

October 11, 2005

**Letter of Comment No:** 5  
**File Reference: 1210-001**

Technical Director(s)  
File Reference Nos. 1210-001 and 1225-001  
Financial Accounting Standards Board  
401 Merritt 7  
Norwalk, CT 06856-5116

Re: Proposed Statements of Financial Accounting Standards:  
Accounting for Certain Hybrid Financial Instruments (Ref 1210-001)  
Accounting for Transfers of Financial Assets (Ref 1225-001)

Dear Director(s):

Prudential is pleased to take this opportunity to comment on the proposed standards captioned above (the EDs). Prudential supports the Board's efforts to improve and clarify the application of FASB Statements 133 and 140, and offers commentary and suggestions on certain aspects of the EDs. We would be happy to discuss any of these issues with the Board or Staff.

Our key points are summarized as follows:

- The exposure draft addressing the accounting for certain hybrid financial instruments (the Hybrids ED) nullifies DIG Issue D-1, which was issued in part in reaction to the difficulty in assessing whether an embedded derivative exists within a beneficial interest in a securitized financial asset. The decision to apply the strip-security exception was to provide standard setters time to consider and provide useful guidance to ensure the consistency in such considerations. The Hybrids ED does not provide sufficient guidance in that area, and in fact provides conflicting guidance on how to assess whether an embedded credit derivative exists.
- The exposure draft addressing the accounting for transfers of financial assets (the Transfers ED) needlessly proposes a restriction on the ability of a qualifying SPE from holding passive equity instruments. The further restriction provided in addition to the restrictions already in FAS 140 will not solve the main issue the Board notes, that equity method investments can be converted to another basis of accounting, because investors in such investments can convert from the equity method without making any transfer.
- The Transfers ED also proposes a restriction on combinations of involvements, such that certain entities that otherwise would be a qualifying SPE will not qualify. While we agree that certain combinations of involvements may establish a controlling financial interest for the enterprise holding that combination of involvements, we believe a better approach to this issue would be to allow the entity to be a QSPE, but then further limit the exception from the consolidation rules that QSPEs enjoy. We have proposed language that may form a basis for enacting this proposal.

Hybrids ED

The Hybrids ED establishes a requirement that beneficial interests in securitized financial assets, other than those that meet the amended definition of an interest-only or principal-only security, be assessed for the existence of an embedded derivative that would require measurement in accordance with FAS 133. While we do not disagree with

that particular change, we wish to highlight that the Hybrids ED does not provide much by way of implementation guidance.

The Hybrids ED does provide a statement that credit risk in a beneficial interest resulting from assets or liabilities of the issuing entity would not be considered an embedded derivative. While we agree with that as a concept, we believe that statement should be better reconciled to the statement in paragraph A21, that the Board's other decisions on concentrations of credit risk such as the conclusions in Implementation Issue B36 would continue to represent credit risk. If a beneficial interest is exposed to credit risk of just some of the assets of the issuing entity, for example, the statement in paragraph 14B would seem to 'clear' the beneficial interest from having an embedded credit derivative, while application of Issue B36 may indicate the existence of an embedded credit derivative.

It would be helpful if the final statement would include an example of a beneficial interest that does not contain an embedded derivative, and an example of one that does. This would also serve to explain the Board's comment in paragraph A17, "... a senior interest with a market rate of return may require little further investigation, whereas a residual interest that absorbs risk disproportionate to other interests may require significant investigation." Residual interests typically absorb disproportionately higher risk; the statement seems to suggest that residual interests will require significant investigation.

As a final note on the Hybrids ED, we agree with the Board's conclusion that it is appropriate to permit a qualifying SPE to hold passive derivative instruments that pertain to a transferor's beneficial interest. This expansion of a QSPE's ability to hold derivatives is consistent with the Board's notion that a transferor's beneficial interest is a new financial asset and also consistent with the consistent treatment of beneficial interests regardless of whether the holder is the transferor.

#### Transfers ED

FAS 140 permitted qualifying SPEs to hold passive equity instruments. The Transfers ED proposes a blanket prohibition against QSPEs holding equity instruments. We are glad the Board has proposed to allow QSPEs to hold for a brief period equity instruments received in conducting otherwise permitted activities, such as collections, but do not agree with the prohibition against a QSPE holding passive equity instruments. Some equity instruments, such as non-voting equity, are passive by nature, and are no more passive than equity instruments that can be made passive, for example through an irrevocable waiving of voting rights, and therefore holding such instruments is consistent with the conceptual basis for providing the QSPE designation. The rationale given in paragraph A26 for expanding the prohibition does not support the proposal. The first reason provided for the prohibition is that transferors could effectively convert equity instruments such as limited partnership interests accounted for under the equity method to securities classified as available for sale, and record changes in value through Other comprehensive income. We believe that an investor can accomplish that change without involving an SPE and without transferring its interest. An investor in a limited partnership interest can irrevocably waive its rights without the involvement of an SPE, and would then determine that the equity method is no longer appropriate because that investor has virtually no influence. While it would likely be the case in this instance that the investor would apply the cost method to its LP interest (as opposed to FAS 115), we understood the Board's issue to be the conversion from the equity method and not necessarily the conversion to FAS 115. The other reason provided is that investors in an SPE that holds (passive) equity instruments sometimes require protection from most of the variability of those instruments, for example via a guarantee, derivative or substantial equity position held by the transferor. In those cases, such arrangements would likely cause true-sale problems for the transferor, such that the transferor would not derecognize the transferred equity instruments.

The Transfers ED proposes a new restriction for those qualifying SPEs that are permitted or required to roll over its beneficial interests. Such entities may not be QSPEs, if any holder of beneficial interests holds a combination of involvements with the SPE that provide the holder with an opportunity to obtain a "more than trivial" economic benefit. We understand the Board's rationale for this restriction, but recommend the following mechanism to resolve the Board's concern while continuing to enable most enterprises with a beneficial interest in an otherwise

qualifying SPE to enjoy the time-savings of the exception to consolidation of QSPEs. We propose the FASB amend the language in paragraph 46, as follows, and to make conforming changes to the language in FIN 46(R) paragraph 4.d.:

A qualifying SPE shall not be consolidated in the financial statements of a transferor or its affiliates. Any enterprise unless that enterprise either: (1) has the unilateral ability to cause the entity to liquidate or to change the entity so that it no longer meets the requirements in paragraph 35; or (2) has the opportunity to obtain a more-than-trivial incremental benefit by virtue of having more than one type of involvement with the entity. Any enterprise meeting the conditions in (1) or (2) must consider whether consolidation of the entity is required.

The Transfers ED establishes separate sale accounting criteria for 'participating interests'. We generally agree with the Board's conclusions in this area because the resulting accounting will better portray the economics; in particular, we agree that the transferor's retained participating interest does not represent a new asset and should continue with an allocated cost basis, with the same result regardless of whether the entire asset was first transferred to a QSPE. However, we question why equity instruments have been precluded from participating interest treatment. We understand the difficulty in applying participating interest treatment to a hybrid financial instrument, and we would expect that a participating interest in a derivative financial instrument would itself be a derivative. However, no clear explanation for the exclusion of equity instruments has been provided.

The Transfers ED proposes two new items (in paragraphs 9d and 9e) as 'conditions' in establishing whether a transferor has surrendered control over a transferred financial asset. We believe these two items are not new conditions in and of themselves, but rather application guidance for the isolation criteria in paragraph 9a. We agree with the concepts the Board is addressing in these items, but believe they do not merit consideration as separate criteria for determining whether a transferor has surrendered control. For example, the item discussed in paragraph 9d is a very narrow issue that is already more broadly discussed by the requirements in paragraph 55 – there is no reason to 'promote' this one specific application of paragraph 55 to its own condition. If the Board believes it is necessary, all of paragraph 55 could be moved to a new paragraph immediately before paragraph 10. We believe the guidance proposed in paragraph 9.e. would more appropriately be presented in a new paragraph, 27C.

Sincerely,



Dennis G. Sullivan  
Principal Accounting Officer