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Mr. Russell G. Golden Technical Director Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116 * I S S U E - C 2 2 *

LETTER OF COMMENT NO. 5

File Reference: Proposed Issue C22

Dear Mr. Golden:

Deloitte & Touche LLP is pleased to comment on proposed Statement 133 Implementation Issue No. C22, "Scope Exceptions: Exception Related to Embedded Credit Derivatives" (the "proposed Issue" or the "proposal").

We support the Board's efforts to resolve ambiguity about application of the embedded credit derivative scope exception in paragraph 14B of Statement 133; however, we do not believe that the proposed Issue in its current form will achieve this objective. We do not believe the proposal succeeds in establishing a clear principle that will be consistently applied in practice. Moreover, the amended examples in the proposal introduce additional uncertainty about how to appropriately apply the guidance in paragraphs 14A and 14B of Statement 133. We also encourage the Board to consider whether undertaking a convergence project in this area with the IASB would provide greater benefit to constituents.

Principle Established in the Proposed Issue

Overall Principle for Identifying an Embedded Derivative

The proposal, as drafted, does not set forth a clear principle regarding how the holder of an interest in securitized financial assets should apply paragraphs 14A and 14B of Statement 133 when assessing whether its interest is a freestanding derivative or contains an embedded derivative. The lack of a clear principle will perpetuate the diversity in practice that this proposed Issue is attempting to eliminate.

As amended by the proposed Issue, paragraph 14B would be limited to stating that the "concentration of credit risk in the form only of subordination of one financial instrument to another shall not be considered an embedded credit derivative"; however, that paragraph would not provide guidance on determining what should be considered a credit derivative that needs to be evaluated under paragraphs 12 and 14A. FSP FAS 133-1 and FIN 45-4² describes a credit

¹ FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities.

² FASB Staff Position No. FAS 133-1 and FIN 45-4, "Disclosures About Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45; and Clarification of the Effective Date of FASB Statement No. 161."

derivative, but that description focuses on the derivative seller's perspective and seems inadequate for assessing whether an interest in a securitization structure contains an embedded credit derivative. Also, none of the examples in the proposal refer to that description.

In the absence of a more comprehensive description or definition of a credit derivative, an interest holder's ultimate determination of whether its interest contains an embedded derivative would depend on its interpretation of how to apply paragraph 14A of Statement 133. That paragraph requires the holder of an interest in securitized assets to "determine whether the interest is a freestanding derivative or contains an embedded derivative" that would require bifurcation. An entity must make that determination "based on an analysis of the contractual terms of the interest in securitized financial assets, which requires understanding the nature and amount of assets, liabilities, and other financial instruments that compose the entire securitization transaction."

The proposed Issue does not clearly articulate a principle regarding when an embedded derivative exists in a beneficial interest and thus requires further bifurcation analysis. However, two possible principles may be inferred from a review of the examples included in the proposal.

Under the first principle, a beneficial interest would be deemed to contain an embedded credit derivative that the interest holder must evaluate for bifurcation only if the terms of underlying instruments held by the special-purpose entity (SPE) create the possibility that the interest holder could, on the basis of a credit event, lose more than its original investment (i.e., the interest holder would be required to invest additional amounts in the trust or pay the issuer). Any other reduction in cash flows available to the interest holder that is capped at the amount of its original investment (i.e., no obligation to provide additional capital) would be viewed as subordination that would not be considered an embedded derivative in accordance with the amended paragraph 14B. The analysis in Example 40 seems to suggest that as long as assets in the SPE are sufficient to absorb any losses on a credit default swap written by the SPE that is referenced to a third party's credit, thereby ensuring that the investor cannot lose more than its original investment and would not be required to provide additional capital, there would not be an embedded credit derivative.

Under the second principle, an embedded derivative could exist in a beneficial interest solely because the interests issued by the SPE are referenced to credit risks not present in the underlying holdings of the trust, even when it is apparent that the trust still would produce sufficient cash flows to ensure that the interest holder could not lose more than its original investment. The proposed Issue's Basis for Conclusions (the "Basis") seems to suggest that an embedded derivative should be recognized in this circumstance, noting that "the Board emphasized that credit risk that is not related only to the subordination of one financial instrument to another must be evaluated under paragraphs 12, 13, and 14A [of Statement 133]." The Basis also suggests that a credit default swap on unrelated public-company debt would not be clearly and closely related to the host contract and may need to be evaluated for bifurcation. Similarly, Example 38 notes that the "beneficial interests would be a hybrid financial instrument with an embedded derivative . . . because the embedded credit derivative feature referenced to Company B is not based only on the concentration of credit risk in the form of subordination of one financial instrument to another"

The Board should clarify in the body of the proposed Issue the principle that an interest holder should apply in determining whether an embedded credit derivative exists in its beneficial interest. In particular, the Board should specify whether (1) any new risk introduced by an issued interest that is not explicitly referenced to underlying holdings of the securitization structure is an

embedded feature requiring a bifurcation analysis or (2) a determination that an interest holder does not risk losing more than its original investment results in a conclusion that the credit feature is either clearly and closely related to the host (and not subject to a bifurcation analysis) or alternatively should be viewed as a subordination feature that is not deemed an embedded derivative under paragraph 14B.

Other Issues Regarding Application of Paragraph 14A

A number of other questions exist in practice regarding how to appropriately apply paragraph 14A, and the examples in the proposed Issue may raise additional implementation questions. As noted above, paragraph 14A requires an interest holder to determine whether an interest in a securitization is a freestanding derivative in its entirety; however, there is no clear guidance on how to make this determination. For example, it is unclear whether the holder of an interest in securitized financial assets, when the SPE holds nothing but derivative instruments, should consider that interest a freestanding derivative or a debt instrument and evaluate it for embedded derivatives.

Also, the proposed Issue and its examples should indicate whether its principle for identifying embedded credit derivatives that may need to be bifurcated applies equally to the holders of interests in securitizations and the issuers of those interests (or the entities that consolidate the issuers) — i.e., whether the accounting should be symmetrical.

It is also unclear how the guidance in this proposed Issue and paragraph 14A interacts with that in Implementation Issue B36.³ The economic characteristics and risks of the synthetic collateralized debt obligation (CDO) described in Example 40 are similar to the economic characteristics and risks of the credit-linked note described in Implementation Issue B36. In the discussion of the credit-linked note, Implementation Issue B36 concludes that "the credit risk exposure of the reference security (Company X) and the risk arising from the creditworthiness of the obligor (Company A) are not clearly and closely related" and most likely would result in bifurcation of the embedded credit derivative. That Issue also states that its guidance should be applied to all other arrangements that incorporate credit risk exposures that are unrelated or only partially related to the creditworthiness of the issuer of that instrument.

Example 40 concludes, however, that an interest in a fully funded synthetic CDO does not contain an embedded derivative even though the SPE has written a credit default swap on a referenced credit to a third party. Unless the proposed Issue reconciles the conclusion in Example 40 to Implementation Issue B36 (from the perspective of both the interest holder and the issuer or consolidator of the issuer), different accounting could be applied to structures with similar, if not identical, economics (i.e., the form of the structure could dictate the accounting). This may encourage active structuring to receive a desired accounting outcome (e.g., an entity could embed a derivative in a securitization structure and avoid separate recognition of the derivative as a freestanding derivative).

³ Statement 133 Implementation Issue No. B36, "Embedded Derivatives: Modified Coinsurance Arrangements and Debt Instruments That Incorporate Credit Risk Exposures That Are Unrelated or Only Partially Related to the Creditworthiness of the Obligor Under Those Instruments."

Examples in the Proposed Issue

Need for Simplification

The proposed Issue adds a number of examples to illustrate its guidance; however, as noted above, it is difficult to infer from the examples a single principle that should be applied in determining whether an interest in a securitization contains an embedded credit derivative that may require bifurcation. A principle might be more easily illustrated if the examples in the proposed Issue were simplified (e.g., assumed a single tranche instrument) or reflected structures commonly seen in practice.

Overall Principle for Identifying an Embedded Derivative

A number of examples state conclusions about whether a derivative feature would be considered clearly and closely related to the host contract, but do not give any details about the basis for the conclusions. Incorporating such an explanation into the examples would help reduce diversity in practice. In particular, it would be helpful if the final Issue clarified whether the fact that an investor could lose more than its original investment would automatically mean that the holder's interest incorporated a derivative not deemed to be clearly and closely related to its host contract (i.e., whether a paragraph 12(a) analysis would still need to be performed). Also, several examples indicate that the interest holder should apply paragraph 14A after it has determined that an embedded derivative feature exists in the beneficial interest. This reference seems circular, since the entity already would have had to perform an evaluation under paragraphs 14A and 14B to determine that an embedded derivative exists in the beneficial interest.

Similarly, Examples 38, 39, and 40 appear designed to illustrate how to determine whether an interest in a securitization contains an embedded credit derivative. It is unclear why these examples cite the possible need to apply paragraph 13 of Statement 133, which is not related to embedded credit derivatives. The reference to paragraph 13 is particularly confusing in Examples 39 and 40, because the embedded derivative analysis in those examples focuses on whether the investor can lose *more than* its original investment; paragraph 13(a) uses a standard of whether an investor might not recover *substantially all* of its initial recorded investment. In these examples, the Board should clarify how the references to paragraph 13 are relevant.

Reassessment

A number of examples indicate that if the notional amount of a derivative in an SPE trust matches the notional amount of assets whose cash flows are being modified by the derivative, then an interest in the trust most likely would not have an embedded derivative because the derivative would not negatively affect the trust's cash flows to the extent that an interest holder could lose more than its original investment. However, it is possible that notional amounts that match at the inception of the trust could become mismatched over time. For example, if defaults occur on the assets held by the trust and a derivative instrument issued by the trust requires the trust to make payments to the counterparty, the derivative instrument would increase the losses to the trust and potentially require additional capital support from the interest holder. Because of these potential mismatches in future periods, the Board should consider whether to require continuous reassessment of whether a beneficial interest is a freestanding derivative or contains embedded derivatives. As an alternative to requiring continuous reassessment, an interest holder could be required to perform its assessment regarding the existence of embedded derivatives at inception

only, but such an assessment would have to consider future potential mismatches in notional amounts.

Example 36

This example explains an entity's evaluation of whether its variable-rate beneficial interest contains an embedded derivative when the notional amounts of the underlying fixed-rate bonds held by the trust match the notional amount of a pay-fixed/receive-variable interest rate swap held by the trust. The example concludes that if the notional amounts did not match, the holder would have to evaluate the variable-rate interest provisions for embedded derivatives under paragraph 13 of Statement 133.

The parenthetical statement added to this example by the proposed Issue may cause confusion because of the focus on whether the instruments held by the SPE may not provide the necessary cash flows to the swap counterparty. It is unclear whether this language implies that an embedded credit derivative may exist in the beneficial interest. The reference to paragraph 13 seems to suggest that the example is analyzing possible embedded interest rate derivatives, not credit derivatives; such an analysis would try to ascertain whether the interest holder might not recover substantially all of its initial investment. The Board should provide additional details about its embedded derivative analysis in the example (i.e., embedded credit derivative versus embedded interest rate derivative). Otherwise, constituents may become confused because the language in the parenthetical is similar to the language in Examples 39 and 40, which appears to focus on whether the investor could lose more than its original investment.

Effective Date and Transition

The Board proposed an effective date for the proposed Issue of the first day of a reporting entity's first fiscal quarter beginning after December 15, 2008. We do not believe that this effective date will give preparers and auditors sufficient time to evaluate the impact of the proposed Issue.

It appears the Board intended the transition in this proposed Issue to include all preexisting contracts that were subject to the transition provisions of Statement 155.⁴ To make the transition guidance consistent, the Board should consider the following wording (added text is <u>underlined</u> and deleted text is <u>struck out</u>):

At the date of adoption for the implementation guidance in this Issue, an entity shall assess each preexisting contract that was acquired, or issued, or subject to a remeasurement (new basis) event occurring on or after the date of the reporting entity's adoption of FASB Statement No. 155....

The description of the transition amount (recorded as a cumulative-effect adjustment to beginning retained earnings) is unclear. Specifically, the term "existing bifurcated hybrid instrument" implies that the hybrid instrument was previously bifurcated, which is not consistent with the purpose of this proposed Issue. Further, the proposed Issue permits entities to elect the fair value option at transition for certain instruments. The Board should consider the following wording (added text is <u>underlined</u> and deleted text is <u>struck out</u>):

⁴ FASB Statement No. 155, Accounting for Certain Hybrid Financial Instruments — an amendment of FASB Statements No. 133 and 140.

At adoption, any difference between the total carrying amount of the individual components of the <u>newly existing</u>-bifurcated hybrid instrument <u>or the fair value</u> of the hybrid instrument for which the fair value option was elected pursuant to the transition provisions herein and the carrying amount of the combined hybrid instrument prior to bifurcation should be recognized as a cumulative-effect adjustment to beginning retained earnings for the period of adoption.

There may be circumstances in which application of the guidance in the proposed Issue will no longer require separation of a previously bifurcated hybrid instrument and the embedded derivative and host contract will be recombined into a single instrument. The proposed Issue should provide specific transition guidance about such a circumstance.

Finally, after the proposed Issue's effective date, many of the securitized financial assets within the scope of this proposed Issue may be within the scope of FSP FAS 133-1 and FIN 45-4. This is because constituents have viewed the current paragraph 14B as a scope out of the disclosure requirements in the FSP. The Board should consider providing language in this proposed Issue to clarify how the embedded derivative analysis under paragraphs 14A and 14B (as revised) affects what instruments should be disclosed under FSP FAS 133-1 and FIN 45-4 and to remind constituents to reevaluate their disclosures.

Deloitte & Touche LLP appreciates the opportunity to comment on the proposed Issue. If you have any questions concerning our comments, please contact Mark Bolton at (203) 761-3171.

Yours truly,

Deloitte & Touche LLP cc: Bob Uhl