$100 gain position in an existing forward contract where it agreed to sell commodity X to an end user at fixed prices. A VIE is formed and purchases the existing forward contract (“Contract 1”) from the producer by issuing \$100 of debt to one investor. The interest is payable on the debt at a fixed rate. In order to purchase commodity X and lock in the cash flows to service the debt, the VIE enters into an at-market forward purchase contract (“Contract 2”) for commodity X with a dealer. Both forward contracts will be physically settled and all other critical terms (except price) of the two forward contracts are the same. Both forward contracts will have rights senior to those of the investor.

Analysis

Contract 1 (a recorded asset of the VIE on day 1¹¹) and Contract 2 (neither an asset or a liability on day 1) both create offsetting changes (i.e., a long position and a short position) in the fair value of commodity X and are secondarily exposed to the other’s credit. The combination of the two contracts creates a cash annuity to the VIE that services the VIE’s debt. The issued debt absorbs the credit risk of the two forward contract counterparties, while the price volatility of commodity X has no impact on those cash flows. The credit risk absorbed by the investor may be small (if the forward counterparties are of high credit quality), but they still outweigh the contingent credit risk borne by the forward counterparties (typically senior in the waterfall). Therefore, the investor will be the primary beneficiary.

Note the conclusion in Example 4 differs from the conclusion in Example 3 because the VIE in Example 4 does not physically own commodity X. By themselves, each forward contract introduces (creates) commodity price risk to the VIE. However, when taken together based on the design of the entity, each forward contract creates offsetting variability (i.e., the VIE gains and losses when the price of X increases and the VIE losses and gains when the price of X decreases). That is, the forward purchase contract creates a long *derivative* exposure while the forward sale contract creates a short *derivative* exposure. That combination results in the creation of a cash annuity to the VIE that services the VIE’s debt.

Proponents of this view believe that a derivative forward purchase contract does not economically constitute an “owned” or “held” “asset,” as those terms are used in paragraphs B12, B13, and B17 (and elsewhere within Appendix B). Owning an asset and owning a contract to purchase an asset in the future have potentially significant economic differences and risk profiles, especially as it relates to physical commodities. For example, ownership of a physical asset exposes the holder of that asset to a variety of risks, such as changes in near-term supply/demand, funding, transportation and storage costs. These economic differences can also be seen in the volatility of prices in the spot market versus the volatility of prices in the *forward* market. Natural gas is a prime example, as spot volatility can be and often is greater than forward volatility due to changes in, for example, weather patterns.

¹⁰ There are four parties involved in the transaction in Example 4: 1) the distressed producer, 2) the end user, to which the VIE has a forward sale, 3) the investor, and 4) the dealer, from whom the VIE has a forward purchase.

¹¹ Note that the asset referred to is the fair value of the net projected cash flows of the contract which could become a liability depending on changes in market factors. This asset does not represent the full notional amount of the commodity to be delivered under the forward contract.

View D proponents also look to the conceptual framework and note that a forward purchase contract embodies an obligation of the counterparty to transfer assets. In contrast, a physical position in the asset underlying a forward contract does not embody an obligation to the VIE but represents a probable future benefit of future net cash inflows to the VIE. Fixed price forward purchase or forward sale contracts may result in either a future net economic benefit (net cash inflows) or sacrifice (net cash outflows) for the VIE as evidenced by their measurement at fair value as either assets or liabilities under FAS 133 depending on changes in underlying asset prices.

Consistent with paragraphs 2.c., B12 and B13 and as demonstrated above, neither forward contract in Example 4 by itself constitutes an "owned" or "held" asset or relates to an asset "owned" or "held" by the VIE, and therefore neither forward contract in that example can be considered a variable interest. Paragraph 2.c. states that "variable interests in a variable interest entity.... change with changes in the fair value of the entity's net assets **exclusive of variable interests**." Therefore, View D proponents believe that, from the VIE's perspective, the two offsetting risk profiles of the forward contracts create a cash annuity asset to the entity that may then be monetized (i.e. sold to the investor). The inter-relationship of the forwards is fundamental to the economic design of the entity.

View D proponents believe that the conclusion of their model that the investor in Example 4 is the sole variable interest holder, and therefore the primary beneficiary, validates their interpretation of FIN 46R and effects an accounting result that aligns with their understanding of the economics of the transaction, that includes a consideration of the design of the entity.¹² In contrast, the other views would result in the end user being deemed the primary beneficiary despite the fact that the end user's commodity price risk and cash flows remain unchanged while its counterparty risk for delivery of commodity X was reduced in all likelihood (because the dealer will generally have a higher credit rating than the producer).

Other tests of the View D approach on variants of Examples 3 and 4 would yield consistent accounting results that align with the economics of those transactions as perceived by View D supporters. Proponents of this view believe that Example 3 (long cash asset, forward sale) and Example 4 (forward purchase, forward sale) illustrate the deliberate distinctions made in the drafting of paragraphs B12, B13 and B17 (see above) by the FASB staff. Paragraph B12 states that most forward contracts *to buy* or *to sell assets* at a fixed price that are not owned by the entity expose the VIE to risks that will increase expected variability. Paragraph B13 states that a forward contract *to sell assets* that are *owned* by the entity at a fixed price will usually absorb the variability in the fair value of the asset (example 3).

Conclusion

ISDA members acknowledge that judgment is required in the implementation of either View C or View D and agree that the purpose of the transaction and the related derivative should be considered to determine that the conclusions are appropriate and consistent with the concepts in paragraph B5¹³. ISDA members believe that the application of judgment is preferable to a model that results in inappropriate consolidation

¹² The entity is designed to facilitate the purchase by the investor of the producer's financial asset which was initiated by the producer.

¹³ Paragraph B5 states: "The identification and analysis of variable interests must be based on all of the facts and circumstances of each entity."

conclusions and are troubled by a conclusion that a swap counterparty to a plain vanilla interest rate swap, for example, could be considered to have a controlling financial interest in a VIE. As the swap is collateralized by the VIE's holdings, it is counterintuitive to conclude that a swap counterparty has a controlling financial interest in the vehicle – or the motivation to control the vehicle.

Though View C and View D differ in certain respects, both approaches result in similar consolidation conclusions for the following types of derivatives that ISDA members consider to expose the counterparty to higher risks and may frequently result in the counterparty being considered the primary beneficiary of the VIE:

- Selling a credit default swap against the underlying assets held by the VIE
- Writing puts against the underlying assets held by the VIE
- Forward purchases of the assets held by the VIE
- Total return swaps against the underlying assets held by the VIE