ISDA_®



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March 10, 2009

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

Re: Proposed Issue C22, Exception Related to Embedded Credit Derivatives

Dear Mr. Golden.

The International Swaps and Derivatives Association (ISDA)¹ appreciated the opportunity to comment on the proposed DIG Issue No. C22, Exception Related to Embedded Credit Derivatives ("DIG C22"), and to listen to the public discussion of the FASB Board (the "Board") and the FASB staff (the "Staff") regarding the comments submitted by ISDA and other organizations on March 4, 2009. Based on the discussion at that meeting, we would like to offer the following additional comments and observations and hope you will find them useful.

1. Application of SFAS 155 in Practice

Current practice to not bifurcate fully funded single tranche synthetic CDOs is based on the understanding that during the FASB Statement No. 155, Accounting for Certain Hybrid Financial Instruments, an amendment of FASB Statements No. 133 and 140 ("SFAS 155") deliberations, the Board considered whether credit risk arising from the assets and liabilities of an entity should have a different accounting treatment

¹ ISDA members represent leading participants in the privately negotiated derivatives industry and include most of the world's major financial institutions, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. Collectively, the membership of ISDA has substantial professional expertise and practical experience addressing accounting policy issues with respect to financial instruments and specifically derivative financial instruments.

depending on whether those assets and liabilities are cash instruments or derivatives, and decided that the accounting treatment should be consistent.

We recognize the challenge to both those who share this recollection and those who do not, as the public record that we have been able to find of the deliberation of the "concentrations of credit risk" is limited. However, our understanding is recorded in the first sentence in paragraph 14B of the Exposure Draft of SFAS 155, which stated that "Credit risk in a beneficial interest resulting from financial instruments or other assets and liabilities (including derivative contracts) that are held by the issuing entity, shall not be considered an embedded derivative under this Statement." understanding of the Board's original decision was further recorded in paragraph A22 of the fatal flaw draft of the final standard, which stated that "The Board noted that the creditworthiness of an entity is determined by the assets it holds. The Board considered whether the form of those assets (whether cash instruments or derivatives) should result in different accounting conclusions for the financial instruments issued by the entity. For example, a single class of financial instruments that receives the credit risk and market return of a financial instrument such as a corporate bond that is held by the issuing entity is not considered to include an embedded credit default swap. The same economic profile could be created if the entity issuing the single class of financial instruments sold a credit default swap referenced to the corporate bond and purchased high-quality collateral. The Board decided that the accounting for financial instruments with similar credit risks should be similar and should not be based on whether a cash instrument or a derivative contract created the credit risk. The Board also concluded that no embedded credit derivative is present in the financial instruments in either of the above examples. However, when the credit risk of an asset held by an entity is different than the credit risk of a senior interest issued by an entity where the difference in credit risk is allocated to a subordinated interest would result in the identification of the subordinated interest as either a derivative in its entirety or as a hybrid financial instrument requiring bifurcation."

While the issued standard's Basis for Conclusions did not include discussion of the Board's decisions on this topic, we did not understand there to be a change in the Board's views, due to the lack of public discussion of such a change and because both example 38 and the first sentence of paragraph 14B as included in the final standard clearly articulated the principle that the cash flows related to changes in credit risk that are present in the financial instruments held by the entity do not require bifurcation.

2. Form of Credit Risk versus Economic Substance

Our agreement with the first sentence in paragraph 14B of SFAS 155 is based on the economic understanding that there is no market risk difference between fully funded credit risk instruments that are purchased from the issuer, or purchased from a trust that synthetically creates the credit-sensitive bonds (there is the added element of derivative counterparty credit risk, but derivative counterparty risk is also present in the GM bond

with GM purchased credit protection example that would not require bifurcation per the discussion during the March 4, 2009 FASB Board meeting). Further we must express our disagreement with the notion expressed by the Staff on March 4, 2009 that an enterprise, without any other unrelated party taking a risk absorbing position, could achieve a different accounting outcome by creating a special purpose entity for the purpose of holding credit derivatives and highly rated collateral. Any investor who unilaterally sought to create an SPE (for which it would be the sole investor) to hold a US Treasury note and a credit default swap referencing a third party credit risk in order to avoid derivative accounting, would find itself consolidating that SPE under FIN 46(R) and would not achieve their desired result.

Structured credit products that utilize derivative are a useful asset class alternative for certain investors with long term liabilities who seek to buy and hold bonds with particular durations, credit rating requirements and diversification profiles that often are not available or practicable to obtain in traditional bond markets. We would be happy to provide further information regarding single tranche securitization markets and products and their similarities and differences to traditional bond and derivative investments.

3. Communication of Proposed Guidance

While we now realize that the Board's view regarding credit risk may now differ from our original understanding, we do not believe that this view was sufficiently apparent in the DIG C22 Exposure Draft. Although expressed differently, the principle expressed in the DIG C22 Exposure Draft that the assets in the vehicle must provide the necessary cash flows for the beneficial interests issued was perceived to be sufficiently similar to the principle in the first sentence in paragraph 14B. Accordingly, many respondents did not believe that DIG C22 represented a major shift in policy or practice. The Staff and Board's continued assertion that the purpose of the project was to limit the "overly broad" application of the credit derivative exception was believed to be embodied by new Example 39, a partially funded synthetic CDO that the new guidance clarifies must be evaluated for bifurcation. We noted that respondents agreed with your conclusion on Example 39, and surmised that communicating the Staff's analysis under Example 39 must have represented the primary purpose of DIG C22.

We also disagree with a key element of the "clearly and closely related" discussion led by the Staff on March 4,2009, that seemed to create an accounting distinction between credit default swaps that are written vs. those that are purchased. While we understand that FSP FIN 39-1 and FIN 45-1 created a disclosure requirement distinction, we are unaware of any GAAP literature or Board discussion that ever created a derivatives accounting distinction. Furthermore, we understood the Staff to believe that the "clearly and closely related" comparison is made inside the SPE between the credit default swap and the bond or security that the SPE also holds (e.g., "a purchased GM

credit default swap" is clearly and closely related to a "GM bond".) Statement 155 does not establish either concept. Paragraph 14A establishes the principle that the investor compares the terms of the *beneficial interest* it holds to the nature and amount of assets, liabilities, and other financial instruments that compose the entire securitization transaction. Perhaps the Board seeks now to create a different model for purchased vs. written credit default swaps, and a different model for how to evaluate "clearly and closely related" as well, but that model should be exposed and allowed due process.

Furthermore, the distinction made by the Staff at the March 4th meeting between the investor's accounting for their beneficial interest in a tranche that is part of a multitranche structure vs. that of a single-tranche structure was not at all apparent to constituents that commented on DIG C22. We do not understand the logic behind why an investor in a fully funded synthetic CDO issued as part of a multi-tranche structure (Example 40) would not have an embedded derivative to evaluate under paragraph 12 but an investment in a fully funded CDO issued as part of a single-tranche structure would. We heard the comment that the tranching and subordination of the securitization structure somehow "cures" the presence of a credit default swap that the Staff would otherwise believe to be "not clearly and closely related" but we do not understand the principle behind that and believe it should be articulated. We believe the "clearly and closely related" principle was covered by the first sentence of paragraph 14B, Example 38, and the Basis for Conclusions paragraph that was deleted from the "fatal flaw" draft. The concentration of credit risk in the form of subordination (the second sentence of paragraph 14B) was always intended to be a separate concept, not one that somehow "cured" an otherwise bifurcatable credit derivative (such as the one in Example 38). We have never believed that Statement 155 was structured in the way that it was described on March 4, 2009, and we believe that a read of Statement 155's original exposure draft and Statement 155's "fatal flaw" draft makes this clear.

Based on the above understanding of the Board's views in SFAS 155 and the drafting of the proposed DIG C22, we do not believe that constituents, particularly investors in these products, were aware prior to the DIG C22 comment deadline of the FASB's view of the accounting for single tranche securitizations expressed during the March 4, 2009 Board meeting.

We believe that a clear articulation of the Board's views in a revised Exposure Draft is warranted so as to provide those organizations which have invested in these instruments, for all of the valid business reasons discussed in section 2 above, the opportunity to evaluate and comment on the economic, operational and capital impacts of this proposed change, especially given the current market conditions.

We look forward to the opportunity to comment on a future Exposure Draft if the Board agrees that re-exposure is warranted given the impact to practice for single tranche

securitizations that was articulated during the March 4, 2009 meeting. We welcome the opportunity to participate in any fatal flaw reviews on this subject.

We thank you for the opportunity to communicate our observations and recollections, and would be happy to provide any additional information. We hope that this letter will prove useful in your deliberations.

Best Regards, Lauren Smith

Laurin Smith

J.P. Morgan Chase & Co.

Chair, N.A. Accounting Policy Committee

International Swaps and Derivatives Association

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