

vember 7, 2005

Mr. Larry Smith
Director of Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Letter of Comment No: 27
File Reference: 1210-001

RE: Proposed Statement of Financial Accounting Standards, Accounting for Certain Hybrid Financial Instruments, an Amendment of FASB Statements No. 133 and 140 (File No. 1210-001), and Proposed Statement of Financial Accounting Standards, Accounting for Servicing of Financial Assets, an amendment of FASB Statement No. 140 (File No. 1220-001)

Dear Mr. Smith:

The Accounting Standards Executive Committee of the American Institute of Certified Public Accountants (AcSEC) appreciates the opportunity to comment on the Exposure Drafts of proposed amendments to Statements of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities (FAS 133), and No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (FAS 140). AcSEC appreciates FASB's continued efforts to improve financial reporting. Although the Exposure Drafts (EDs) were separately issued and may be issued as separate final standards, AcSEC has decided to offer comments for ir consideration in a single letter for the two Exposure Drafts stated above. Each one is addressed individually and referenced as appropriate in the areas of overlap. We will forward our comments on the third ED relating to transfers of financial assets separately.

## **General Comments**

AcSEC is generally supportive of the proposed amendments pertaining to servicing rights and hybrid instruments, which will permit these instruments to be measured at fair value with the changes in fair value recognized in earnings. We believe that these amendments will help to achieve FASB's mission of improving financial accounting standards and will result in accounting that more closely reflects the economics of how certain entities manage these assets and liabilities.

However, AcSEC believes certain provisions in the proposed statements may give rise to consequences that were not specifically contemplated by the Board. For example, these two EDs would intersect with the Fair Value Measurement (FVM) Standard and a related yet-to-be-proposed FASB Staff Position on EITF Issue 02-3, Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities (proposed FSP) that would require deferral of day-1 gains and losses for derivative instruments that fall in Level 5 of the FVM standard's fair value hierarchy. Some classes of servicing rights, as well as certain hybrid financial instruments that fall in the scope of both Exposure Drafts, could also be

vel 5 instruments requiring the deferral of related day-1 gains or losses, if the proposed FSP's approach is ended to other instruments.

We are also concerned that the analysis required under the Hybrid Instruments ED to determine whether there is an embedded derivative that would need to be bifurcated under FAS 133 lacks clarity, is extremely complex and would prove inoperable for constituents. Although we agree that fair value is generally the most relevant measurement attribute of financial instruments, we do not believe preparers who are interested in reporting at fair value should be subject to such complicated series of analyses and decisions that would need to be made for every hybrid instrument, simply to make that determination. Accordingly, we articulate our concerns in a more detailed analysis below.

#### **Transition Provisions and Effective Date**

We also find the transition guidance to be confusing, although we support prospective application of the EDs. Due to the overlap of the proposed statements, the FASB emphasizes the importance of considering all three documents together in order to better understand the overall effect on FAS 140. This raised the expectation that there would be more synergy among the EDs with regard to transition guidance. However, this guidance is quite perplexing. For example, the Hybrid Instruments ED would be effective even before being issued, since it can be applied in the "entity's fiscal year that begins during the fiscal quarter in which the Statement is issued," although it also says that "Provisions of this Statement shall not be applied to instruments that an entity holds at the effective date." These provisions seem contradictory.

therefore recommend that the transition provisions be more explicit, that the information be combined in one tabular format covering all three of the proposed standards to ease understandability and be included as a single table in each final standard. Also, the information in Appendix B needs additional clarity and possibly some related examples, as the connections between the referenced EITF and DIG Issues and the proposed changes are not readily apparent. We also recommend that the amended language in the affected EITF and DIG Issues be made available for review before the standards are finalized, including any impact on matters on the EITF agenda awaiting resolution of these proposed amendments. Finally, we ask that the effective dates be delayed (with earlier application permitted) to give companies the time needed to study the final amendments and implement necessary procedures and controls, particularly for securitized assets that were previously exempt from the bifurcation analyses.

# **Accounting for Certain Hybrid Financial Instruments**

AcSEC is broadly supportive of the proposed statement relating to hybrid financial instruments and believes that the FASB has made positive strides in its attempt to improve the accounting for business activities involving similar instruments. We support the Board's decision to permit fair value measurement for instruments where bifurcation would be otherwise required. In addition, we are pleased with the decision that will allow entities the flexibility to elect fair value measurement on an instrument-by-instrument basis, as opposed to an entire class of such instruments, thereby making this election more practical for preparers.

AcSEC is concerned, however, that under this proposed ED the FASB has expanded the population of instruments religious to the bifurcation analyses by eliminating the exemption from bifurcating beneficial interests in securitized ancial assets under DIG Issue D1, but leaves constituents without guidance on how to determine whether

ircation of these instruments is required. In addition, many more complex hybrid instruments that were previously exempt will now have to be considered under this requirement, and both issuers and investors alike may be uncertain with how to proceed in performing the required analysis.

The following illustrates one instance in the ED where we feel that clarification is necessary. The proposed guidance seems to require a "look-through" model in order to assess whether there is an embedded derivative, stating in paragraph A16 that, "The Board believes sufficient evidence can generally be obtained by analyzing the arrangements that govern the payoff structure and the subordination status of the instrument" and would require "an understanding of the nature and amount of assets and the nature and amount of liabilities and other beneficial interests comprising a transaction." However, paragraph 3(b) of the ED (i.e., proposed paragraph 14A of FAS 133) would seem to contradict that notion by stating that, "The determination [of whether an instrument contains an embedded instrument or not] should be based on the contractual terms of the beneficial interest" with no explicit reference to the underlying assets in the structure that are generating the cash flows for the instruments, which implies that an examination of the contractual terms would suffice without having to "look through" to or further investigate the underlying assets.

We therefore believe that some guidance is needed so constituents can implement the ED with reasonable consistency. While AcSEC recognizes that the FASB is moving towards more principles-based standards, we think it reasonable and necessary that the final statement include more substantive guidance on when bifurcation is required, as well as how to determine whether an instrument contains an embedded derivative, particularly due to the complexity of identifying the specific terms of embedded derivatives. Thus, in addition to the reference made to credit risk in paragraph A21, some illustrative examples would help practitioners and lead to more comparable plementation of the proposed guidance.

We suggest that in support of further convergence with international accounting standards, the FASB should consider adopting the more reasonable criteria established by the IASB. IAS 39, Financial Instruments: Recognition and Measurement (IAS 39), permits the election of fair value for any hybrid instrument with an embedded derivative unless it is clear "with little or no analysis" that the embedded derivative would not require bifurcation. This would be comparable to the election allowed under FAS 115, Accounting for Certain Investments in Debt and Equity Securities (FAS 115), to classify any security as trading. As such, constituents could avoid performing these costly and complicated analyses just to determine if an instrument needs to be bifurcated. This would facilitate subsequent convergence initiatives and would allow beneficial interest holders to forego the rigorous analysis required under FAS 133, while improving financial reporting.

We observe that for credit-linked notes, paragraph 14B creates a different requirement to bifurcate if the instrument were issued by a Qualifying Special Purpose Entity (qualifying SPE) as opposed to a different kind of entity. If XYZ Bank issues credit-linked notes directly or through a SPE that is not a qualifying SPE, then both the issuer and the investors would be required to bifurcate the embedded credit derivative. However, if XYZ Bank establishes a qualifying SPE to issue the identical credit-linked notes, neither the qualifying SPE nor the investors would bifurcate. AcSEC does not object to the Board's decision to exclude embedded credit derivatives from those requiring bifurcation, but we are confused as to why the FASB would limit that exclusion to qualifying SPEs and require different accounting treatment for instruments with very similar economic risks based solely on the type of issuer. We have the following questions and suggestions for clarification:

- We suggest that the FASB provide a better explanation for the reasoning behind limiting the exclusion and creating this disparity based on the type of issuer.
- We suggest that the FASB clarify whether the credit risk exemption provided in proposed paragraph 14B relates only to securitized financial assets or to any hybrid financial instrument within the scope of this ED.
- We question whether the different treatment should be limited to qualifying SPEs as opposed to the guidance being applicable to all SPEs. We note that it may be difficult for investors to know whether an SPE that issues credit-linked notes is or is not a qualifying SPE. For investors who buy only part of an issuance of credit-linked notes, whether the SPE is a qualifying SPE would be irrelevant if not for this provision in paragraph 14B of the Exposure Draft.

We also are concerned about the amendment to paragraph 14A of FAS 133 within the ED, which would now require *investors* to perform a bifurcation analysis for hybrid instruments that were previously exempt. Investors may not have the detailed information needed to determine whether or not their investment contains an embedded derivative, particularly if the Board intended a "look-through" model. In addition, this guidance would seem to compel investors to use accounting that does not reflect their intent. Specifically, it overrides FAS 115's intent-based model, because it would restrict the beneficial interest holder's ability to choose to classify an entire bifurcatable hybrid instrument as an available-for-sale security under FAS 115. Rather, the beneficial interest holder would be forced either to bifurcate and separately recognize the change in the fair value of the derivative in earnings or to classify it as a trading security. We recommend that the Board consider softening the bifurcation analysis requirements for investors by adopting the more reasonable and judgmental criteria established by the IASB, as mentioned before. Consequently, when electing to use fair value for such instruments, beneficial interest harders could avoid having to make such difficult determinations and improve their financial reporting. However, le AcSEC members would prefer that the Board reinstate the DIG Issue D1 exemption indefinitely for investors, thereby allowing them the option of accounting for the changes in the value of the beneficial interests in securitized financial assets through other comprehensive income or earnings, using the guidance in FAS 115.

AcSEC also questions the proposed removal of the provision in paragraph 16 of FAS 133 that requires an entire contract to be fair valued when the embedded derivatives cannot be reliably identified and measured. With the proposed deletion of this provision, constituents are now uncertain what to do if they choose to forego the fair value election, but cannot reliably identify and measure the embedded derivative. Furthermore, we think it ironic that the Board would chose to delete this provision and simultaneously revoke the exemption afforded under DIG Issue D1. This existing provision in paragraph 16 has not been used frequently up to this point. However, we believe that the need for this guidance will be even greater given the increase in volume and types of bifurcatable instruments that were previously exempt from bifurcation under DIG Issue D1, and also due to the proliferation of complicated structures in the market for which there is no precedent with respect to a reliable bifurcation analysis. We therefore request that the FASB reinstate the deleted sentence to avoid any confusion and to ease the transition of applying this ED.

This ED, in combination with the FVM standard and the proposed FSP on EITF 02-3, would require an entity to complete several steps before it could determine the appropriate accounting for a hybrid instrument. The entity must: (1) identify the hybrid instruments that may contain embedded derivatives; (2) determine if the embedded derivatives would need to be bifurcated under FAS 133; (3) decide whether it would like to elect to record the whole hybrid instrument at fair value; (4) if not, then determine to which level in the fair value hierarchy the whole 'rument and the embedded derivative belongs; (5) defer day-1 gain or loss if either would fall in Level 5 of the merarchy; and (6) reconsider the election of fair value for the entire instrument. Since Level 5 instruments are

se whose value is dependent on model inputs that are not observable in the markets, many of the embedded a livatives covered in the Hybrid Instruments ED would be classified as Level 5. We urge the Board to consider the increased complexity to an already highly difficult analysis that would arise from the interaction of these new standards if they are finalized as proposed.

# **Accounting for Servicing of Financial Assets**

AcSEC is also generally supportive of the ED on Servicing Rights. We are pleased with the relief that the fair value measurement of any servicing rights brings, particularly for entities that economically hedge the fair value of these rights with instruments that do not qualify for hedge accounting under FAS 133. This decision will alleviate the volatility in earnings experienced by entities arising from the mismatch of the accounting for the hedging instruments and the related servicing rights due to the mixed attribute accounting model.

While we support the decision to allow the subsequent measurement of servicing assets at fair value, we do not think the rationale for the proposed requirement to value all servicing rights at fair value on day-1 is conceptually valid for those servicing rights that are separated from transferred assets and retained by the transferor, since we do not believe these to be, technically, new assets to the transferor. Re-characterization of an asset on a balance sheet should not constitute a re-measurement event and runs counter to FASB's aversion to raising form over substance in accounting standards. We agree with the alternative view in paragraph A27 and think, perhaps, that it would be less confusing if the Board simply states that their rationale for recording servicing assets at fair value on day-1 is to maintain consistency with the Board's ultimate goal of measuring all financial assets and liabilities at fair value. Although servicing rights and liabilities are not considered to be financial assets, they are closely related to activities with financial assets, (for example, lending activities) and measurement and reporting at fair value could ustified under that premise.

The proposed amendments to paragraph 13 of FAS 140 provide that the election for measuring servicing assets at either fair value or amortized cost be made on a class-by-class basis. Each class is based on the major asset types being serviced. While we agree that this approach is favorable for entities, giving them greater flexibility, we believe that the determination of a class of servicing rights outlined in this paragraph should be more granular. Indeed, a particular class of servicing rights based on a major asset type can be further subdivided into classes that have different risk characteristics and thus require different hedging strategies. For example, mortgage loans can be divided into commercial versus residential loans, which can be further subdivided into prime versus sub-prime loans. Each of these lending categories has differing risks and the related servicing assets and liabilities have differing liquidity and, therefore, different fair values. For this reason, we recommend that entities be allowed to make separate elections to report one or more subclass of each class (as defined in paragraph 13) at fair value. Since many impacted by this proposal are banks and thrifts, Call Report and Thrift Financial Report loan categories could be mentioned as a possible basis for identifying categories for which separate election for reporting at fair value could be made, in the Basis for Conclusions. Another possible class identification methodology could be to apply the same categories used in stratifying servicing rights for impairment testing.

## Transition and Transfers of Available-for-Sale Securities to Trading

believe that the Board should allow a one-time "transfer holiday" (similar to the one permitted for the FAS 133 transition) that would permit the reassignment of securities classified as available-for-sale (AFS) to the trading category at the time an election is made to record a class of servicing rights at fair value, when the final standard is adopted. This reprieve should therefore not be considered to be a violation of FAS 115 and would facilitate the goal of achieving full fair value for financial instruments, which is consistent with the objective of the Board. Since the Board is concerned with possible abuses, we suggest that the net impact of this provision be recorded as income from continuing operations with disclosure required.

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We thank the Board for its consideration and would welcome the opportunity to discuss this matter with Board members and their staff.

Sincerely,

Ben Neuhausen Chairman Accounting Standards Executive Committee Linda Bergen Chair FAS 140 Amendments Task Force