

Letter of Comment No: 7
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Technical Director
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401 Merritt 7
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Re: Accounting for Certain Hybrid Financial Instruments; Accounting for Servicing of Financial Assets; and Accounting for Transfers of Financial Assets
(File References 1210-001, 1220-001, and 1225-001)

Ladies and Gentlemen:

Merrill Lynch appreciates the opportunity to comment on the proposed amendment to Statement No. 140. We have followed with interest the development of Statement No. 140 and continue to be keenly interested in the development of this guidance as it has far reaching effects on both our business and that of our clients.

Overall Comments

Merrill Lynch supports the proposed standards on *Accounting for Certain Hybrid Financial Instruments* (the Hybrid ED) and *Accounting for Servicing of Financial Assets*. However, as a general matter, we do not support the ED on *Accounting for Transfers of Financial Assets* (the Transfers ED). Although the Board has stated that one of the purposes of issuing the Transfers ED is “to revise or clarify the derecognition requirements for financial assets,” we believe that, as currently drafted, the Transfers ED raises many more questions than it answers.

Many of those questions, regarding common types of sale and securitization transactions, are articulated in the American Securitization Forum’s response to the Transfers ED, which we endorse. We believe that the Transfers ED, as currently drafted, simply adds more detailed rules to an already complex standard, and the underlying rationale for these rules is hard to discern. The SEC recently released a study endorsing a principles-based accounting system, and Merrill Lynch continues to support this approach. We believe that a rule-based approach has led to increasingly complex standards, has reduced the

accountant's ability to rely on experience and logic when analyzing transactions, and has, in many cases, resulted in accounting treatment based on form rather than substance. We do not support the issuance of the Transfer ED in that it seems to further complicate matters and many of the changes introduced lack a clear conceptual underpinning.

Accounting for Certain Hybrid Financial Instruments

We strongly support the Board's decision to permit fair value measurement for hybrid financial instruments that contain embedded derivatives that would otherwise require bifurcation. Merrill Lynch is a member of The International Swaps and Derivatives Association ("ISDA") and supports all of the comments and issues raised in the ISDA comment letter to the FASB on this proposal. We have always believed that it is preferable to value such instruments as a whole as this is consistent with the legal form of the instrument. Furthermore, we believe this approach is superior for instruments that have a quoted market price in that it results in a more objective valuation as opposed to a bifurcation approach, which requires a significant amount of estimation and results in reporting components of financial instruments that are not recognized or traded in the market.

We also support ISDA's recommendation to permit the option to elect fair value measurement for *all* hybrid instruments that were previously bifurcated and are not being used as hedging instruments at the transition date. Given that many of the instruments in question have maturity dates that can extend 10 or more years into the future, we believe that it is critical to provide for this option as without it, it will be many years before an entity achieves consistency in accounting for these instruments.

In addition, we would recommend retaining paragraph 16 of Statement No. 133 as there may be some limited scenarios where it may still be difficult to identify and measure the embedded derivative that must be bifurcated from the host contract.

We also support the Hybrid ED because it helps to further address issues arising from the mixed attribute accounting model. In that regard, we take this opportunity to request that the Board expedite the fair value option project, which we believe will greatly improve the quality of reporting and relieve many of the complexities that arise from the application of Statement No. 133.

Accounting for Servicing of Financial Assets

We support and appreciate the option under the exposure draft to subsequently report servicing assets and liabilities at fair value. However, we believe that certain of the disclosure requirements presented in paragraphs 17(e) and 17(f), which require presentation of significant quantitative and qualitative information about servicing assets and liabilities, are unwarranted. In general, we feel that these provisions amount to disclosure overload, and will be extremely costly to prepare for entities that retain

servicing assets and liabilities in a securitized transaction. With regard to 17(e)(5) and 17(f)(8), the requirement to provide a sensitivity analysis showing the effect of at least two variations in each of the key assumptions used to value servicing assets and servicing liabilities is excessive. Under SEC Rule 305 of Regulation S-K, all registrants are required to provide information regarding market risk for all financial instruments. We see no merit in providing detailed sensitivity information for what can often amount to a tiny portion of the overall population of market risk-sensitive instruments. Furthermore, if the Board's goal is to provide comparability between those entities that report servicing assets and liabilities at fair value versus those that report servicing assets and liabilities at amortized cost, the disclosure should apply to only one of the measurement options selected, which would put the entities that selected that option on the same basis as those entities that selected the alternative measurement option.

Accounting for Transfers of Financial Assets

We do not support the Transfers ED because it adds significant complexity to an already complex standard without readily apparent improvements to current financial reporting. Our comments cover the following key areas:

- the requirements of paragraph 8A regarding participations
- the legal isolation requirements of paragraph 9a
- the transferability requirements of paragraph 9b which would appear to require all entities in a multi-step transaction to be a qualified special purpose entity (QSPE)
- the requirement to initially measure transferor's beneficial interests at fair value

There is one aspect of the Transfers ED that we do strongly support, which is the Board's decision to change the limit on the amount of passive derivative instruments that a QSPE can hold to the total notional amount that pertains to all beneficial interests issued or sold by the QSPE, including beneficial interests sold to the transferor (paragraphs 35(c)(2) and 40(a)). The rescission of DIG Issue D1 and the issuance of the Hybrid ED addresses the Board's original concern that an entity may be able to circumvent Statement No. 133 accounting for an embedded derivative by using a securitization structure. For the same reason, we believe that paragraph 40 of Statement 140 can and should be eliminated in its entirety, as we believe all of the limitations in this paragraph are rendered unnecessary by the finalization of the Hybrid ED. We further suggest that these changes be incorporated into the Hybrid ED (along with the amendment to paragraph 40 that eliminates the prohibition on a QSPE holding a derivative that pertains to a beneficial interest other than another derivative financial instrument), as we believe all of these changes are related to the same issue.

Transfers of participating interests under paragraph 8(A)

We believe that one of the main reasons that the Board initially embarked on the Transfers ED was as an attempt to clarify how the existence of setoff rights impacted the derecognition of loan participations. It appears that the Board ultimately decided, as

indicated in paragraph A14, that such rights would not be an impediment to meeting the isolation requirement. However, paragraph 8A, which establishes significant new requirements, seems designed to specifically address the accounting for loan participations. Many of the issues raised by paragraph 8A are discussed in the Loan Syndications and Trading Association (LSTA) comment letter, which we endorse.

In general, it is unclear why, if the Board was satisfied that loan participations meet the legal isolation test for derecognition, paragraph 8A is considered necessary. The basis for conclusions (paragraphs A22 through A25) is unpersuasive in this regard. Our concern arises from the fact that although it is clear how to apply paragraph 8A to loan participations, we believe it raises a host of questions on how to analyze many other common types of transactions where the transferor retains an interest in the assets but the transfer was not to a QSPE – for example, transfers to collateralized debt obligations (CDOs); transfers to multiseller conduits; and loan assignments (where a portion of the loan, rather than a portion of the loan cash flows is sold). The proposed requirements also result in an increased use of QSPEs, and given the IASB's view on QSPEs, we believe that this will result in greater divergence from international accounting standards.

Accordingly, we question the need for and value of the requirements in paragraph 8A. Instead, we recommend either no change to the current guidance included in paragraphs 104 – 106, or an expansion of paragraph 9 to explicitly address the transfer of an interest in the cash flows arising from financial assets by requiring that these cash flows be analyzed under paragraph 9. However, given that the isolation issue is no longer a concern, we do not see the benefit of adding the extra layer of complexity included in the Transfers ED.

Legal isolation requirements of paragraph 9a

The proposed changes to paragraph 9a emphasize the need to consider all consolidated affiliates of the transferor in the isolation analysis. In general we do not object to this emphasis. However, paragraph 27A requires legal analysis under the laws in the applicable jurisdiction of **all** consolidated affiliates of the transferors, supporting the conclusion that the transferred interests would not be deemed part of the estate of any consolidated affiliate in bankruptcy or receivership. We are concerned that the increased emphasis on a transferor's consolidated affiliates may lead auditors to require legal opinions with respect to all affiliates of the transferor, regardless of whether they actually entered into any transactions with the transferee that would impact a legal isolation opinion. For Merrill Lynch, a large international organization with subsidiaries incorporated in many different countries, we foresee practical difficulty in meeting this burdensome requirement. Accordingly, we recommend that the Board, either in the body of the standard or in the basis for conclusion, limit the isolation analysis to affiliates that are a party to or are directly involved in the transaction.

In addition, paragraph A17 is drafted to suggest that the Board would expect a legal isolation opinion to not only *consider* all arrangements between consolidated affiliates

and the transferee but also be written *as if such affiliate transactions had been entered into directly by the transferor*. We believe that if this is indeed what is required, this is a fundamental change to the requirements of paragraph 9(a), and we do not support this change for the reasons discussed below.

Paragraph 9(a) requires a legal analysis of a transaction, and such legal analysis respects the separateness of discrete legal entities. We believe that it is inappropriate to require a legal isolation analysis, which respects the corporate form of a transaction, and then require lawyers to alter that legal analysis so as to ignore the corporate form. We recognize that the legal approach is different from the traditional way in which accountants view transactions with affiliates, *i.e.*, as transactions within a single consolidated economic unit; but we believe that if the standard for sale treatment in 9(a) is meant to be isolation in bankruptcy, then the requirement should be to obtain a legal opinion for the actual transaction as it is understood from a legal perspective.

We also acknowledge that because of this standard, there are situations in which a transfer of assets may pass the legal isolation test even though an affiliate of the transferor provides some level of support or credit enhancement. However, as long as it is limited, and as long as the transferred assets are outside the chain of title of the transferor, a legal isolation opinion may be rendered. We further note that the impact of affiliate involvement is separately (and, we believe, adequately) addressed by the requirements of paragraphs 9b and 9c, as well as through the substantive non-consolidation opinion required by AU9336. We believe these requirements, taken together, appropriately address whether such involvement results in a situation whereby the transferor, as a consolidated whole, retains “effective control” over the transferred assets such that derecognition would not be appropriate.

In sum, we agree that it is appropriate that opinions as to legal isolation explicitly *consider* all arrangements between the transferee and consolidated affiliates of the transferor that are a party to or are directly involved in the transactions, but we strongly believe that the actual fact pattern of the transaction should be respected, and the legal opinion should not impute a different party to the contract than is the actual party to the contract.

Transferability requirements under paragraph 9b

The guidance in paragraph 9b of the Transfers ED explicitly states that each entity in a multi-step transaction is considered to be a transferee and, unless structured as a QSPE, must be able to pledge or exchange the transferred assets without constraint or if there is any constraint, that constraint cannot provide more than a trivial benefit to the transferor. This appears to directly conflict with the guidance in paragraph 83 which explicitly allows for a two-step transaction, whereby the first transfer is to a bankruptcy remote entity that is not a QSPE, and the second transfer is to an entity that is a QSPE. In the transaction described in paragraph 83, we do not see how the first entity (the bankruptcy-remote entity or BRE) would satisfy the new requirement of paragraph 9b because it is

directed by the transferor to immediately sell its assets to the second entity (and this direction presumably provides more than a trivial benefit to the transferor because it is essential to effect the securitization transaction).

Does the Board now believe that in a multi-step transaction, every entity needs to be a QSPE? Such a requirement would have a substantial impact on how transactions are currently structured in the securitization markets. It is not clear why the structure as described in paragraph 83, which is often required in securitization transactions to satisfy the legal isolation condition in paragraph 9a, would be an issue for meeting the requirements of paragraph 9b. We see no compelling reason why every entity in a multi-step transaction should be a QSPE, and in our view, the Transfers ED fails to provide a satisfactory rationale for this added complexity. Therefore, we strongly recommend the removal of the last sentence in paragraphs 9b and 80.

As noted in paragraph 83, the first entity in the traditional two-step securitization structure is typically consolidated with the transferor from an accounting perspective, even though from a legal perspective it is considered to be legally isolated. We believe the provisions of 9b should apply to the consolidated group, and therefore the test of whether the transferee can freely pledge or exchange the transferred assets should be applied only to those transferees that are not consolidated, for accounting purposes, with the transferor.

Measuring retained interests at fair value

The Transfers ED requires fair value as the initial measure of a transferor's retained interest (except for retained participating interests) in transferred financial assets. Previously, retained interests were accounted for at their allocated carryover basis. We do not object to this change on a conceptual basis as we are in agreement with the FASB's broader effort to record transactions at fair value, but we are concerned about the possible ramifications of this proposal, specifically in its application to assets that are not subsequently accounted for at fair value with changes in value recorded in earnings. Consider the following example:

- An entity securitizes appreciated debt securities currently classified as available-for-sale (AFS) using a QSPE;
- The QSPE issues 10% of its beneficial interests to a third party. The transferor retains the remaining 90% of the beneficial interests;
- The transferor records a gain on sale for the full amount of AFS securities transferred to the QSPE, and initially records the 90% transferor's beneficial interest at fair value; and
- As permitted under Statement No. 115, the transferor elects to classify its beneficial interest as an AFS security and record subsequent changes in fair value in Other Comprehensive Income.

We believe that the above fact pattern is tantamount to transferring a security from AFS to Trading, recognizing a gain, and transferring it back again to AFS. While it is arguable whether a “new” security has been created by virtue of selling only a small portion of the beneficial interests to third parties, we believe that if the FASB decides to move forward with its proposal, to prevent abuse, it should require that the transferor’s beneficial interests be marked to market through earnings both initially as well as subsequently.

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Thank you again for the opportunity to comment on the ED. We hope that the Board will give serious consideration to our comments as they further deliberate this project. Please do not hesitate to contact me with any questions or requests for additional information.

Sincerely,

/s/ Esther Mills

Esther Mills
First Vice President