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October 10, 2005

Letter of Comment No: File Reference: 1210-001

Ms. Suzanne Q. Bielstein Director of Major Projects and Technical Activities Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

RE: File Reference No. 1210-001, Accounting for Certain Hybrid Financial Instruments - an amendment of FASB Statements No. 133 and 140

Dear Ms. Bielstein:

PricewaterhouseCoopers LLP appreciates the opportunity to respond to the Financial Accounting Standards Board's (FASB or the "Board") Exposure Draft, Accounting for Certain Hybrid Financial Instruments - an amendment of FASB Statements No. 133 and 140 (the "proposed Standard"). We commend the Board for taking steps towards the greater use of fair values by permitting the use of the fair value measurement attribute for financial instruments as part of this project (and its Fair Value Option (FVO) project).

We are a proponent of accounting and financial reporting that faithfully portrays the economic substance of transactions. We believe that fair value, generally, is the most relevant measurement attribute for financial instruments, including hybrid financial instruments. Under the current model prescribed by FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FAS 133), the embedded derivative in a hybrid financial instrument would be bifurcated and measured at fair value separately from the host contract. In our view, the measurement of the hybrid financial instrument as a whole, at fair value, would better represent the economics of the instrument. Accordingly, we agree with the proposal to provide entities with a fair value option for hybrid financial instruments that contain an embedded derivative that would otherwise require bifurcation.

We also believe that the valuation of hybrid financial instruments as a whole could simplify the administrative activities that are necessary to account for those instruments. Under FAS 133, the host contract may have been required to be accounted for using a different measurement attribute than the embedded derivative, depending on the accounting guidance applicable to that host contract if it stood on its own. If the fair value option is elected, an entity would no longer be required to track and measure the two instruments, i.e., the host contract and the embedded derivative, separately.

We also support the proposed Standard because it will converge with the international standards in this area, since International Financial Reporting Standards provide entities the option of recognizing at fair

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value certain hybrid financial instruments. Moreover, because we believe that fair value is generally the most relevant measurement attribute for financial instruments, we encourage the Board to continue to develop the broader fair value option for financial instruments. That option would have the added benefit of furthering convergence between U.S. and international accounting standards.

Further, we recommend that the three projects amending FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (FAS 140) be issued as a "revision" of FAS 140, rather than as three separate amendments to FAS 140. We believe that our recommended format would be more efficient for users of the guidance because it would only require looking at one document for all of the amendments, implementation guidance, and Basis for Conclusions.

The attachment to this letter describes our views on the guidance in more detail. Our comments also highlight several areas where the Board's underlying principle or thought-process could be clarified.

We appreciate the opportunity to express our views on the proposed Standard. If you have any questions regarding our comments, please contact Tom Barbieri (973-236-7227) or Gerard O'Callaghan (973-236-7817).

Sincerely,

PricewaterhouseCoopers LLP



Scope of the Fair Value Option for Hybrid Financial Instruments

We agree that fair value is the most relevant measurement attribute for financial instruments. The proposal to provide a fair value option for hybrid financial instruments that contain an embedded derivative that would otherwise require bifurcation is consistent with the Board's objective of moving towards fair value accounting for financial instruments. However, we recommend that the Board clarify the scope of the fair value election:

- We understand that the Board intends that the fair value option be applicable to any hybrid financial instrument that contains an embedded derivative otherwise requiring bifurcation However, the summary of the project currently on the FASB's website (last updated September 13, 2005) states that hybrid financial instruments that have host contracts listed in paragraph 8 of FASB Statement No. 107, Disclosures about Fair Value of Financial Instruments, such as insurance contracts, would be excluded from the fair value measurement option. We recommend that the Board resolve this apparent conflict and clarify its intent in the final Standard.
- The proposed Standard provides a fair value option for hybrid financial instruments that contain an embedded derivative that would otherwise be bifurcated. However, it is unclear whether that financial instrument must be recognized in order to qualify for the election. For example, question 1 of the FAS 140 Staff Implementation Guidebook, A Guide to Implementation of Statement 140 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, states that minimum lease payments to be received under operating leases are an unrecognized financial asset. If that asset contains an embedded derivative that would otherwise have to be bifurcated under FAS 133 (e.g., the minimum lease payments vary based on changes in the price of gold), the proposed fair value option could be interpreted as applying to that asset. Such application would result in the asset being recognized on the balance sheet. We believe that the proposed fair value option should not be extended to minimum lease payments to be received under operating leases because bringing this unrecognized asset onto the balance sheet would conflict with the underlying principles of FASB Statement No. 13, Accounting for Leases, and FAS 140. Therefore, we recommend that the final Standard explicitly state that it applies only to recognized hybrid financial instruments.

Electing the Fair Value Option for Hybrid Financial Instruments

The proposed amendments to paragraph 16 of FAS 133 would require that the fair value option for hybrid financial instruments be elected at the inception of the hybrid financial instrument. We believe that requirement will raise implementation questions in the following two scenarios: (1) when the embedded derivative is determined to exist after initial inception due to changing conditions and (2) when a hybrid financial instrument that contains an embedded derivative is acquired by an entity subsequent to the instrument's inception (e.g., in a business combination). To address these scenarios, we recommend that the requirement provide that the election should be made at the time the instrument is "first required to be accounted for as an embedded derivative."

We also note that paragraph A26 of the Basis for Conclusions states that the fair value election should be applied irrevocably at initial recognition. This appears to be inconsistent with the proposed amendments to paragraph 16. Therefore, we recommend that the two sections of the proposal be made consistent in the final Standard.



Evaluation to Determine If Embedded Derivatives Exist, Including Beneficial Interests

There has been debate whether beneficial interests in securitized financial assets meet the definition of a derivative under FAS 133, whether they contain an embedded derivative, or whether they are eligible for the scope exception described in paragraph 14 of FAS 133 related to interest-only or principal-only strips. Specifically, when determining whether a beneficial interest contains an embedded derivative, it is unclear whether one should consider the nature of the beneficial interest itself or whether one should look through to the underlying assets generating the cash flows of the beneficial interest.

The proposed Standard states that one must look at the contractual terms of the beneficial interest to determine whether one has an embedded derivative. Further, it requires a holder to obtain sufficient information about the payoff structure and payment priority to determine whether an embedded derivative exists. There may be different types of risks inherent in beneficial interests that may be considered embedded derivatives, such as credit risk, currency risk, interest risk, and price risk. The proposed Standard would add paragraph 14B that explicitly states that credit risk contained within a beneficial interest is not an embedded derivative. We believe the intent of paragraphs 14A and 14B is not explicitly clear. We interpret the proposed Standard as requiring one to "look-through" the beneficial interest into the assets of the "vehicle" to assess whether an embedded derivative has been created, except where the underlying assets contain credit risk. This view is supported by the statement in paragraph A16 that understanding the payoff structure and subordination status will require an understanding of the nature and amount of assets and liabilities comprising the transaction. However, the guidance could also be interpreted to require no "look-through" because of the focus on the contractual terms of the beneficial interest and no reference is explicitly made to the underlying assets of the "vehicle." Accordingly, we recommend that the Board clarify whether one must "look-through" the beneficial interest into the assets of the "vehicle" to assess whether an embedded derivative exists.

Furthermore, we recommend that the Board update the examples included in DIG Issue No. D2, Recognition and Measurement of Derivatives: Applying Statement 133 to Beneficial Interests in Securitized Financial Assets (a Resolution of the Issues Raised in Implementation Issue D1), for the changes in the proposed Standard. We believe that the use of practical examples would benefit the users of the final Standard in determining whether a beneficial interest contains an embedded derivative.

Interest-Only and Principal-Only Strips

The proposed Standard would exempt interest-only (IO) and principal-only (PO) strips from FAS 133 if they "(a) result from portions of the contractual cash flow labeled interest and principal and (b) do not incorporate any terms not present in the original financial instrument." We understand that the intent of the amendments to paragraph 14 of FAS 133 is to make the exception for IO and PO strips narrower (i.e., the exception should apply only to "plain-vanilla" IO and PO strips). We believe that the exception, as amended by the proposed Standard, may be inappropriately applied to any instruments that "label" a portion of their cash flows interest and principal. For example, some may interpret that an instrument whose underlying is tied to the price of gold will qualify for the exemption in paragraph 14 as long as the portion of the cash flows to be received is called "interest." Therefore, we believe that a literal read of the proposed definition of an IO or PO security allows for a more broadly applied exception, and a wider range of instruments could meet the definition. We recommend that the underlying principle and the Board's thought process regarding the exemption of IO and PO strips be clarified.

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Effective Date

We believe that the proposed effective date of the final Standard will provide sufficient time for implementation by calendar-year reporting entities. However, we recommend the Board permit a transition provision that would allow companies to combine previously bifurcated derivatives and their host contracts, and to recognize the effects of the election for existing hybrid financial instruments as a cumulative effect adjustment. This would be consistent with the underlying principle of the proposed amendments to recognize financial instruments at fair value and to simplify the accounting for hybrid financial instruments. We believe that allowing such a transition provision will result in more companies making a fair value election, thereby promoting greater consistency in the accounting for hybrid financial instruments among various entities.

Impact on Other Guidance

Paragraph A21of the proposed Standard states that Example 2 of DIG Issue No. B36, Modified Coinsurance Arrangements and Debt Instruments that Incorporate Credit Risk Exposures That Are Unrelated or Only Partially Related to the Creditworthiness of the Obligor Under Those Instruments (DIG B36), is not affected by the guidance on concentrations of credit risk. We believe that Example 1 of DIG B36 is also not affected by the guidance on concentrations of credit risk. We recommend that the paragraph be revised to indicate that both are unaffected.

In addition, Appendix B lists DIG B36 as a DIG issue that is affected by the proposed Standard. Given that the concentrations of credit risk in these instruments would constitute an embedded derivative, we expect DIG B36 to be updated to state that the fair value option for hybrid financial instruments may apply to such arrangements. If this is done, we recommend that the guidance be clarified regarding whether the receivable or payable component of the modified coinsurance arrangement would be considered the hybrid financial instrument, or if the insurance contract itself is the hybrid financial instrument. If insurance contracts are excluded from the hybrid financial instrument fair value election, as discussed in the scope considerations above, we believe that the receivable or payable component of the arrangement should still be within the scope of the guidance. If insurance contracts are included in the scope of the fair value election for hybrid financial instruments, we believe that, depending on facts and circumstances of the arrangement, either the entire arrangement or the receivables or payables component could be viewed as the hybrid instrument. We recommend that the underlying principle and the Board's thought process in this area be discussed further and clarified.

Furthermore, we believe that Appendix B, which describes the impact the proposed Standard would have on other guidance, is not complete. We believe that the proposed Standard would also affect DIG Issues: A1, Initial Net Investment, B5, Investor Permitted, but Not Forced, to Settle without Recovering Substantially All of the Initial Net Investment, B8, Identification of the Host Contract in a Nontraditional Variable Annuity Contract, B25, Deferred Variable Annuity Contracts with Payment Alternatives at the End of the Accumulation Period, B26, Dual-Trigger Property and Casualty Insurance Contracts, B29, Equity-Indexed Annuity Contracts with Embedded Derivatives, B30, Application of Statement 97 and Statement 133 to Equity-Indexed Annuity Contracts, B31, Accounting for Purchases of Life Insurance, and B35, Application of Statement 133 to a Not-for-Profit Organization's Obligation Arising from an Irrevocable Split-Interest Agreement.