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# OJPMorganChase

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Ms. Suzanne 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 1100-163

<u>Proposed Statement of Financial Accounting Standards, Amendment of Statement 133 on Derivative</u> Instruments and Hedging Activities

Dear Ms. Bielstein:

J.P. Morgan Chase & Co. appreciates the opportunity to comment on the Financial Accounting Standards Board's ("FASB" or the "Board") May 1, 2002 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 No. 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 the purposes of this comment letter, the proposed guidance covering beneficial interests in securitized financial assets may be referred to as the "D2 model."

We have actively participated in the drafting of the comment letter submitted by the Joint Industry Working Group ("IIWG") comprised of members of The Bond Market Association, the International Swaps and Derivatives Association and the Securities Industry Association. As such, our detailed comments to the specific issues raised by the Board in the Exposure Draft, the implementation guidance and the Statement 140 Q&As are reflected in that comment letter. However, since we have serious concerns regarding this proposed guidance, we felt it necessary to provide our overall views separately.

In summary, we are concerned that the complex changes proposed by the FASB will increase the difficulty that investors and other users have in understanding a company's investments and derivative positions. As currently written, the proposed guidance will be costly to implement and provide little benefit to investors analyzing the financial position of a company. Additionally, we are concerned that

the Exposure Draft represents a further departure from principle-based standard setting, as the guidance is primarily a set of detailed rules and in some instances "bright lines." There is no clear conceptual basis for several changes proposed in the Exposure Draft, including the revisions to the definition of a derivative, a cornerstone of Statement 133.

A summary of our concerns is as follows:

#### Evaluation of Beneficial Interests in Securitized Financial Assets

We believe that without significant revision and simplification, financial statement preparers will have considerable difficulty understanding and applying the proposed D2 model. Requiring investors to perform what appears to be an exhaustive search for embedded derivatives based on accounting definitions rather than the underlying economic nature of a beneficial interest creates confusing accounting results and a myriad of practice issues for which the guidance is not clear or is silent. Frequently, the derivative identified represents a theoretical component of an instrument that is not recognized in the market.

In fact, we believe that application of the proposed D2 model will decrease transparency in financial statements as instruments are divided into separate but interdependent theoretical pieces accounted for under different accounting models. We acknowledge that certain hybrid instruments are currently bifurcated under Statement 133. However, the analysis of beneficial interests is significantly more complicated than the analysis of a typical structured note. The guidance itself is so complex that we have concerns that financial statement preparers will not be able to consistently apply the guidance and financial statement users will have difficulty comparing results between different companies.

We strongly believe that the following changes are critical to make the D2 model workable:

1) The Board should not establish a separate framework for the analysis of beneficial interests in securitized financial assets. Rather, beneficial interests should be evaluated for embedded derivatives in accordance with paragraphs 12-15 of Statement 133 and existing Statement 133 Implementation Issues, the same evaluation applied to all other hybrid instruments. Specifically, the model should be based on the concepts in Implementation Issues No. B19, Embedded Derivatives: Identifying the Characteristics of a Debt Host Contract and B20, Embedded Derivatives: Must the Terms of a Separated Non-Option Embedded Derivative Produce a Zero Fair Value at Inception?, and the definition of an equity host in Statement 133. Additionally, there should not be nonsubstantive distinctions between qualifying SPEs and other SPEs. We strongly believe that the long-term benefits of a simpler model for evaluating beneficial interests based on the stated and implied substantive terms of an instrument far outweigh any perceived benefits of prescribing additional detailed implementation guidance.

We believe that any concern that embedded derivatives may not be bifurcated under a simplified model is mitigated by existing accounting guidance, including EITF 99-20. To comply with EITF 99-20, constituents must capture all of the expected future cash flows that are incorporated in the beneficial interest and update those cash flow expectations at each reporting period to

properly depict the effective yield of the instrument and to record any other-than-temporary declines in value that might occur.

2) To minimize the operational burdens associated with this guidance, we propose that all existing beneficial interests issued prior to the effective date of the amendment, regardless of the type of SPE that issued the instruments, should be grandfathered from the application of the proposed guidance. Proper valuation of an embedded derivative requires valuation of the embedded derivative at inception of the hybrid instrument, not just at the adoption date of the new guidance. Retrospective application of the new guidance will require companies to evaluate multiple years of data to record a cumulative-effect-adjustment of net income. Our proposal is consistent with the original grandfathering guidance for hybrid instruments upon the initial adoption of Statement 133 that allowed prospective application of the hybrid instrument bifurcation rules.

#### Statement 133 Implications for Qualifying SPEs ("QSPE")

We strongly disagree with the concepts presented in the Statement 140 Q&As, which indicate that investor accounting for beneficial interests under the proposed D2 model can impact the characterization of a vehicle as qualifying. The intent of the Statement 140 financial components approach was to introduce a framework that would result in accurate reporting of an entity's rights and obligations. These rights and obligations could result from innovative financial techniques, which include SPEs entering into various types of derivative transactions to create a specific risk profile. Depending on the terms of the interests issued by the QSPE, an investor may or may not have an embedded derivative under the proposed guidance. However, Statement 133 and other existing accounting guidance such as EITF 99-20 will ensure that these risks are captured.

The QSPE nonconsolidation framework and investor accounting for the beneficial interests issued by the QSPE are two distinct and separate issues. We believe the QSPE model should focus on elements that indicate whether the entity is controlled, which is unrelated to the investor's accounting for its interest issued by the QSPE. Therefore, our recommendation is for the Board to amend Statement 140 by removing the following paragraphs and phrases:

#### Paragraph 35(c)2:

The revised language should read: Passive derivative financial instruments.

# Paragraph 40:

Delete lead-in sentence, and delete paragraphs 40b and 40c. Retain paragraph 40a.

We believe these modifications will eliminate limitations that do not relate to whether the QSPE is a controlled entity. We understand that the Board is reluctant to amend Statement 140; however, common structures that clearly meet the intent and requirements of Statement 140 today may no longer be considered qualifying if the proposed D2 model is adopted and Statement 140 is not amended.

For example, assume that \$100 million of fixed-rate assets are transferred to a QSPE. The QSPE issues three classes of floating-rate beneficial interests for a total of \$90 million and the transferor retains a \$10 million residual interest and one of the classes of floating-rate beneficial interests issued (\$10 million).

There are no freestanding derivatives held by the QSPE. Under the proposed D2 model, the transferor may be required to bifurcate an embedded inverse floating interest rate swap with a notional of 90 million from the residual interest. Paragraph 35(c)2 of Statement 140 requires that derivatives held by the QSPE pertain to beneficial interests issued to third parties. In this case the "derivative" bifurcated from the residual interest may relate, in part, to the floating-rate beneficial interest retained by the transferor, not to beneficial interests held by third parties, resulting in the QSPE losing its qualifying status. Another example of a common securitization structure that would be negatively impacted by the proposed guidance is a net interest margin (NIM) securitization, which is described in detail in the Joint Industry Working Group letter.

We do not believe that the Board intended to disqualify these types of QSPEs and urge the Board to reconsider the derivative provisions of Statement 140 as proposed above to address this. Consistent with our proposals herein, we recommend the elimination of the Statement 140 Q&As.

#### Definition of a Derivative

We do not support the establishment of arbitrary "bright lines" to determine if an instrument should be considered a derivative as we do not believe that standards set without a clear conceptual basis are sustainable long-term. To the contrary, we believe that judgment is appropriate for determining the accounting for an instrument, since judgment allows one to consider the substance of the contract and account for similar transactions similarly. We realize that the Board has reservations about the level of judgment that one may apply in evaluating derivatives. However, the proposed revision does not fully resolve those concerns and, in certain cases, it creates additional accounting inconsistencies. For example, a call option with a strike price of zero would be considered a derivative in its entirety under the Exposure Draft, whereas a nonoption-based contract would be analyzed under the five percent initial net investment threshold. If the Board proceeds with the proposed definition, then the Board should acknowledge that the revised derivative definition might result in inconsistent accounting for contracts with similar economic profiles. Again, we believe that judgment is more appropriate in these circumstances and recommend that the current concept of "small" initial net investment be retained. For nonoption-based instruments that require an initial net investment but are still considered derivatives in their entirety, we support the Board's proposal to allow constituents a practical alternative to either bifurcate these instruments or account for them as derivatives in their entirety.

As a market maker and provider of derivatives, we strongly believe that the requirement to bifurcate certain derivative contracts into a cash instrument and a separate derivative is not justified from a cost-benefit analysis and that more relevant information is provided to users of our financial statements when the entire contract is reported at fair value with changes in value recognized in earnings. The systems and operations effort required to automate these initial net investment tests and to account for these instruments would be tremendous. The Board's mission statement charges the Board to determine that a proposed standard will fill a significant need and that the costs it imposes will be justified in relation to the overall benefits. Paragraph A8 of the Basis for Conclusions further states, "The Board recognizes that the need to evaluate contracts under the new guidance in this Statement comes at a cost. However, the Board believes that the benefits of more consistent reporting of contracts will outweigh the cost of implementing this Statement." We do not believe that that the costs of this particular guidance are justified for financial intermediaries who actively utilize these instruments for trading purposes. We

firmly believe that the only practical solution is for the Board to provide optional mark-to-market accounting for these instruments.

### Providing an Alternative to Bifurcation

We strongly support the Board providing constituents with the option to record hybrid instruments with embedded derivatives that are not clearly and closely related to the host contract at fair value with changes in value recorded in earnings. This is particularly important considering the proposed revision of the definition of a derivative and the proposed model for evaluating beneficial interests. Allowing this treatment would not only achieve the Board's objective of ensuring that all derivatives are recorded at fair value, but would also lessen the significant operational burdens that would be created for constituents. Such an approach is consistent with the proposed amendment to IAS 39, where the IASB has proposed that any financial asset or liability may be measured at fair value with changes in fair value recorded in earnings by designating the instrument as held for trading. The objective of the proposed amendment to IAS 39 is to simplify the application of the standard (for example, for hybrid instruments) and to provide for consistent measurement of financial assets and financial liabilities.

#### Financial Guarantees

We support the Board's attempt to clarify paragraph 10(d) and believe that the proposed guidance in paragraph 7(c) of the Exposure Draft is intended to capture the substance of a guarantee, which is the contract must provide for payments to be made only to reimburse the guaranteed party for failure of the debtor to satisfy its required payment. However, the additional detailed guidance included in paragraph 7(c), the Basis for Conclusions, and related implementation guidance does not reflect the nature of financial guarantees and creates additional confusion. We therefore recommend that the Board simplify and reduce the amount of guidance in this area and focus on the basic concept of a financial guarantee. A more detailed explanation of our concerns with this guidance and our recommendations are included in Attachment I of this letter.

#### Effective Date

We believe it is necessary for the Board to allow at least one year from the issuance date of the amendment for constituents to implement the new guidance. The proposed effective date does not allow sufficient time for companies to review the final guidance and implement necessary operations and system changes for new and existing transactions. Implementation will require significant data gathering, analysis and complicated valuations of a large population of financial instruments. As previously noted, we urge the Board to grandfather beneficial interests issued prior to the effective date of the final amendment from the application of the proposed guidance.

#### Other Matters

We do not understand why paragraph 19 is being removed as a technical correction to Statement 133.
 This guidance is used in practice and we believe it should be retained in the standard.

We understand that paragraph 68(d) has been revised for consistency with the revised definition of a
derivative for option-based contracts. However, we believe that the Board should allow for the
initial fair value of a swap with an embedded option to equal either the time value of the option
component or zero (consistent with current practice).

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Overall, we believe the proposed changes included in the Exposure Draft, the implementation guidance and the Statement 140 Q&As will add significant burdens to financial statement preparers without significantly increasing the usefulness of the financial information presented. As a result, the Board needs to consider whether the significant cost and effort needed to implement these changes as proposed are warranted. Finally, we urge the Board not to release a final D2 model until the Board completes its pending consolidations guidance. These proposed standards are significantly interconnected and we expect additional issues to be raised during the comment period for the Consolidations Exposure Draft.

We appreciate the opportunity to submit our views and would be pleased to discuss our comments with you at your convenience. If you have any questions, please contact me at 212-270-7559.

Very truly yours,

# Financial Guarantee Scope Exception (Paragraphs 7c and A28-A31)

Overall, we support the Board's attempt to clarify the types of financial guarantee contracts that are included in the scope exception in paragraph 10(d) of Statement 133. However, we find the guidance described in the proposed amendment ambiguous and difficult to apply. Specifically, the exact terms and characteristics the contract must have in order to be eligible for the scope exception are unclear because there are at least two different interpretations of the proposed amendment.

#### Interpretation 1

In order for a contract to qualify for the scope exception, the contract must provide for payment to be made only to reimburse the guaranteed party for failure of the debtor to satisfy its required payment obligations, either:

- · at pre-specified payment dates, or
- because an event of default, as defined in the financial obligation covered by the guarantee contract, occurred and payments were accelerated automatically or by means of notice to the debtor.

# Interpretation 2

In order for a contract to qualify for the scope exception, the contract must provide for payments to be made only to reimburse the guaranteed party for failure of the debtor to satisfy its required payment obligations,

- at pre-specified payment dates or because an event of default, as defined in the financial obligation covered by the guarantee contract, occurred, and
- payments were accelerated automatically or by means of notice to the debtor.

The main difference between the two interpretations is in whether the failure to pay by the debtor must be the result of an acceleration of all payments due under the obligation. We believe that Interpretation 1 is the appropriate interpretation since the guaranteed party should have the right to request payment from the guarantor once the debtor fails to make any contractual payment. This is important because traditional financial guarantees generally permit the guaranteed party to seek reimbursement on the missed payment (e.g., an interest payment) from the guarantor. In addition, certain guarantees (e.g., MBIA bond insurance agreements) provide solely for payment of the failed payment and not for payment upon the acceleration of the obligation. We believe that these types of guarantees should be eligible for the scope exception since they entitle the guaranteed party to compensation for the failure to pay, which the Board has concluded to be the insurable event. In addition, if Interpretation 2 was intended, then creditors would be forced to accelerate the underlying financial obligation in order to gain recourse to a guarantee, rather than to seek to work out and restructure the terms of the financial instrument with the debtor. This unintended result should be avoided. Paragraph A30 of the Basis for Conclusions states "that, in order for a financial guarantee 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." Based on this statement, we believe the Board intended the guidance to be reflective of Interpretation 1; therefore, we recommend the wording be

changed to clarify the guidance. See below for our suggested wording for the financial guarantee scope exception.

We also strongly encourage the Board to reconsider the requirement that, "the guaranteed party be exposed to risk of nonpayment both at inception of the financial guarantee contract and throughout its term." We are not sure why the Board proposed this requirement since the amendment includes language that requires payments must be made to reimburse the guaranteed party. The critical point is that the contract will not result in payment unless the debtor fails to make a required payment to the guaranteed party. If the guaranteed party does not have the actual credit exposure at the time of the default, then the guaranteed party will not be paid under the guarantee contract. We believe this distinction must be made since a guaranteed party cannot represent that it will have exposure throughout the guarantee's term because a debtor may be entitled to prepay on its obligations. In addition, there are times that a creditor will only consider extending credit if an existing guarantee agreement is in place. Consequently, the guaranteed party may not have exposure at inception of the guarantee contract. Furthermore, a guaranteed party might acquire a guarantee when it purchases a loan, which is after the inception of the original financial guarantee contract. Therefore, we recommend that the Board change the proposed guidance to state that the guaranteed party must be exposed to the risk of nonpayment as a precondition for payment of a claim by the guarantor.

Furthermore, we recommend that the guidance in Issue C7 be removed, because it raises significant issues with respect to the requirement for contractual documentation. Specifically, Issue C7 mandates that the contract require the guaranteed party be exposed to loss at inception and throughout its term and that the compensation paid to the guaranteed party under the contract not exceed the direct exposure of the guaranteed party relating to the referenced asset. Requiring that the contract itself specify these features introduces the real possibility that the contract will be indistinguishable, as a legal matter, from an insurance contract, which is generally differentiated from other financial contracts by virtue of the requirement that the guaranteed party suffer loss in order to be compensated. While financial guarantees present similar economic features to credit insurance, financial guarantees are distinguishable from insurance because they do not contain such requirement. As a result, providers of guarantee protection are unwilling to accept these features in contracts precisely because of the risk that their activity might be construed as selling insurance, with potentially adverse regulatory and economic implications. Consequently, requiring such language to be included in our financial guarantees will have a materially negative impact on our ability to source credit protection for credit assets. Fortunately, as we elaborate in the subsequent two paragraphs, it is redundant for the contract itself to include this language in order to be excluded from Statement 133, because the contract will only provide payments to be made to the reimburse the guaranteed party for a failure of the debtor to make a payment.

If the Board decides not to remove Issue C7, then we request that the language in Issue C7 be modified to delete the requirement that the contract require the guaranteed party be exposed to loss at inception and throughout its term. As indicated above, we believe it is redundant for the contract to include this requirement in order for the contract to be excluded from Statement 133, because the contract will only provide payments to be made to reimburse the guaranteed party for a failure of the debtor to make a payment. Also for reasons noted above, a guaranteed party cannot represent that it will have exposure over the life of the contract.

Paragraph A31 states that the amended language was written to include financial guarantees with certain characteristics, including that "the compensation paid to the guaranteed party under the contract does not exceed the direct exposure of the guaranteed party relating to the referenced asset..." We believe this characteristic is explicit in the amendment itself. The amendment requires that guarantees qualifying for the scope exception provide for payments to be made only to reimburse a debtor's prior failure to pay such obligation. Thus, a guarantor is not required to pay a guaranteed party more than what the debtor owes to such party. Again, we are concerned that this statement in paragraph A31 could cause a financial guarantee contract containing this provision to be considered an insurance contract for legal purposes. Therefore, instead of the financial guarantee contract requiring that the amount paid under the contract not exceed the referenced asset's exposure, we believe this concept could be satisfied by a guarantee that states that the guarantor will pay the guaranteed party those amounts due from, but not paid by, the debtor.

Paragraph A30 states that in order for a financial guarantee to qualify for the scope exception in paragraph 10(d), the guaranteed party must relinquish rights of subrogation to the guarantor in order to receive payment by the guarantor. If these words are taken literally, then the requirement of subrogation will inappropriately disallow many financial guarantees from being eligible for the scope exclusion that would have otherwise qualified for the exclusion. Certain financial guarantees, including parent/subsidiary guarantees, contain a provision pursuant to which the guarantor waives all rights of subrogation until such time as the guaranteed party no longer has exposure to the debtor under the referenced asset. This is done in order to preserve the guaranteed party's priority of claim over any claim against the debtor that the guarantor, by means of subrogation, may have. However, what is important is that the waiver of subrogation not permit the guaranteed party to receive payment from the debtor for amounts already paid by the guarantor. Thus, the waiver of subrogation is consistent with the concept that the guaranteed party not receive payment in excess of its exposure. Based on the above, we strongly recommend the Board remove the requirement of subrogation from the amendment.

We ask the Board to clarify the following statements in paragraph A29, "to emphasize the need for the guaranteed party to demand payment and <u>attempt collection</u> prior to collecting any payment from the guarantor." Most financial guarantee contracts used today are "guarantees of payment" which only require notification to the debtor if there has been an event of default *and* payments have been accelerated, unless a bankruptcy event has occurred, which normally results in automatic termination of a loan commitment and acceleration of all amounts then outstanding. The basis for conclusion may be interpreted to mean that the guarantor would have to exhaust all its collection rights from the debtor before being paid under the guarantee, which is not required under a guarantee of payment. Based on the March 13, 2002 FASB Board meeting, we do not believe it was the Board's intent to have the guaranteed party exhaust all rights of collection before being paid in order for the guarantee contract to be excluded from Statement 133. Indeed, our understanding of the Board's point was the guaranteed party must demand payment from the debtor and if the debtor does not honor the request, then the guaranteed party may seek payment from the guarantor. The Board should consider clarifying this in the Basis for Conclusions

Also, paragraph 7c includes in the scope exception guarantee contracts that reimburse the guaranteed party for a failure to pay resulting from an automatic acceleration of the payment obligation. We agree

with the provision for automatic acceleration, but the Basis for Conclusions is silent on this point. We believe this should be added to paragraph A29 of the Basis for Conclusions for completeness.

In addition, we recommend that the guidance not use the term "pre-specified" payment dates because some payment obligations within a loan agreement do not have pre-specified payment dates (c.g., demand loans and mandatory prepayments based on an occurrence of a contingent event, such as an asset disposition or an equity offering). We believe that it is the Board's intent to include all contractual payment obligations, even if the obligation does not have a pre-specified payment date.

Based on our above comments, we strongly recommend the Board rewrite paragraph 7 as follows:

Financial guarantee contracts are not subject to this statement if they provide for payments to be made to reimburse the guaranteed party for a failure of the debtor to make any payment when due under its financial obligation. This would include, among other situations, the debtor's failure to make payment subsequent to an acceleration (automatic or by notification to the debtor) of all payments due under the financial obligation because an event of default as defined in the financial obligation covered by the guarantee has occurred. The guaranteed party must be exposed to the risk of nonpayment as a precondition for payment of a claim by the guarantor. 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.

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We believe the above changes to the guidance address our concerns as well as clarify the scope exception for all interested parties.

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