

November 12, 2009

Mr. Russell G. Golden Technical Director Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

File Reference: Proposed Accounting Standards Update, Derivatives and Hedging (Topic 815), Scope Exception Related to Embedded Credit Derivatives

Dear Mr. Golden:

Citigroup appreciates the opportunity to comment on the Proposed Accounting Standards Update, *Derivatives and Hedging (Topic 815), Scope Exception Related to Embedded Credit Derivatives* (Proposed ASU). We believe that the Proposed ASU raises very significant implementation issues that have not been adequately addressed and does not provide sufficient time for adoption. Given the short timeframe between finalizing the guidance and its effective date, Citigroup requests alternative transition guidance that would permit classifying any available-for-sale or held-to-maturity debt security as trading upon initial adoption of the final Accounting Standards Update.

Background

The question of whether beneficial interests in securitized financial assets contain embedded derivatives has been debated since 2000, with no general consensus reached by the FASB. After the initial issuance of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (Statement 133), the Derivatives Implementation Group (DIG) discussed the issue in significant detail. Ultimately the DIG finalized Issue No. D1, "Recognition and Measurement of Derivatives: Application of Statement 133 to Beneficial Interests in Securitized Financial Assets" (DIG Issue D1). Rather than providing specific guidance on when bifurcation of embedded derivatives is required, DIG Issue D1 states:

The determination of whether beneficial interests in securitized financial assets meet the definition of a derivative are complex issues that warrant further study. Further, if it is determined that some of those beneficial interests do not meet the definition of a derivative in its entirety, the staff believes further study may be required to determine...whether the beneficial interest has an embedded derivative that must be accounted for separately under paragraph 12 of Statement 133.

After the issuance of DIG Issue D1, significant further debate and analysis was performed (but never finalized) under DIG Issue D2. DIG Issue D2 was removed from further discussion in 2003. We understand one primary reason for this is that the bifurcation analysis is extremely complex and there are a myriad of implementation questions that the FASB has not been able to adequately address.



In 2006, the FASB issued principles-based guidance on beneficial interests in securitized financial assets under FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments* (Statement 155). In our view, the principle in Statement 155 is that beneficial interests in securitized financial assets that would otherwise qualify for classification as available-for-sale or held-to-maturity should continue to qualify for that classification, regardless of whether the exposures created by the securitization vehicle are in cash or synthetic form. Citi continues to support the guidance in Statement 155. We believe the principles in Statement 155 are clear, have been consistently and appropriately applied in practice, and question why the Proposed ASU is necessary.

Implementation Issues Not Adequately Addressed

The Proposed ASU states that embedded credit derivative features "related to credit default swaps on a referenced credit" require further analysis for bifurcation, and the illustrative examples contained in the Proposed ASU conclude that bifurcation would be required by the investors in the beneficial interests issued by the securitization vehicle. The Proposed ASU contains simplified illustrative examples. In our view, the following significant implementation issues remain (note this is not a comprehensive list):

- If a securitization vehicle holds predominantly cash assets with a limited amount of exposure generated through credit default swaps, is bifurcation required? For example, assume a CDO with \$1 billion in total assets purchases \$990 million of mortgage-backed securities, \$10 million of U.S. Treasuries, and writes a credit default swap on \$10 million notional of another mortgage-backed security. Is bifurcation required?
- If a securitization vehicle holds only cash assets at inception, but is permitted to (and later does) sell certain cash assets and replace the exposure with credit default swaps, is bifurcation required by the investors in the beneficial interests from that date?
- If a securitization vehicle invests in cash assets issued by other securitization vehicles, are the investors required to "look through" the first securitization vehicle to those other securitization vehicles? If so, how many levels of "look through" are required?
- If a securitization vehicle is actively managed and the underlying credit default swaps change from one period to another, are investors required to change the accounting for the debt host contract and the bifurcated embedded derivative? If so, and the remaining fair value allocated to the debt host contract under DIG Issue No. B6, "Allocating the Basis of a Hybrid Instrument to the Host Contract and the Embedded Derivative" changes, is that a realized gain or loss on the debt host contract required to be recorded in earnings? How would such potential scenarios impact the other-than-temporary-impairment analysis for available-for-sale securities? Would such scenarios potentially be considered tainting events for held-to-maturity securities?
- If a securitization vehicle *purchases* credit protection, do the beneficial interests contain purchased credit default swaps that are required to be bifurcated?

- If a securitization vehicle purchases credit protection in the form of a financial guarantee, are the investors required to determine whether that financial guarantee meets the detailed requirements for the "financial guarantee exception" in paragraph 10(d) of Statement 133? If so, how would investors be able to obtain the necessary information to perform that analysis?
- How does the Proposed ASU amend or otherwise impact the guidance in Implementation Issue No. B36, "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" (DIG Issue B36)? DIG Issue B36 concludes that a credit-linked note issued directly by a corporation contains embedded credit derivatives, regardless of whether the corporation owns the underlying referenced asset. The Proposed ASU seems to focus on whether the issuer of the beneficial interests owns the underlying referenced asset vs. obtains that exposure synthetically. Applying the concepts in the Proposed ASU, we would expect the guidance in DIG Issue B36 to be similarly updated to state that a credit-linked note issued directly by a corporation does not contain embedded credit default swaps if the corporation owns the underlying referenced asset.
- Does the Proposed ASU apply to both the *investors* in the beneficial interests as well as the issuer? This question is particularly relevant where an enterprise is required to consolidate a special purpose entity or securitization vehicle, and must determine how to account for the beneficial interests (issued debt) in consolidation. There is also an important interaction with the questions raised directly above for DIG Issue B36.

The Proposed ASU also attempts to clarify when interest rate swaps or cross-currency swaps executed by special purpose entities (which we assume are a broader population of vehicles than just securitization vehicles) are considered clearly and closely related to the interests issued by those entities. The Proposed ASU uses the term "matching" but with no additional implementation guidance. We believe the following implementation issues arise (again this is not a comprehensive list):

- Is the term "matching" meant to be an exact match of notional amounts, tenors, settlement (interest payment) dates, and other economic terms? In practice, mortgage-backed securitization vehicles often hold assets with various interest payment dates throughout each quarter. The vehicle may execute a single interest rate swap with one quarterly settlement date. While that swap economically hedges the interest rate exposure of the vehicle, is it "matching" based on the guidance in the proposed ASU? If not, do all of the beneficial interests issued by the securitization vehicle contain some sort of embedded interest rate derivative that could potentially require bifurcation, and how should that bifurcation analysis be performed?
- If assets of the special purpose entity can be prepaid or sold without an exact "matching" reduction in the notional amount of the derivative, do all of the beneficial interests issued



by the special purpose entity contain some sort of embedded interest rate derivative that could potentially require bifurcation? How should that bifurcation analysis be performed?

Where an investor determines bifurcation is required, we note that the fair value measurement of the embedded derivative is extremely complex. The Proposed ASU provides no guidance on how to estimate fair value, in particular how to assess how credit derivatives executed by a securitization vehicle could be allocated to the various tranches (while at the same time *excluding* the overall impact of tranching from the accounting for each beneficial interest).

Alternative Transition Provisions Required

For financial institutions and insurance companies with large and diverse portfolios of available-for-sale and held-to-maturity debt securities, Citigroup believes it is not possible to implement the Proposed ASU in the allotted timeframe. However, we understand that the FASB intends to finalize the guidance during 2009 with a short timeframe for adoption. Given those circumstances, Citigroup believes alternative transition provisions are required. Rather than permit reclassification to trading (fair value option¹) *only* for beneficial interests that would otherwise require bifurcation, we believe that *any* debt security classified as available-for-sale or held-to-maturity should be permitted to be reclassified at the transition date for the following reasons:

- This would alleviate the requirement to analyze large portfolios of debt securities for bifurcation in an extremely short timeframe under rules that are not clear and not well-developed. The bifurcation analysis for many investments in securitization vehicles or other special purpose entities would require collecting and analyzing in detail prospectuses and other documents that often run into the hundreds of pages. Additional discussion with the originating bank, manager or other third parties would often be required. If an investor is required to "look through" each vehicle that purchases beneficial interests issued by other securitization vehicles or special purpose entities, the problem is magnified. We estimate it could take 12-18 months to properly analyze all of the investments held by a financial institution or insurance company with a large and diverse portfolio of debt securities. Even within that timeframe the costs to implement the Proposed ASU would not justify the benefits to financial statement users. In our view, the only appropriate solution is to permit investors to elect trading for any debt security upon transition.
- We believe that the Proposed ASU represents a fundamental change in the application of the bifurcation guidance in Statement 133 and, as such, similar transition provisions as for the initial adoption of Statement 133 are appropriate. Statement 133 permitted any

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¹ The Proposed ASU states that an investor may elect the fair value option for hybrid instruments that would otherwise require bifurcation. Since many of the hybrid instruments would be debt securities under FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities (Statement 115), a more appropriate election would be trading under Statement 115. Our proposed transition approach would be consistent with the guidance in paragraph 29 of FASB Statement No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (Statement 159), which states "If an entity elects the fair value option for a held-to-maturity or available-for-sale security in conjunction with the adoption of this Statement, that security shall be reported as a trading security under Statement 115."



available-for-sale or held-to-maturity security to be reclassified to trading upon adoption. As discussed above, Statement 159 also provided for those elections.

• The resulting fair value accounting would be consistent with the FASB's stated goals to increase the use of fair value accounting for financial instruments going forward.

We thank the Board for its consideration and would welcome the opportunity to further discuss our comments with Board members and their staff. Please do not hesitate to contact me at (212) 559-7721.

Very truly yours,

Robert Traficanti

Vice President and Deputy Controller

Robert Draficanti

Citigroup Inc.