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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 No: 1740-100

Re: Proposed Accounting Standards Update — Scope Exception Related to Embedded

Credit Derivatives

Dear Mr. Golden:

Deloitte & Touche LLP is pleased to comment on the proposed Accounting Standards Update, *Scope Exception Related to Embedded Credit Derivatives* (the "proposed ASU").

We support the Board's efforts to resolve ambiguity about the application of the scope exception for embedded credit derivatives in paragraphs 15-8 and 15-9 of ASC 815-15<sup>1</sup> (formerly paragraph 14B of Statement 133<sup>2</sup>); however, we believe the Board should address this issue as part of its joint project with the IASB on accounting for financial instruments and not as a stand-alone project. Deliberating the issues addressed in this proposed ASU along with the other issues associated with the joint project on financial instruments will (1) ensure the scope exception is addressed in the context of a comprehensive model for accounting for financial instruments and (2) minimize burdens on preparers that would occur if preparers were required to adopt the requirements of a new ASU in the near term only to have to move to a converged standard in the future.

If the Board chooses instead to issue an ASU on the scope exception related to embedded credit derivatives, we believe it should address certain key issues in the proposed ASU, which are discussed below.

Overall Principle for Indentifying the Host Contract and an Embedded Derivative

The proposed ASU does not set forth a clear principle regarding how the holder of an interest in a securitized financial asset should identify the host contract and assess the "clearly and closely related" criterion in ASC 815-15-25-1(a) when determining whether an embedded credit derivative feature must be separated and accounted for at fair value through earnings. Instead, the proposed ASU uses examples to illustrate its guidance.

As a result, although the examples in the proposed ASU identify the host contract in their analysis of whether the economic characteristics and risks of the embedded derivative feature are clearly and closely related to the host contract, it is unclear how that determination was

<sup>&</sup>lt;sup>1</sup> FASB Accounting Standards Codification Subtopic 815-15, *Derivatives and Hedging: Embedded Derivatives*.

<sup>&</sup>lt;sup>2</sup> FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities.

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made. For example, proposed ASC 815-15-55-222 provides an example of a situation in which a special-purpose entity (SPE) issues a dollar-denominated variable-rate interest to investors and holds yen-denominated variable-rate bonds. The example describes the SPE's liability and investor's investment as a host contract of yen-denominated variable-rate bonds having an embedded foreign currency derivative instead of a simple dollar-denominated variable-rate debt instrument with no embedded feature. We can only surmise that for such a structured entity, the FASB intends to establish a look-through model (i.e., look through the structure to what instruments generate cash flows to pay the principal and interest). Identification of the host contract is a critical first step in any analysis of whether there is an embedded derivative feature and whether it is clearly and closely related to the host. The final ASU should provide a clear principle that an entity can use to identify the host contract in securitized structures, and each example should highlight application of this principle.

In addition, in its analysis of whether embedded derivatives are clearly and closely related to the host contract, the example in ASC 815-15-55-104 provides an illustration of an entity (without noting whether the entity is a structured vehicle or holds the referenced security) issuing a credit-linked note indexed to the credit risk of a third party (X) and concludes that "the credit risk exposure of the reference security (Entity X) and the risk arising from the creditworthiness of the obligor (Entity A) are not clearly and closely related" and most likely would result in bifurcation of the embedded credit derivative. The guidance requires an investor in (and issuer of) a credit-linked note that refers to a basket of third-party bonds to conclude that the note contains an embedded credit derivative feature that is not clearly and closely related to its host. The investor (and issuer) could obtain a similar risk exposure by creating a structured investment vehicle (SIV) with a tranched pure pass-through structure that actually holds the basket of bonds and simply passes through actual cash receipts to interest holders. Under the proposed ASU, it appears as though the interests issued under the SIV would not be treated as having an embedded credit derivative feature that is not clearly and closely related. In the absence of a clearly defined principle, it is unclear why the two instruments discussed above (the credit-linked note and the SIV issued interest) would receive different accounting treatment even though both instruments in isolation are similarly exposed to risk of the referenced bonds' default.

The final ASU also should address whether the economic characteristics and risks of a purchased credit default swap (CDS) could be considered clearly and closely related to the economic characteristics and risks of the host contract when the purchased CDS is referenced to the credit risk of (1) the bonds held by the issuing entity (i.e., the securitization vehicle) or (2) a third party.

#### Effective Date and Transition

The proposed ASU's effective date is the first day of a reporting entity's first fiscal quarter beginning after December 15, 2009. We encourage the Board to seek feedback from preparers regarding whether this provides sufficient time to analyze all securitization structures for embedded credit derivatives that may require bifurcation. This may be a challenge, because a number of other standards also must be adopted in the same time frame.

Appendix A below contains our comments on specific paragraphs of the proposed ASU, and Appendix B contains our responses to the questions in the proposed ASU's Questions for Respondents.

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

Yours truly,

Deloitte & Touche LLP

cc: Bob Uhl

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# APPENDIX A Deloitte & Touche LLP Comments on Specific Paragraphs of the Proposed ASU

### ASC 815-15-55-222

• It is unclear from the proposed example why an investment in yen-denominated bonds is considered to be the host contract. In addition, without additional information on the variable rate (i.e., whether the variable rate is the market rate in the same currency environment as the host contract), it is difficult to conclude that the economic characteristics and risks of the currency swap are clearly and closely related to the host.

As noted in the body of our letter, the Board should articulate how the host contract is identified.

## ASC 815-15-55-223

• The wording in the last sentence of the paragraph should be clarified to indicate that the notional amounts of the bonds and the swap were not designed to match; otherwise, this guidance could be interpreted as implying that the swap always would be clearly and closely related if its notional amount happened to match the notional amount of the bonds at inception. The following changes would provide this clarity (additions are underlined and deletions are struck out):

However, if the notional amounts of the fixed-rate bonds and the variable interest rate swap do not match are not designed to always match, the variable-rate interest provisions would have to be evaluated for an embedded derivative under paragraph 815-15-25-26 (paragraph 815-15-25-26 applies when because the underlying is a single interest rate or interest rate index).

#### ASC 815-15-55-224 and 55-225

It is difficult to understand how the example in these paragraphs relates to the proposed scope exception in ASC 815-15-15-9. The first sentence of ASC 815-15-55-225 indicates that the "embedded credit derivative feature related to the credit loss allocation among tranches [is subject to a bifurcation analysis] because the related transfer of credit risk is not created only by the subordination of one financial instrument to another . . . but also includes the introduction of variable-rate-based payments." The facts presented in the example do not indicate that an investor in any of the tranches could lose more than its original investment as a result of the embedded credit features; therefore, it would appear that there is no embedded credit derivative in any of the tranches, other than that arising solely from subordination. The derivative exposure that arises from the introduction of floating-rate payments appears to be related to interest, not credit. Accordingly, ASC 815-15-9, as amended, would indicate that the embedded credit derivatives would not be subject to a bifurcation analysis. The potential mismatch between the cash flows generated by the fixed-rate bonds in the trust and the variablerate interest issued by the trust would give rise to an embedded interest rate derivative that would require analysis under ASC 815-15-25-26, which is consistent with the analysis provided in the revised example. The rationale for the conclusion should be clarified in the example.

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In addition, the example concludes that the senior tranche does not meet the conditions in ASC 815-15-25-26 through 25-29, but does not provide the basis for that conclusion. The example would be clearer if it included a basis for the conclusion.

## ASC 815-15-55-226 through 55-226C

- The example in ASC 815-15-55-226A indicates that the credit derivative features related to the written credit default swap must be assessed for bifurcation. It would be helpful if the example reached a conclusion about whether bifurcation was necessary and provided the basis for that conclusion.
- The last sentence in ASC 815-15-55-226C should include a specific reference to the disclosure requirements for credit derivatives to ensure consistent application.
- The Board should consider discussing with the Valuation Resource Group the proposed ASU's requirement to determine fair value for components of compound credit derivatives. Determining fair value of derivatives that include subordination may merit additional consideration. Such discussions may help in the determination of whether additional fair value guidance may be warranted.

#### ASC 815-15-55-226D

- It is unclear why the host contract in ASC 815-15-55-226D is identified as U.S.
   Treasury securities. Articulating a consistent principle for identifying the host contract, as discussed in the body of this letter, will promote consistent application of the requirements of the proposed ASU.
- The third sentence in ASC 815-15-55-226D should be clarified as follows (addition is underlined):

Furthermore, none of the tranches expose the investor to <u>making</u> potential future payments related to defaults on the written credit default swap.

- In the next to last sentence in the example, the following phrase should be deleted: "With respect to determining fair value for the tranches that do not expose the investor to making potential payments." The third sentence of the example states that none of the tranches expose the investor to potential future payments.
- The last sentence in ASC 815-15-55-226D should include a specific reference to the disclosure requirements for credit derivatives to ensure consistent application.

## ASC 815-15-55-226E

- It is unclear why the host contract in ASC 815-15-55-226E is identified as U.S. Treasury securities. As noted before, articulating a consistent principle for identifying the host contract will promote consistent application of the requirements of the proposed ASU.
- The proposed example indicates that "[i]f the fair value option is not elected by the investor" an investor would be required to bifurcate the embedded credit derivative. The reference to the fair value option is included only in this example and not the

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other examples in the proposed ASU. To ensure consistency, the Board should include the reference to the fair value option in all the examples in the proposed ASU.

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# APPENDIX B Deloitte & Touche LLP Responses to Questions for Respondents

Issue 1: Do the amendments resolve the potential ambiguity about the breadth of the embedded credit derivative scope exception in paragraph 815-15-15-9?

The proposed ASU resolves some existing ambiguity about the breadth of the embedded derivative scope exception. Additional clarity could be achieved, however, if the final ASU establishes a clear principle that can be applied when an entity is (1) assessing whether an embedded credit derivative feature is clearly and closely related to the host contract and (2) identifying the host contract in securitization structures.

Issue 2: Are the revisions to the existing examples and the new examples in paragraphs 815-15-55-226 through 55-226E effective in clarifying the breadth of the embedded credit derivative scope exception in paragraphs 815-15-15-9?

Although the revised examples are helpful, we have noted in Appendix A several ways the examples could be improved.

*Issue 3: Is the proposed effective date operational and the transition provisions appropriate?* 

As discussed in the body of the letter, we question whether the proposed effective date will provide preparers with sufficient time to evaluate the impact of the final ASU on embedded credit derivatives in securitization structures, and we encourage the Board to solicit feedback on this issue from the preparer community. In addition, we encourage the Board to address the issues raised in this proposed ASU through its joint project with the IASB on accounting for financial instruments.