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November 12, 2009

Technical Director  
Financial Accounting Standards Board  
401 Merritt 7  
PO Box 5116  
Norwalk, Connecticut 06856-5116

**RE: Proposed Accounting Standards Update, “Scope Exception Related to Embedded Credit Derivatives” (File Reference No. 1740-100)**

Dear Technical Director:

We appreciate the opportunity to comment on the proposed Accounting Standards Update, “Scope Exception Related to Embedded Credit Derivatives” (the “proposed ASU” or “the proposal”). We are concerned that the principles set forth in the proposed ASU do not comprehensively address the principles applied in the examples. In addition, we are concerned that the proposal does not provide a clear explanation for the basis on which these principles were developed and, as a result there may be inconsistent application of the guidance in fact patterns that differ from the examples provided. Our general observations and specific comments on the proposed ASU are set forth below.

***Clarification of Principles***

The proposed ASU includes examples to illustrate the application of paragraph 14B of Statement 133 (ASC 815-15-15-9). However, we are concerned that the principles included in paragraph 14B (ASC 815-15-15-9) do not entirely capture the principles that would be required to reach the conclusions under certain examples in the proposal. We understand the principles set forth in paragraph 14B (ASC 815-15-15-9) to be as follows:

- Embedded credit derivative features that are created solely by subordination between tranche holders are embedded derivatives that are not subject to further evaluation under paragraphs 12 and 14A (ASC 815-15-25 and 815-10-15-11).
- All other embedded credit derivative features would be subject to further evaluation under paragraphs 12 and 14A (ASC 815-15-25 and 815-10-15-11).

In addition, paragraph 14B (ASC 815-15-15-9) states that based on these principles in the circumstance where a tranche holder may be required to make additional payments to the securitization vehicle, any transfer of credit risk for that tranche should not be considered to be only in the form of subordination of one financial instrument to another because the future payments are considered to be related to credit risk that is created outside of



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subordination. Consequently, the tranche holder would be required to evaluate its interest under paragraphs 12 and 14A (ASC 815-15-25 and 815-10-15-11). This guidance appears to set forth a third principle, namely that if a holder's interest has more than one embedded credit derivative feature, one of which is not solely related to subordination, the embedded credit derivative features should be combined and evaluated as a group under paragraph 14B (ASC 815-15-15-9) (i.e., the unit of account for evaluating the guidance in paragraph 14B (ASC 815-15-15-9) is the group of embedded credit derivative features).

This principle is consistent with one of the conclusions reached in Case Y related to a partially funded synthetic CDO with multiple tranches. Case Y concludes that for those tranches where the investors may be required to make additional payments, the embedded credit derivative feature is not related only to subordination and therefore must be further evaluated under paragraphs 12 and 14A (ASC 815-15-25 and 815-10-15-11). In that circumstance, the embedded credit derivative feature, which the proposed ASU identifies as a compound derivative related to both the subordination provisions and the credit default swap, would not be considered clearly and closely related to the host contract, and would be separated.

However, this principle does not appear to be consistent with the conclusion reached in Case Y related to investors that would not be required to make additional payments and the conclusion reached in Case Z related to a fully funded synthetic CDO with multiple tranches. Case Y concludes that for those tranches where investors would not be required to make additional payments, the holder's interest contains two embedded credit derivative features: one related to subordination between tranche holders and one related to the written credit default swap on a referenced credit. This Case concludes that the two embedded credit derivatives features should be evaluated separately, which results in the embedded credit derivative feature related to subordination meeting the paragraph 14B scope exception (ASC 815-15-15-9) and the embedded credit derivative feature related to the written credit default swap having to be evaluated under paragraphs 12 and 14A (ASC 815-15-25 and 815-10-15-11) for bifurcation. A similar conclusion is reached in Case Z for those investors in a fully funded synthetic CDO, as they would not be required to make additional payments. As such, the conclusions in these Cases appear to be based on a principle that the unit of account for evaluating the guidance in paragraph 14B (ASC 815-15-15-9) is the individual embedded credit derivative feature.

Additionally, the conclusion reached in Case X related to a securitization involving subordination applies a similar principle that the unit of account for evaluating the guidance in paragraph 14B (ASC 815-15-15-9) is the group of embedded credit derivative features; however, Case X appears to extend the principle to circumstances



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where a holder's interest has an embedded credit derivative feature related to subordination and another embedded non-credit derivative feature. Although the guidance is not entirely clear, we understand that the conclusion reached in Case X is that in a situation where the embedded interest rate derivative feature would be required to be bifurcated under paragraph 12 of Statement 133 (ASC 815-15-25), the embedded credit derivative feature would be required to be analyzed under paragraphs 12 and 14A (ASC 815-15-25 and 815-10-15-11) for bifurcation. As such, the holders of the subordinated and residual financial instruments are required to analyze both the embedded credit derivative and embedded interest rate feature for bifurcation. The holder of the senior instrument would not be required to analyze the embedded credit derivative feature under paragraphs 12 and 14A (ASC 815-15-25 and 815-10-15-11) because the embedded interest rate derivative feature is considered to be clearly and closely related to the host contract.

The conclusion reached in Case X implies that an embedded credit derivative feature is not created solely by subordination if another embedded derivative feature would be required to be bifurcated from the holder's interest. Therefore, for purposes of evaluating paragraph 14B (ASC 815-15-15-9), the embedded credit derivative feature should be combined with other embedded derivative features that are required to be bifurcated and evaluated as a group. This would result in the embedded credit derivative feature not meeting the paragraph 14B scope exception (ASC 815-15-15-9).

Case X is unclear because it refers to the need to analyze the embedded credit derivative feature related to the credit loss allocation among tranches but the analysis refers only to the embedded interest rate derivative feature. Also, the analysis refers to paragraphs 13(a) and 13(b) (ASC 815-15-25-26) which only apply to an embedded derivative with an underlying that is a single interest rate or interest rate index. We believe the embedded feature has both a credit underlying and an interest rate underlying.

Given that the examples in the proposed ASU result in different conclusions related to the unit of account that should be used for evaluating the guidance in paragraph 14B (ASC 815-15-15-9), we believe that the Board must clearly articulate the principle or principles behind these conclusions, ensure that the principle(s) is consistently applied across similar fact patterns, and provide the basis on which the principle(s) was developed so that it may be applied consistently to facts and circumstances that do not clearly fit into the examples. We do not believe that a holder's interest with two embedded credit derivative features, one related to potential future payments and one related to subordination, should be evaluated differently than a holder's interest with two embedded credit derivative features, one related to a written credit default swap and one related to subordination. In both circumstances, it could be interpreted that the transfer of



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credit risk would not be solely in the form of subordination of one financial instrument to another; however, under the proposed ASU in the former the embedded credit derivative features are evaluated under paragraph 14B (ASC 815-15-15-9) as a compound derivative and in the latter the embedded credit derivative features are evaluated under paragraph 14B (ASC 815-15-15-9) on an individual basis.

Additionally, we do not believe there is a basis for evaluating the guidance in paragraph 14B (ASC 815-15-15-9) at a compound derivative level. The unit of account for purposes of evaluating Statement 133 (ASC 815) is the individual derivative instrument, whether freestanding or embedded. We believe that paragraph 12 of Statement 133 (ASC 815-15-25) requires entities to analyze potential embedded derivatives separately. Therefore, we believe that in Cases X, Y and Z, the embedded credit derivative related to subordination should be able to meet the embedded credit derivative scope exception.

#### ***Valuation of Embedded Credit Derivative Features***

The proposed ASU indicates in Case Y that if an entity is required to separately account for an embedded credit derivative feature (such as a written credit default swap), the fair value of each tranche's embedded credit derivative is based on the expected cash flows of the instrument, which are affected by the subordination between the tranches. This is done even though no derivative is recognized for the subordination provisions. We do not understand how one should consider the impact of the subordination provisions on the fair value of the separated credit derivative without concluding that some of the subordination provisions are part of the separated derivative. If this is the case, we believe that the Board should consider the implication of this guidance on the evaluation of all embedded derivatives.

For example, assume that an entity issues 10-year convertible debt that is callable after three years. The decision of whether to call the debt after three years will be depend, in part, on changes in interest rates but also on the price of the stock. If the valuation of the conversion option should be impacted by the probability of the call option being exercised, it implies that the conversion option includes a feature that is dependent on changes in interest rates. If the conversion option (which is impacted by changes in the entity's stock price) includes an interest rate feature, it may call into question whether the conversion option would be considered indexed to the entity's own stock under paragraph 11(a) of Statement 133 (ASC 815-10-15-74). We believe that this may be an unintended consequence of the proposed guidance and should be considered by the Board.

#### ***Scope***



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The proposed ASU should clarify if the guidance relates only to interests in securitized financial assets or if it relates to all interests that may have embedded credit derivative features, such as interests in senior/subordinated loan participation structures. The proposed ASU deletes the first sentence of paragraph 14B (ASC 815-15-15-9), which referred to “Changes in cash flows attributable to changes in the creditworthiness of an interest resulting from securitized financial assets and liabilities (including derivative instruments)...” Based on this deletion, we believe that the Board’s intention is for the revised guidance in paragraph 14B (ASC 815-15-15-9) to apply to all interests that have embedded credit derivative features, not only to interests in securitized financial assets and liabilities. However, given the wording and placement of the guidance following a discussion of interests in securitized financial assets, and application of the legacy guidance, we believe that it would be helpful to explicitly clarify the scope of the proposed ASU.

***Interaction of Paragraph 14 of Statement 140 (ASC 860-20-35-2) and the Proposed ASU***

Case X of the proposed ASU states that because the holders of the subordinated and residual financial instruments might not recover substantially all of their initial recorded investments in their interests, their interests would be subsequently measured at fair value in accordance with paragraph 14 of Statement 140 (ASC 860-20-35-2). This implies that an instrument that meets the criteria in paragraph 14 of Statement 140 (ASC 860-20-35-2) is required to account for the entire investment as an available-for-sale (AFS) or trading security under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (Statement 115) (ASC 320).

In practice, we believe that some entities choose to bifurcate the embedded interest rate derivative feature under Statement 133 (ASC 815) and account for the host contract under other applicable GAAP, rather than as a debt security under Statement 115 (ASC 320). We are concerned that these entities would be required to reevaluate their existing interests if the proposed ASU is finalized as currently drafted.

In addition, the conclusion in Case X that the subordinated and residual financial instruments would be subsequently measured at fair value under Statement 115 (ASC 320) as either AFS or trading securities implies that the investors would not be required to bifurcate the embedded credit or interest rate derivative features. Although that is correct for a trading security, if an entity classifies its investment as an AFS security, the changes in the fair value of the investment would be recorded in other comprehensive income, rather than earnings; therefore, the embedded credit and interest rate derivative features would be required to be bifurcated as the condition in paragraph 12(b) (ASC 815-15-25-1(b)) continues to be met.



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## **Other Comments**

### *Case X*

Case X states that because the senior, variable-rate financial instrument does not meet the conditions in paragraphs 13(a) and 13(b) (ASC 815-15-25-26), the embedded interest rate derivative feature is clearly and closely related to the host contract. We do not believe that the conclusion related to paragraph 13(b) (ASC 815-15-25-26(b)) can be assumed as the answer is dependent on the rate of the host contract, which is not specified in the example. We suggest that the wording of this example be revised to indicate that the conclusion that the embedded derivative is clearly and closely related is assumed or the example should provide a discussion of why paragraph 13(b) (ASC 815-15-25-26 (b)) would not be met.

In addition, given the recent economic conditions, we do not believe that an investor can or should automatically assume that the senior interest will recover substantially all of its initial recorded investment. Therefore, we suggest that this example indicate that it is an assumption that the senior interest holders will recover substantially of their initial recorded investment.

### *Codification References to Disclosure Requirements*

Paragraphs 815-15-55-226C and 815-15-55-226D state that “Each investor would be required to consider the disclosure requirements for credit derivatives.” We believe that the final ASU should provide ASC references to the disclosure requirements for credit derivatives.

### *Reference to Fair Value Option in Case AA*

Case AA indicates that “If the fair value option is not elected by the investor and the criterion in paragraph 815-15-25-1(c) is met, paragraph 815-10-15-11 and Section 815-15-25 would require bifurcation and separate accounting....” Since the election of the fair value option in any of the Cases provided in the proposal would cause an evaluation of whether an embedded derivative feature should be analyzed for separation to be irrelevant, we do not understand why it is necessary to include this discussion only in Case AA.

### *Application of Fair Value Option upon Transition*

The proposed ASU states that if a contract contains an embedded derivative feature that no longer qualifies for the paragraph 14B scope exception (ASC 815-15-15-9) upon transition, an entity may elect the fair value option. It further states that this election would be “supported by documentation completed by the end of the fiscal quarter of



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initial adoption.” We believe that the guidance in FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (Statement 159) (ASC 825-10), requires documentation of the fair value option on the election date. We believe that this documentation requirement is a departure from the guidance in Statement 159 (ASC 825-10) and should be described as such in the proposed ASU.

*Cumulative Effect Adjustment Disclosure upon Transition*

The transition guidance of the proposed ASU states that “An entity shall separately disclose the gross gains and gross losses that make up the cumulative-effect adjustment, determined on an instrument-by-instrument basis.” We believe that there could be two cumulative-effect adjustments upon transition: (1) an adjustment related to the election of the fair value option and (2) an adjustment related to the proforma bifurcation for those hybrids for which the fair value option was not elected. We believe that the Board should clarify if the disclosure of the “gross gains and gross losses that make up the cumulative-effect adjustment” should be applied to each of these adjustments individually or only in the aggregate.

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We would be happy to further discuss these issues at the request of the Board or the staff. If you have any questions about our comments or wish to discuss any of the matters addressed herein, please contact Enrique Tejerina at (212) 909-5530.

Sincerely,

A handwritten signature in black ink that reads 'KPMG LLP'.