



Corporate Treasury  
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July 19, 2002

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

**Letter of Comment No:** 40  
**File Reference:** 1100-163  
**Date Received:** 8/1/02

By Electronic Mail:

File Reference No. 1100-163: *Proposed Statement of Financial Accounting Standards, Amendment of Statement 133 on Derivative Instruments and Hedging Activities.*

Dear Ms. Bielstein:

Bank of America Corporation appreciates the opportunity to comment on the Financial Accounting Standards Board's (the "Board") Exposure Draft of the Proposed Statement of Financial Accounting Standards, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, (the "Exposure Draft"), the guidance in tentative Statement 133 Implementation Issues A20, B12, B36, C17, and D2, and Questions and Answers Related to Derivative Financial Instruments Held or Entered into by a Qualifying Special-Purpose Entity (SPE) (the "Statement 140 Q&As"). For purposes of this comment letter, the Exposure Draft as it pertains to beneficial interests in securitized financial assets, the reference Statement 133 Implementation Issues, and the Statement 140 Q&As may also be collectively referred to as the "D2 model." These comments are offered by one of the nation's largest financial institutions.

In summary, Bank of America believes the Exposure Draft and the proposed D2 model adds significant complexity to a standard that is already challenging to understand and apply. In addition, the Exposure Draft would result in accounting that is in direct conflict with the Board's objectives to "developing neutral standards that result in accounting for similar transactions and circumstances in a like manner," and to improve transparency and understandability of financial information. Our comments cover the following key areas:

- Changes to the Definition of a Derivative
- Changes to Shortcut Method
- Financial Guarantee Contracts

- Proposed D2 Model
  - Presumption that the Host Contract is Debt
  - Determination of Clearly and Closely Related Based on Substance
  - Statement 133 Implications for QSPE Status
- Aggregating Guidance for Beneficial Interests

### **Changes to the definition of a derivative**

We do not support the proposed changes to the definition of a derivative, as we believe the current definition is workable. We do not see how financial reporting transparency will be improved if a swap, with an embedded option for which no premium is initially exchanged, is accounted for a financing element and an on-market swap with an embedded option, rather than as a derivative in its entirety. Furthermore, market participants view this type of contract to be a derivative in its entirety and do not make a distinction of the financing element.

Due to the proposed changes in the definition of a derivative, substantial costs will be incurred to modify relatively new accounting systems that were put into place upon adoption of SFAS 133, to accommodate artificially created derivatives whose terms would be different from what its contract reflect (such as the artificially created at-the-money swap with embedded call/puts that result from bifurcating an interest rate swap with an embedded call/put when the fair value of the swap equals zero at inception).

We strongly believe that companies should be permitted to treat a hybrid contract that would otherwise have to be bifurcated, as a derivative in its entirety and carried at fair value. Currently, the Board has provided that choice for non-option-based contracts that require an initial net investment that is less than 5% of the fully prepaid amount. Permitting that discretion for option-based contracts would be consistent with the Board's goal of having more derivatives on the balance sheet being marked to market.

### **Changes to Shortcut Method**

Based on our understanding of the proposed changes to paragraph 68(b), it appears that the assumption of no ineffectiveness (the "shortcut method") would not be permitted for an interest rate swap with a mirror-image call option unless a premium equal to the fair value of that call was exchanged at inception. Apparently, this change was necessitated by the proposed changes to the definition of a derivative pertaining to option-based contracts in paragraph 6(b).

One of the original benefits of applying the shortcut method as described in paragraph 68 of SFAS 133 was that "it significantly simplifies the computations necessary to make the accounting entries." Since most interest rate swaps with embedded calls or puts have a zero fair value at inception (that is, the premium for the call or put is received over the life of the swap as part of each payment under the swap), such swaps would not meet the definition of a derivative in their entirety, and would therefore not be eligible for the shortcut method. The swap would have to be bifurcated into a debt host and a compound

derivative comprised of an at-the-money swap component and a call/put option component. This required bifurcation and resulting complexity negates the original intent to providing a simplified approach in accounting for the most common and widely held derivative instrument. We urge the Board to consider permitting the shortcut method for interest rate swaps with a mirror-image call or put when the fair value of the swap equals zero or the time value of the embedded call or put option.

We are also concerned that the Exposure Draft provides no transition guidance for existing hedging relationships, that at their inception, qualified for shortcut method, but under the Exposure Draft, would not qualify for shortcut method as it would not have met the 68(b) criteria (as amended) at its inception. As noted above, we urge the Board to expand paragraph 68(b) to include interest rate swaps with a mirror-image call or put that have a fair value of the zero at inception. However, if the Board does not make such a change, we ask that it consider transition guidance to permit the continuation of shortcut method accounting for hedging relationships that qualified for such accounting prior to the effective date of the new standard.

### **Financial Guarantee Contracts**

We support the Board's intent to revise the definition of a financial guarantee contract to more closely align the exemption with that of insurance contracts. However, in paragraph A31 of the Basis for Conclusions of the Amendment, the identified characteristics for a financial guarantee contract are internally inconsistent. In one characteristic, the Board only appears to contemplate a financial guarantee contract in which the guaranteed party has direct exposure by owning the asset directly. In another characteristic, the Board seems to acknowledge that an insurable exposure may result from a contractual commitment, rather than by owning the asset directly.

Specifically, paragraph A31 articulates the characteristics of a financial guarantee that is exempt under paragraph 10(d):

- (a) the guaranteed party's direct exposure on the reference asset must be present both at the inception of the contract and throughout its life;
- (b) the guaranteed party has an amount due from the debtor (...because an event of default occurred ...) and that amount is past due; and
- (c) compensation paid to the guaranteed party under the contract does not exceed the direct exposure of the guaranteed party relating to the referenced asset either from owning the referenced asset or from other contractual commitments...

The wording in (c) of paragraph A31 is very clear that the guaranteed exposure may result from a contractual commitment, but the wording in (a) and (b) is not.

As noted in paragraph A30 of the Basis for Conclusions, the Board attempts to establish symmetry between the exception for insurance contracts and financial guarantee contracts, and states, "guarantees eligible for the scope exception are similar to insurance

contracts in that they entitle the holder to compensation only if, as a result of an insurable event ... the holder incurs a liability or there is an adverse change in the value of a specific asset or liability for which the holder is at risk.” This notion of having an insurable exposure due to the incurrence of a liability is not carried through to characteristics (a) and (b) in paragraph A31.

For example:

Assume Company A has assumed credit risk by entering into a credit derivative with Company B, a third party. The credit derivative is marked-to-market through earnings. Company A then purchases a financial guarantee contract, which provides for Company A to be paid in the event it has to pay Company B (because the underlying debtor fails to satisfy its payment obligation). Company A would receive 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 Company B was paid. Company A, in turn, seeks reimbursement for the amount paid to Company B under its financial guarantee contract.

In the above example, the financial insurance contract protecting Company A appears to have met the criteria in the paragraph 10(d) amended language. However, it is not clear whether the characteristics articulated in items (a) and (b) of paragraph A31 of the Basis for Conclusions have been met.

## **Proposed D2 Model**

### ***Requirement that the Host Contract is Debt***

We do not agree with the Board’s conclusion that all beneficial interests issued by QSPEs are debt host contracts. We believe this view is arbitrary, and causes bifurcation when there is essentially a 100% pass-through of cash flows. We note that paragraph 60 of Statement 133 discusses the Board’s views on application of the clearly and closely related criteria, and states, “if the host contract encompasses a residual interest in an entity, then its economic characteristics and risks should be considered that of an equity instrument. ...” So the proposed change appears to be inconsistent with existing Generally Accepted Accounting Principles (“GAAP”). Additionally, we note that the absence of voting rights in a legal-form equity interest is not unique to beneficial interests. Companies may have several classes of common and preferred stock outstanding, of which some may not carry voting rights. Thus, we believe the determination of the host contract should be an area of judgment based on the substance of the beneficial interest and the application of existing literature.

### ***Determination of Clearly and Closely Related Based on Substance***

We strongly believe that beneficial interests that are economically substantially the same should be accounted for in the same manner. This is consistent with the Board’s objective to “developing neutral standards that result in accounting for similar transactions and circumstances in a like manner.” However, the tentative conclusion in

Statement 133 Implementation Issue No. B36 (“Issue No. B36”) is in conflict with that objective, and results in vastly different accounting for virtually identical instruments.

There is no compelling economic reason or conceptual accounting rationale to distinguish between beneficial interests issued by an SPE with a synthetic credit risk and beneficial interests issued by an SPE that directly owns the assets on whose credit the beneficial interests are based.<sup>1</sup> In the former case, investors in synthetic credit SPE must bifurcate their beneficial interest. In the latter case, investors in cash SPE do not bifurcate their beneficial interest.

The tentative conclusion to Issue No. B36 focuses on whether the beneficial interest “incorporates a credit risk exposure that is different from the risk exposure arising from the creditworthiness of the issuer.” The examples provided in Issue B36 focus on whether the referenced assets are physically held inside of the SPE. We strongly believe the determination of clearly and closely related should focus on whether the referenced *exposure* (whether an asset or liability) resides within the issuing SPE.

Additionally, we find it inconsistent for Statement 133 Implementation Issue No. B12 to look to the “securitized instruments” (assets and derivatives held by the vehicle) to determine whether there is sufficient cash flow to satisfy the terms of the beneficial interest, but under Issue No. B36, an investor may only look to the securitized assets held by the SPE.

Economically, there is no difference in holding an exposure by owning a beneficial interest in underlying cash assets and holding that exposure synthetically through a beneficial interest in Treasuries (or like collateral) combined with a written credit default swap referencing those same cash assets. The beneficial interests hold the same credit profile under each scenario.<sup>2</sup> It is conceptually unsupportable that different accounting treatment results from how the same economic risk gets assembled before the tranching of beneficial interests and sale to investors.

Additionally, in many cases, the SPE with the synthetic credit risk via a credit default swap must take physical delivery of the referenced cash assets upon default. Again, it is conceptually unsupportable that different accounting treatment results depending on

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<sup>1</sup> SPEs with synthetic credit risk (e.g., synthetic CDOs) are created when comparable cash transactions may be unachievable. For example, synthetic CDOs are created to give investors access to (1) customized credit exposures that might not exist in cash form (e.g., a 3.2 year exposure to the credit risk of a 10 name pool of mortgage reinsurers), (2) asset classes that investors could not maintain a direct investment in for legal, operational or other reasons (e.g., operationally intensive bank lending agreements), or (3) specific credit exposures relating to assets that the existing owner does not wish to transfer for relationship reasons or that are very difficult or impossible to transfer due to applicable legal or consent requirements.

<sup>2</sup> We note that synthetic exposure introduces counterparty credit risk. However cash CDOs often swap fixed rate assets to floating rate assets, thereby introducing the same type of counterparty credit risk through ongoing credit default swap premium payments. While less common, synthetic CDOs could be designed such that the credit default swap premium is prepaid (rather than over time) thereby eliminating post-closing counterparty credit risk.

whether a SPE owns the referenced assets at closing or has committed (via the derivative) to take forward delivery of those assets upon a default.

Finally, the application of Issues No. B36 and D2 assumes either a pure cash SPE structure or a pure synthetic SPE structure. In our experience, it is increasingly common for SPEs to be “blended,” that is, owning referenced assets directly and synthetically. Many cash collateralized debt obligation structures (“CDOs”) own 90-95% referenced assets and have 5-10% credit exposure from derivatives or credit-linked notes. Conversely, many synthetic CDOs are beginning to own referenced assets directly. It is unclear how the conclusions reached in Issues No. B36 and D2 will be applied in assessing whether the beneficial interests issued by these blended structures should be bifurcated.

For the reasons articulated above, we strongly believe that Issue No. B36 be deleted in its entirety and that the guidance in Issue No. D2 and various implementation issues should be modified to require that the prepayment and credit risks embedded in beneficial interests related to referenced exposures that are held both directly and indirectly by the SPE. We propose that Issue No. D2 be modified to read as follows:

“Consistent with the logic in Implementation Issue B15, if either prepayment or credit risks are embedded in subordinated beneficial interests and those risks relate only to the securitized ~~assets~~ instruments, then those implicit prepayment or credit derivatives should not be bifurcated from the host contract.”

### ***Statement 133 Implications for QSPE Status***

We strongly object to the idea that the forced creation or recognition of additional derivatives through the D2 model can result in a QSPE losing its qualifying status. Consider the following:

- The loss of qualifying status would result in the transferor consolidating the QSPE’s assets and liabilities (including the various tranches of beneficial interests sold). We believe requiring consolidation due to the application of the D2 model undermines, and is in conceptual conflict with, existing and proposed consolidation standards for QSPEs, which focus on effective control.
- The existing Statement 140 model provides that the transferor will not consolidate a QSPE if certain conditions are met. Requiring consolidation simply because “derivatives” are created due to the application of the D2 model, when the form and the substance of the structure has not changed is not conceptually supportable.
- As a practical matter, existing QSPEs were entered into with an existing body of GAAP governing their structure, permitted activities, permitted holdings, etc. Market transactions were entered into in good faith within the framework of that

existing GAAP. We believe it is unduly burdensome to force an extremely time-intensive exercise on the parties to these transactions.

- The proposed grandfathering provision of paragraph 42 of the Exposure Draft is inadequate for a large number of investor (as distinct from issuer) QSPEs. First, a number of such QSPEs issue beneficial interests to repay maturing beneficial interests and thus would not qualify for the proposed grandfathering provision of paragraph 42 solely due to how they funded previously acquired assets.<sup>3</sup> Second, a number of such QSPEs were designed to passively receive assets over time in conformity with FAS 140. To the extent such QSPEs currently own assets that may be subject to bifurcation under the Exposure Draft, they are now unable to receive new assets without the potential loss of QSPE status purely due to the retroactive application of the proposed D2 model to beneficial interests and not any failure to meet previously understood GAAP.

Therefore, we strongly urge the Board to exempt all beneficial interests in securitized assets issued prior to the effective date of the Amendment. Additionally, we urge the Board to provide an opportunity for a holder of a beneficial interest to transfer that interest into the “available for sale” or “trading” category under Statement 115. This would enable a holder to avoid bifurcating an instrument under the proposed guidance and recognize the entire change in fair value in earnings.

Finally, we do not believe that it was the Board’s intent to disqualify common securitization structures from being QSPE’s solely due to the presence of “derivatives” that are created by the D2 model. Accordingly, we believe the Statement 140 Q&As should not be issued. Rather paragraph 40(c) of Statement 140 should be modified to focus the evaluation of the derivative interest held by the QSPE on whether it pertains to the *economic characteristics* of beneficial interest held by parties other than the transferor, its affiliates or its agents. In that regard, we support the Joint Industry Working Group’s proposal to modify paragraph 40(c) as follows:

*“Has characteristics that relate to, and partly or fully but not excessively counteract, some risk associated with those beneficial interests or the related transferred assets, or serve to allocate cash flows within the qualifying SPE in order to provide for risks and cash flows to the beneficial interest holders that are consistent with the substantive terms of the beneficial interests.”*

### **Aggregating Guidance for Beneficial Interests**

We urge the Board to consider aggregating guidance for beneficial interests. Currently, in order to determine how to account for a beneficial interest under Statement No.133 and its interpretations, one has to consider all of the following guidance: Statement Nos. 133,

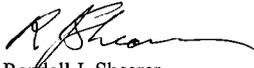
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<sup>3</sup> For example, an investor QSPE that has acquired assets and funded such assets with commercial paper must issue new commercial paper to repay maturing commercial paper. A related FAS 140 issue is being considered by the EITF currently as Issue 02-12.

the proposed amendment, Implementation Issues Nos. A20, B12, B15, B36, C17, and D2. Additionally, within these Implementation Issues, there are confusing cross-references to other Implementation Issues (e.g. Implementation Issue No. D2 references 7 other Implementation Issues).

We appreciate the opportunity to bring these matters to your attention. Bank of America Corporation would be happy to assist the Board in any way it can to facilitate the completion of this project.

Sincerely,

A handwritten signature in black ink, appearing to read 'R. Shearer', with a long horizontal flourish extending to the right.

Randall J. Shearer  
Senior Vice President  
Accounting Policy