

July 12, 2002

Ms. Suzanne Bielstein
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Financial Accounting Standards Board
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Letter of Comment No: 37
File Reference: 1100-163
Date Received: 7/15/02

Re: Comments on the exposure draft, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* (File Reference 1100-163)

Dear Ms. Bielstein:

PricewaterhouseCoopers LLP appreciates the opportunity to comment on the exposure draft, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* (the "Proposed Statement") and assist in developing effective solutions for some of the more difficult implementation issues arising from FASB Statement No. 133 (Statement 133), *Accounting for Derivative Instruments and Hedging Activities*.

Summary of Comments on Amendments Relating to the Definition of a Derivative and Beneficial Interests in Securitizations of Financial Assets

We commend the Board for its time and effort in developing a framework to analyze whether a beneficial interest in a securitization is a derivative in its entirety, eligible for the paragraph 14 scope exception, or contains an embedded derivative requiring bifurcation under the Proposed Statement. We recognize that these issues are some of the most complex accounting issues to arise in applying Statement 133.

We understand that the proposed amendment to the definition of a derivative is being considered largely as a result of the difficulty in analyzing under the current definition many beneficial interests in securitizations due to their leverage. As a result of the proposed revision to the definition, most beneficial interests in securitizations will not meet the definition of a derivative. However, many will contain embedded derivatives that would require separate accounting under the proposed DIG Issues B12, "*Beneficial Interests Issued by Qualifying Special-Purpose Entities*", and D2, "*Applying Statement 133 to Beneficial Interests in Securitized Financial Assets (a Resolution of the Issues Raised in Implementation Issue D1)*".

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We do not support the proposed amendment to the definition of a derivative, nor the models presented in DIG Issues B12 and D2 relating to the analysis of beneficial interests in securitizations of financial assets for the following reasons:

- The revision to the definition of a derivative will certainly affect other contracts, most notably off-market forward contracts and certain compound derivatives. We do not believe that applying the current definition to these contracts is difficult or controversial in practice.
- The proposed guidance in DIG Issues B12 and D2 is overly complex and will lead to inconsistent application in practice; and
- The proposed guidance will confuse users of financial statements and will not increase financial reporting transparency.

We understand the conceptual merit of the Board's conclusions regarding the evaluation of beneficial interests in securitizations in proposed DIG Issues B12 and D2. However, we are concerned that the proposed guidance is overly complex. While the examples provided in the proposed guidance are helpful, they do not necessarily assist in evaluating many of the complex structures that exist in the marketplace. Therefore, it may be difficult for constituents to apply the proposed guidance consistently in practice to beneficial interests in different structures with similar economics. Unfortunately, future implementation issues may need to address the more complex structures. In addition, the use of different accounting treatments for the components of a single investment may be challenging for financial statement users to understand.

We believe that the process of "peeking through" to the underlying assets in the securitization and understanding the structure's waterfalls in order to determine whether or not an embedded derivative will need to be bifurcated will often be difficult to perform and time consuming. Compounding the complexity of the proposed guidance will be the difficulty in determining whether legal forms of equity interests in nonqualifying SPEs should be considered as debt or equity hosts. Additionally, investors in beneficial interests may need to modify their current systems to determine the fair values of embedded derivatives that would need to be bifurcated and to further account for these instruments.

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Certainly there is a level of complexity that exists in much of the accounting guidance governing derivatives and securitizations that exists today. We do not see the benefit to increasing Statement 133's complexity and we are particularly concerned that the proposed guidance will further confuse users of financial statements and will actually decrease financial reporting transparency.

As a result, we do not support the proposed amendment to the definition of a derivative, nor the models presented in DIG Issues B12 and D2 relating to the analysis of beneficial interests in securitizations of financial assets.

Other approaches to consider and our observations thereon

Given the magnitude of the implementation issues identified with the proposed model and the movement away from simplicity towards ever more complexity, we strongly recommend the Board evaluate more rigorously the costs and benefits of the proposed changes. We have presented some alternative approaches for the Board's consideration and have highlighted our more significant observations and concerns below.

EITF 99-20, (EITF 99-20) "*Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets*", currently provides adequate financial reporting of the effects of an embedded derivative in certain beneficial interests within its scope (structures that contain financial assets with contractual cash flows). Under EITF 99-20, the investor in a beneficial interest that contains an embedded derivative is subject to a rigorous impairment model which results in immediate recognition of certain adverse changes in cash flows. The model is straightforward and provides users of financial statements consistent and transparent information regarding the financial performance of the beneficial interest.

Certainly EITF 99-20 is not a perfect model, and one must recognize its scope limitations in that it only applies to beneficial interests in securitizations whereby the underlying securitized assets have contractual cash flows. We recognize that, if the Board were to consider allowing constituents to apply EITF 99-20 as an alternative to the Proposed Statement's approach requiring bifurcation, the model may have to be augmented. Nonetheless, it would be less complex to apply in practice while providing financial reporting transparency.

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Reflecting the need for convergence of accounting guidance on a global basis, we recommend that the Board consider the efforts being made by the International Accounting Standards Board (IASB) to move towards fair value for all financial instruments. For example, the guidance included in the Exposure Draft of the Proposed Amendment to International Accounting Standard 39 (IAS 39), "*Financial Instruments: Recognition and Measurement*" which will effectively permit an entity to account for financial instruments at fair value through earnings if it chooses to do so on an enterprise wide basis. While the IAS proposal is broad in scope affecting any financial asset or financial liability, this guidance would allow an investment in a beneficial interest to be accounted for at fair value through earnings enabling the holder of the instrument to avoid the complexities associated with bifurcation. Due to the conceptual and theoretical concerns that remain unresolved, we do not believe the broad scope of the IAS proposal should be adopted in the Proposal Statement. Though, we do support a similar approach for the narrow scope of beneficial interests.

As a preferred alternative to the proposed model, we recommend the Board consider requiring all investments in beneficial interests to be accounted for at fair value with changes in value recognized currently in earnings. This approach would (1) be consistent with strategic initiatives of the FASB and IASB of moving towards fair value accounting for financial instruments, (2) increase financial statement transparency and consistency, and (3) provide constituents with a straightforward model to apply. As you know, we are a proponent of the Board's goal of moving towards fair value accounting for all financial instruments as we have previously communicated to you in our response to the FASB's Preliminary Views on Major Issues Related to "*Reporting Financial Instruments and Certain Related Assets and Liabilities at Fair Value*". We believe that requiring investments in beneficial interests in securitizations to be accounted for at fair value currently through earnings would be one step closer to the Board's ultimate goal. If the Board decides to consider such an approach, it will be necessary to determine the scope of such investments in beneficial interests in securitizations to be carried at fair value.

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Comments Specific to the Proposed Statement

As mentioned above, we do not believe that the definition of a derivative requires revision at this time. However, to assist the Board in this project, we have included below other observations with the proposed amendment to the definition of a derivative and our comments on various other areas of the Proposed Statement. Please note that paragraphs referenced below are the paragraphs of Statement 133 that will be amended as noted in Appendix B of the Proposed Statement.

Amendment to the definition of a derivative

As a result of the proposed change, it will be critical that preparers of financial statements fully understand the distinction between option-based and non-option-based contracts. We strongly recommend the Board provide several examples of both types of contracts. For example, should credit default swaps which are traditionally called “swaps” by the marketplace be considered option-based or non-option-based under the Proposed Statement? Furthermore, the Proposed Statement should specifically address whether or not deep-in-the-money option contracts should be treated as “non-option-based”. We believe that these contracts behave economically like forward contracts.

We are also concerned that certain forward based contracts (e.g., swaps) could be structured such that there is no initial net investment at inception of the contract, yet they contain significant beneficial/detrimental off-market terms in the short term with offsetting detrimental/beneficial off-market terms in subsequent years of the contract. This structure could be viewed as a financing arrangement in substance, but would be accounted for as a derivative in its entirety under the Proposed Statement.

In order to clarify in the definition of a derivative that a non-option-based contract with an initial net investment of less than 5% may be accounted for as either (1) a derivative in its entirety or (2) a hybrid instrument that must be bifurcated, we recommend that a reference be included in paragraph 6(b) to the alternatives described in paragraph 12.

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Amendment related to power purchase and sales agreements

The Proposed Statement proposes to amend paragraph 58(b) to incorporate the guidance provided by DIG Issue C15, “*Normal Purchases and Normal Sales Exception for Certain Option-Type Contracts and Forward Contracts in Electricity*”. However, in doing so it appears to require all power purchase and sales agreements, including all forward contracts, to meet the applicable criteria in DIG Issue C15 to qualify for the normal purchases and normal sales exception. Because the definition of a capacity contract only covers option contracts and forward/option combination contracts, the proposed amending language to paragraph 58(b) could be interpreted as precluding any pure forward contract for the purchase or sale of electricity from qualifying for the normal purchases and normal sales scope exception. The intent of DIG Issue C15 was to provide an additional avenue for qualifying for the exception, not to provide substitute criteria for all power purchases and sales contracts. One way to clarify the guidance would be to limit the application of the additional criteria in paragraph 58(b) to those contracts qualifying under paragraph 10(b)(4) instead of paragraph 10(b). Thus, pure forward contracts for the purchase or sale of electricity that qualify under paragraph 10(b)(1) would not have to apply the additional criteria specified in paragraph 58(b).

The definition of a capacity contract included in paragraph 540 of the Proposed Statement only describes the characteristics of a capacity contract. DIG Issue C15 provided a comparison contrasting the characteristics of a capacity contract and an option contract. We believe that this additional guidance is helpful to constituents in evaluating both types of contracts. As such, we recommend that the Board include this additional information in the Proposed Statement, perhaps in Appendix A where the implementation guidance is presented.

Amendment to paragraph 57(c)(3)

The guidance provided by DIG Issue A18, “*Application of Market Mechanism and Readily Convertible to Cash Subsequent to the Inception or Acquisition of a Contract*”, indicates that the assessment of whether an asset is readily convertible to cash should be performed on an ongoing basis throughout the contract’s life. However, the parenthetical sentence added to paragraph 57(c)(3) by the Proposed Statement could be read to mean that the asset must be

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readily convertible to cash over the life of the contract, which is inconsistent with the guidance in DIG Issue A18. Therefore, we recommend clarifying the parenthetical sentence as follows:

(The evaluation ~~notion~~ of *readily convertible to cash* shall be applied to a contract at inception and on an ongoing basis throughout a contract's life.)

In addition, we read the amendment to the end of paragraph 57(c)(3) to mean that a contract does not have the "net settlement" characteristic when stock contains restrictions of 32 days or more that are imposed by the issuer. In other words, the impact of such restrictions on the sale of assets received is relevant only for stock purchase warrants and not for commodity or other types of derivative contracts. Assuming this is the intention of the Board, we suggest that the Board clearly communicate in the Proposed Statement that analogies to the accounting for restricted stock to be received upon exercise of a stock purchase warrant should not be made for any other type of option-based or non-option-based contract.

Amendment related to embedded derivative instruments with interest rate underlyings

We agree with the Board's decision to clarify the guidance for embedded derivative instruments with interest rate underlyings. However, the Proposed Statement does not provide sufficient guidance on how to perform the evaluation under paragraph 13(b) for a debt host with multiple derivative features. For example, consider an issuance of convertible debt which pays a floating interest rate subject to a cap and floor and is callable by the issuer. It is unclear to us how the evaluation should be performed for such an instrument by its issuer. Specifically:

- Is the cap evaluated separately from the floor or together as a collar?
- How is the interaction between the cap, floor and call option considered in the evaluation?
- Is the conversion option, which does not require bifurcation per paragraph 11(a), included or excluded from the host contract in the evaluation?
- Is the conversion option's value assumed to remain constant in this evaluation similar to the credit spread in the examples on the website or do other possible variables need to be considered?

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We strongly recommend the Board provide an example of such an evaluation because debt instruments containing multiple embedded derivative features are very common. In addition, paragraph 61(d) should contain a reference back to paragraph 13 to ensure constituents are thoroughly evaluating calls and puts on debt instruments consistent with the logic included in DIG Issue B16, "*Calls and Puts in Debt Instruments*".

Based on our discussions with the FASB staff, we understand that calls and puts in private debt hosts that merely accelerate the repayment of the note do not need to be bifurcated because the underlying debt instrument cannot be readily convertible to cash (i.e., no net settlement of the embedded call or put exists). We believe that this interpretation of Statement 133 should be clarified in the Proposed Statement or in a DIG issue.

We believe that the examples posted to the website illustrating the application of the proposed amendment of paragraph 13(b) are helpful to constituents and should be included in the Proposed Standard. The examples demonstrate that the analysis under possible interest rate scenarios should be performed assuming the credit quality of the issuer (i.e., spread over benchmark) remains the same as it was when the instrument was issued. We agree with this approach and suggest that the Board consider clarifying this subtlety in the amendment to paragraph 13(b).

Amendment for forward purchases or sales of TBA and other similar securities

The amendment to paragraph 59(a) provides a "regular way" scope exception for certain contracts for the purchase and sale of when-, as-, or if-issued, or to-be-announced securities. In addition to meeting certain criteria, the entity will now be required to document the basis for concluding that it is probable that the contract will result in physical delivery. Our interpretation of this paragraph is that the scope exception will be elective since an entity can choose not to prepare such documentation and thereby account for the contract as a derivative. This is the same concept described in DIG Issue C12, "*Interpreting the Normal Purchases and Normal Sales Exception as an Election*." We agree with this notion and recommend that the Board clarify this concept in the Proposed Statement by providing guidance on whether the election can be made on an individual contract, all-or-none, or some other basis.

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The guidance currently provided for contracts designated as normal purchases or normal sales included in paragraph 10(b)(1) should be incorporated into paragraph 59(a) to clarify that the net settlement of contracts that were provided an exemption under paragraphs 10(a) and 59(a) will call into question the continued exemption of all such contracts.

Amendment related to financial guarantee contracts

We recommend that paragraph 10(d) be revised as indicated to clarify the amendment relating to financial guarantee contracts.

Certain financial guarantee contracts. Financial guarantee contracts are not subject to this Statement if they provide for payments to be made only to reimburse the guaranteed party for failure of the debtor to satisfy its required payment obligations, either (1) at pre-specified payment dates or (2) because an event of default occurred (as defined in the financial obligation covered by the guarantee contract) and payments were accelerated automatically or by means of notice to the debtor. The guaranteed party must be exposed to the risk of non-payment both at inception of the financial guarantee contract and throughout its term. In contrast, financial guarantee contracts are subject to this Statement if, for example, they provide for payments to be made in response to changes in an underlying such as a decrease in a specified debtor's creditworthiness.

In addition, there are differing interpretations of the second sentence of paragraph 10(d). Based on the discussion in the Basis for Conclusions of the Proposed Statement and in the draft DIG Issue A22, "Application of the Definition of a Derivative to Certain Off-Balance-Sheet Credit Arrangements, Including Loan Commitments", one interpretation is that the financial guarantee exception applies only in situations where the guaranteed party either directly owns the particular asset that is subject to the guarantee or, in the case of a back-to-back-guarantee or reinsurance, where the guaranteed party has itself provided a guarantee to another party and that party owns the particular asset that is subject to the guarantee. If this interpretation is correct, we believe the second sentence should be revised as indicated below:

The guaranteed party must be exposed to the risk of nonpayment both at inception of the financial guarantee contract and throughout its term, either through direct legal ownership of the guaranteed obligation or through a back-to-back guarantee arrangement or similar

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contractual commitment with another party that has direct legal ownership of the guaranteed obligation.

Another interpretation is that paragraph 10(d) applies to situations where the financial guarantee contract is issued to a party that is exposed to the risk of nonpayment through another contractual arrangement (e.g. a total return swap, with the inward swap payments based on an underlying referenced bond that is not owned by the guaranteed party). In such a situation, the guaranteed party (the holder of the swap) would be exposed to risk of nonpayment on the bond without actually owning the bond. If this is the Board's intention, further clarification of this point should be included in paragraph 10(d).

The Basis for Conclusions appears to require additional criteria, beyond those required in the Proposed Statement, to be satisfied in order for a contract to qualify for the financial guarantee exclusion. The last sentence in paragraph A29 of the Proposed Statement states in part that "...as part of the financial guarantee arrangement, the guarantor receives delivery of the defaulted receivable upon an event of default and obtains the right under the financial obligation to pursue collection of amounts for which the guaranteed party is reimbursed." This wording implies that to qualify for the financial guarantee exception, the arrangement would need to require that the guarantor receive delivery of the defaulted receivable. We understand that under traditional guarantee arrangements, this does not always occur. For example, the guarantor may decide to step in and make any payments of interest or principal as they become due and are not paid by the debtor. In that scenario, the guarantor will not take title to the instrument but will instead receive subrogation rights against the debtor for payments made.

In addition, Paragraph A30 notes that "...the Board determined that, in order for a financial guarantee contract to qualify for the scope exception in paragraph 10(d), the guaranteed party must demand payment from the debtor and, once it is determined that the required obligation is not satisfied by the debtor, the guaranteed party must relinquish rights of subrogation to the guarantor in order to receive payment by the guarantor." This sentence implies that subrogation is a required criterion for the paragraph 10(d) exception; however, paragraph 10(d) has not been revised to reflect this additional requirement. We are aware of situations where subrogation rights may not be a required contract provision or may have been waived. We believe that the Basis for Conclusions should not require that subrogation rights be a required contractual provision. Instead, we believe a contract would meet the 10(d) criteria as

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long as the contract is structured such that the guaranteed party could never recover more than its loss, on the defaulted obligation, as it is the concept of indemnification for loss and no more than the loss suffered, that is critical to an insurance analogy.

Amendment related to the short-cut method

We agree that the proposed amendment to paragraph 68(b) logically follows from the proposed to revision to the definition of a derivative in paragraph 6(b). However, we question whether the interest rate swap containing the mirror image option (for which the fair value of the option component is exchanged up front) is more effective than an interest rate swap containing a mirror image option for which the value of the option is paid over time in the swap payments. Typically, the value of the prepayment option included in a debt instrument is paid by the issuer via a higher interest rate over the life of the instrument. However, under the Proposed Statement, the option embedded in the interest rate swap will be paid upfront rather than over time.

Additionally, the Proposed Statement does not provide guidance on the transition for hedging relationships that previously qualified for the short-cut method. For example, if prior to adoption of the Proposed Statement, an entity hedged fixed rate prepayable debt with an interest rate swap that contained a mirror image prepayment option and it was structured in order to achieve the shortcut method, will the entity be allowed to continue that accounting under the Proposed Statement? We believe that entities should be able to continue to apply the shortcut method to hedging relationships that qualified for the shortcut method before the effective date of the Proposed Statement.

Transition guidance

Paragraph 41 of the Proposed Statement is unclear as to the contractual terms (i.e., original terms at issuance or inception of the contract or terms present at adoption of the Proposed Statement) that should be evaluated to determine whether a contract meets the revised definition of a derivative. We believe the Board intended the evaluation to be based on the original terms and recommend changing the paragraph as follows:

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“If a contract that would not be accounted for as a derivative instrument, based on its original terms at issuance or inception of the contract, under this Statement was previously accounted for as a derivative instrument, that accounting treatment shall not be changed. That is, for those contracts, this Statement applies prospectively only to transactions after the effective date.”

Paragraph 42 of the Proposed Statement is confusing and subject to misinterpretation. Therefore, we recommend that the Board revise this paragraph to clearly communicate the proposed transition for these structures.

Transition for certain beneficial interests in securitizations may be extremely complex under the Proposed Statement. Under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, certain beneficial interests in securitizations may be accounted for at fair value currently in earnings if designated as trading securities. The Board should consider again allowing entities to reclassify beneficial interests in securitizations from available-for-sale into the trading category in order to avoid the costs involved in the bifurcation process.

Derivatives Implementation Group (DIG) Issues Still Outstanding and Impact on EITF Consensuses

We recommend that the FASB staff provide an update on the status of DIG issues not yet issued. We believe that there are several important DIG issues that remain unresolved. It would be helpful if the outstanding DIG issues could be resolved in time to provide constituents the opportunity to evaluate any new DIG Issues in conjunction with the guidance provided by the Proposed Statement.

We also believe that the staff should update the analysis for all EITF Issues impacted as a result of the Proposed Statement.

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We appreciate the opportunity to express our views. If you have any questions regarding our comments, please contact Deidre Schiela at (973) 236-7222, John M. Althoff at (973) 236-7288 or Thomas L. Barbieri at (973) 236-7227.

Very Truly Yours,

PricewaterhouseCoopers LLP